CHAPTER 1

INTRODUCTION

In the last forty years there have been a broad range of studies of the behavior of profitability and earnings. Earnings forecasting research, for one, has flourished since its use of analyst expectational data and its linkage to capital market research. Besides, increased information availability has also greatly aided earnings forecasting research.

The forecasting models have been generated from many approaches. Studies of the predictability of profitability and earnings have been mainly centered on time series studies and the testing of the validity of price/earnings relation. Renowned examples are Lev (1969) and Freeman, Ohlson and Penman (1982). The limitations of these studies include the problems of small sample testing and survivorship bias for time series analysis. However, the approaches that will be adopted in this paper go after the following concept.

The underlying assumption behind the concept of market efficiency in perfect capital markets is that owners of capital would divert their resources to industries that would generate a higher level of returns than their present investments. This assumption would result in equality of the rate of return on investments across industries as resources are allocated to more efficient uses. This implies that profitability and earnings are mean reverting – as more firms operate in the more productive industries, abnormal profits resulting from monopolistic advantages will diminish. Firms that do not meet their required rates of returns will look to move across to industries that are more productive.

Mean reverting has been applied to many models even the time-series one (Brook and Buckmaster (1976), Salamon and Smith (1977), and Beaver and Morse (1978)). Yet, the interesting result came from the time-series cross-sectional study of Fama and French (2000) which report that in a simple partial-adjustment model the estimated ratio of mean reversion in profitability is about 38 % per year in their US sample. Mean reversion in profitability implies the changes in profitability and their results also imply that earnings can be predicted by the mean reversion in profitability to some extent.

Nonetheless, in Thailand most studies about earnings and profitability were chiefly concentrated on the market efficiency, especially the effect of earnings announcement. Though there were some studies about predictability of stock returns but there are only fair amounts that specifically study the prediction of the earnings and the profitability. This study would therefore be more valuable as it attempts to academically and theoretically investigate the predictability of earnings and profitability, using the concept of mean reversion.

1.1 SIGNIFICANCE OF THE PROBLEM

Though many researchers try to model some proxies to forecast earnings and profitability, no models tested so far seem to be appropriate for Thailand Stock Market yet, this paper hence try to adjust the models and find the best fit for Thailand. At the start, this study draws on two approaches adopted by Fama and French (2000) and the time-series model. The model of Fama and French use the mean reversion of profitability to predict earnings while the naïve time-series model use only past earnings to predict future earnings.

1.2 OBJECTIVES

1. To investigate the predictability and mean reversion of profitability.
2. To examine whether the predictability and mean reversion of profitability can link to the predictability of earnings.
3. To test the predictability of time-series model.
4. To compare the predictive power of these different approach models.

1.3 SCOPE OF THE STUDY

1. The samples are the pool of cross-sectional data representing the companies listed on the Stock Exchange of Thailand (SET) and cover the period from 1992 through 2003
2. The yearly accounting data obtained from the ISIM database comprise of the total asset, the book value of equity, earning before interest and tax, the total sales, number of shares outstanding, and dividend yield. While the market data is the market value of stock.

1.4 BENEFITS OF THE STUDY

1. When trying to understand the behavior of earnings and profitability in Thailand, it can certainly be useful to many groups of people
   - To the company itself, this understanding can help the company to better manage their investment and capital structure.
   - To analysts, it will give them the first-hand perspective and information that could be helpful and also reduce the cost of forecasting.
   - To investors, an accurate forecast would reduce variability in securities' prices and help them in stock picking.
2. Given that there are lots of forecasting models, investigation whether there is an appropriate model to predict future earnings for Thai firms should be more useful for those who involve with the stock market.

1.5 ORGANIZATION OF THE STUDY

This research organizes into five sections. The first section is an introduction on the research and then will be the section of the literature review of related researches on profitability and earnings forecasting. The third section presents an empirical methodology of this study whereas the empirical results and an interpretation of the regression model are in section four. Finally, the last section is a conclusion of the research, also further suggests for future studies, and as a finished point, a summary of the references.