

Employing the Residual Income Model in Portfolio Optimization

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January 13, 2006

Abstract

In an empirical study for the German stock market we use consensus analysts' forecasts to derive estimates of implied expected returns using the Residual Income Model. In an out-of-sample study we analyze if the optimal combination of these estimates with time series estimates from realized returns results in an improved performance when implementing portfolio optimization compared to traditional approaches. The results show that an estimator that combines information of analysts' forecasts and time series data is superior to all other strategies. In most of the cases this superiority is even statistically significant. The results differ slightly with respect to different sub-periods and different market-segments. Our results demonstrate that the information contained in analysts' forecasts helps to reduce the severe negative consequences of estimation risk in portfolio optimization.

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