MEASURING EXCESS RETURNS: A GUIDE TO THE DATA

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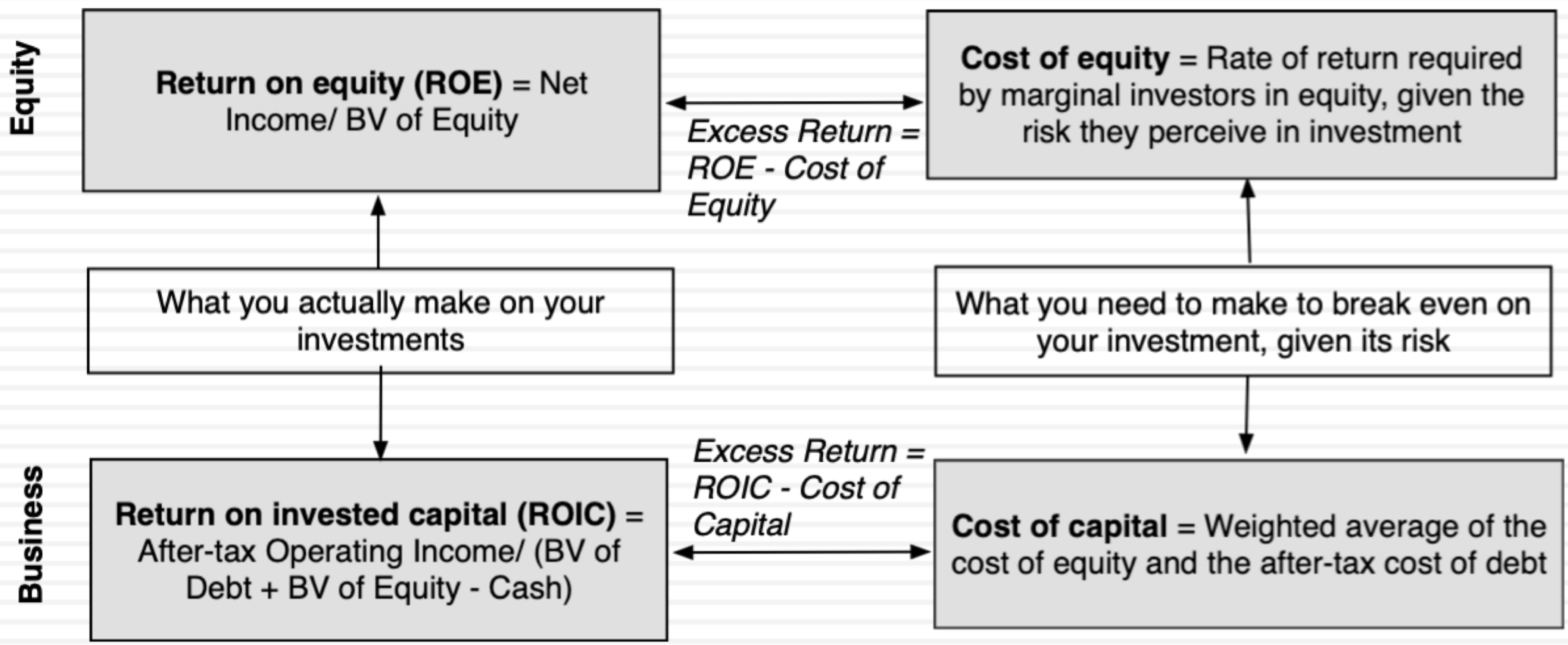
The Value Test

- As a business, making money is easier than creating value, since to create value, you have to not just make money, but more money than you could have if you had invested your capital elsewhere.
  - Profits: How much do you expect to generate as profits and cash flows from existing projects?
  - Invested Capital: How much capital is invested in existing assets/projects?
  - Opportunity Cost: Given the risk of the investment, what return do you need to make to break even?

In a perfect world, here is what you would do..

