Canterbury Investment Advisors, LLC

Evidence Based Investing

Exploring The Profitability Factor

A June 2012 study authored by University of Rochester professor **Robert Novy-Marx,** “The Other Side of Value: The Gross Profitability Premium,” not only provided investors with new insights into the cross-section of stock returns but also led to the development of new factor models that incorporate a profitability factor.

Novy Marx's Findings

Before unpacking a more recent paper with new insights into how accruals and cash flows can impact profitability, I think it’s important to summarize some of Novy Marx's more fundamental findings on this premium:

- **Profitability, as measured by gross profits-to-assets, has roughly the same power as the book-to-market ratio (a value measure) in predicting the cross-section of average returns.**
- **Surprisingly, profitable firms generate significantly higher returns than unprofitable firms, despite having significantly higher valuation ratios (for instance, higher price-to-book ratios).**
- **Profitable firms tend to be growth firms—they expand comparatively quickly. Gross profitability is a powerful predictor of future growth as well as of earnings, free cash flow and payouts.**
- **The most profitable firms earn average returns 0.31 percent per month higher than the least profitable firms. The data is statistically significant, with a *t*-statistic of 2.49.**
- **The abnormal return (alpha) of the profitable-minus-unprofitable return spread relative to the Fama-French three-factor model is 0.52 percent**

- **Gross profitability has far more power in predicting the cross-section of returns than earnings.**
- **High asset turnover primarily drives the high average returns of profitable firms, while high gross margins are the distinguishing characteristic of "good growth" stocks.**
- **Controlling for profitability dramatically raises the performance of value strategies, especially among the largest, most liquid stocks. Controlling for book-to-market improves the performance of profitability strategies.**
- **While the more profitable growth firms tend to be larger than less profitable growth firms, the more profitable value firms tend to be smaller than less profitable value firms.**
- **Strategies based on gross profitability generate value like average excess returns, even though they are growth strategies.**
- **Because both gross profits-to-assets and book-to-market ratio are highly persistent, the turnover of the strategies is relatively low.**
- **Strategies built on profitability are growth strategies, and so they provide an excellent hedge for value strategies. Adding profitability on top of a value strategy reduces the strategy's overall volatility.**