Title: **WHAT DRIVES ANOMALY RETURNS?**

Speaker: **LARS A. LOCHSTOER**
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Importance: Why this matters:

It is important to understand if stock market anomalies are a result of changes in expected cash flows or from changes in discount rates. Based on a clean surplus model of asset values, this study concludes that security-level anomaly effects are driven mainly by changes in expected cash flows (fundamentals).

Investigation: "Speaker analyzed XXX data to address the questions yyy, zzz, etc."

The analysis was performed on cross-sectional financial data of individual companies using data from CRSP, Compustat, and Fama/French. From this they create annual long/short anomaly portfolios (decile 1 minus decile 10). The portfolios are dollar neutral, nearly market neutral, and levered to have market-like volatility.

Innovation: Are there new techniques of interest in the data or approach to the problem?

Using annual data, the authors directly estimate the impacts on stock prices from shocks to discount rates and expected cash flows using a vector autoregression (VAR). The model imposes a present-value relationship based on a clean surplus valuation model. The VAR provides estimates of the impacts of changes in discount rates and expected cash flows at horizons ranging from 1 to 20 years, for firm characteristics related to anomalies, such as value, profitability and investment.

The Book to Market and Profitability variables had the largest impact on expected returns. Book to Market and Relative Value had the largest impact on expected earnings.

Insights: 1-2-3, what are the three most important things the speaker offered?

1. Stock-level anomaly returns are driven largely by fundamentals, specifically changes in expectations of future cash flows. Changes in discount rates amplify cash flow variation.

2. Suggests fundamental analysis is likely to be a fruitful way to forecast anomaly returns. These are hard to time over short horizons

3. Index-level returns are primarily driven by change in discount rates. It will be easier to time the market than anomalies.

Audience rating: 3.53