- For profits: You would use expected earnings and cash flows in future years to measure profits to both equity investors and the business.
- For invested capital: You would have an inflation-adjusted estimate of how much capital is invested in existing assets or equity.
- For hurdle rates: You would have costs of equity and capital that reflected
  - The mix of businesses that a firm operates in
  - The current debt to equity ratio for the firm, with all financial commitments treated as debt
  - The mix of countries that the firm does business in

Different Perspectives



Return on Equity

Return on Equity

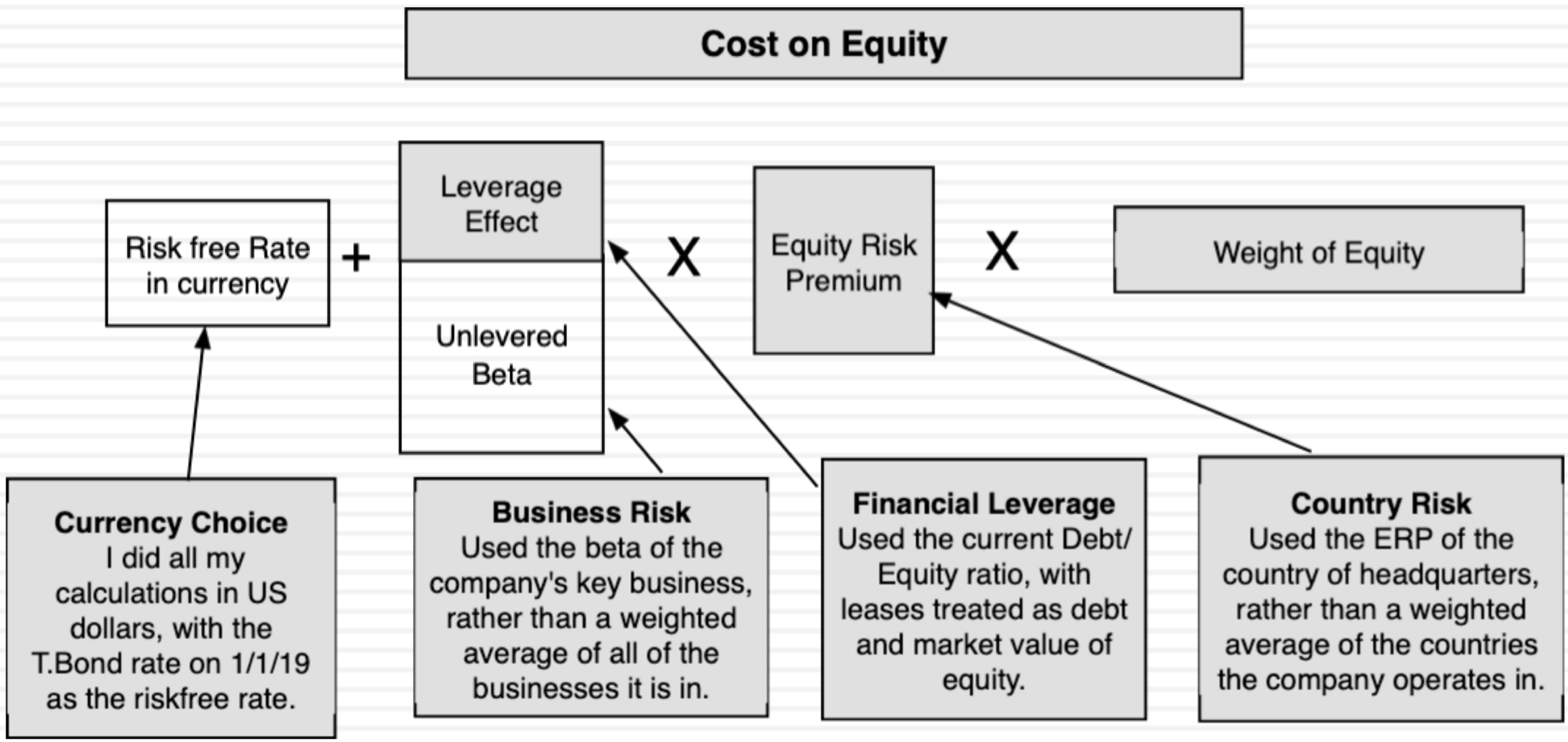
Net income in most recent twelve months.

Equity Income

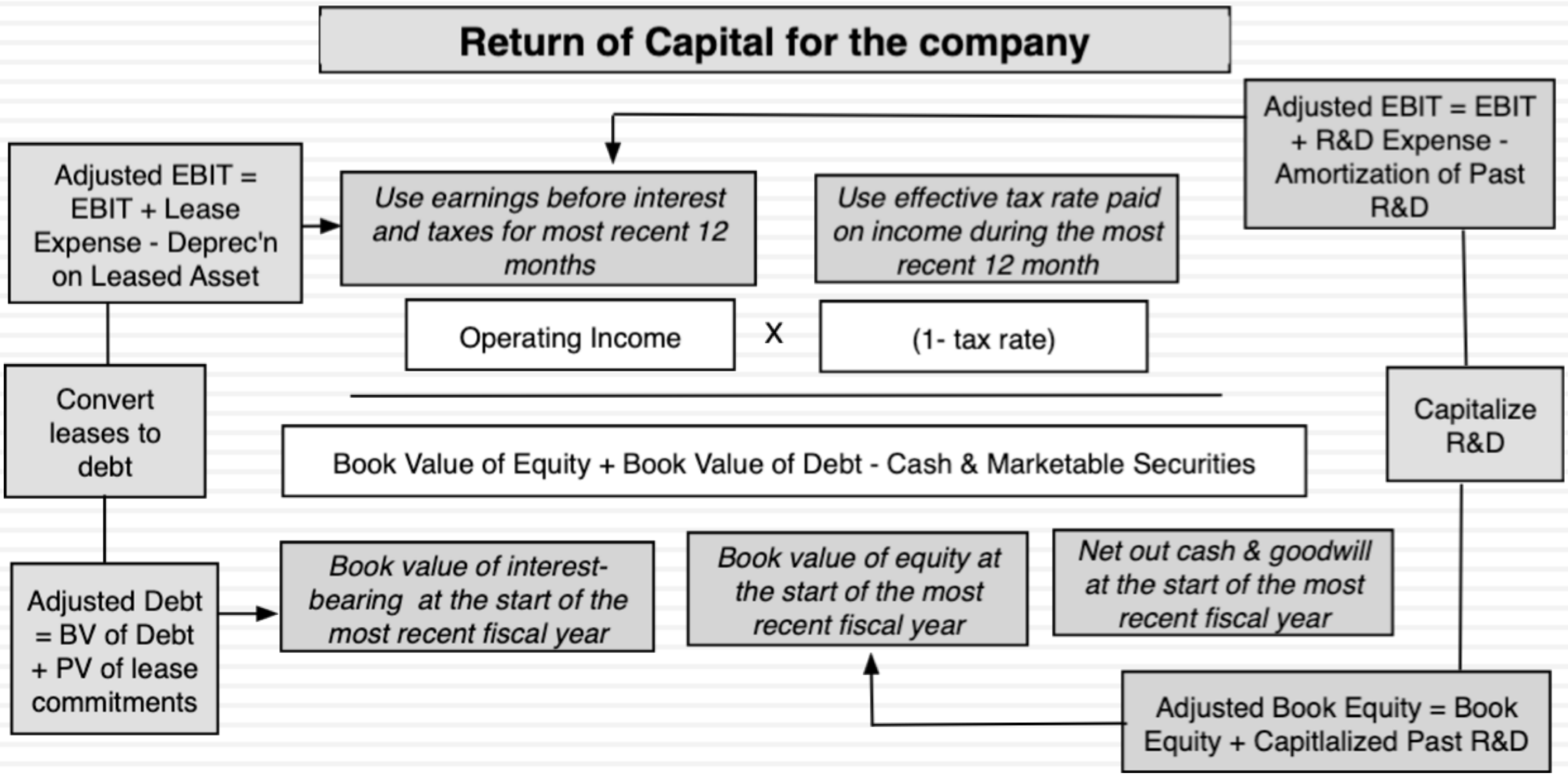
Equity Capital Invested

Book Value of Equity at the start of the fiscal year.

Cost of Equity



Measuring Excess Returns: Estimation Choices for Return on Capital



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