Return on Equity (ROE)

Return on equity (ROE) measures the rate of return on the money invested by common stock owners and retained by the company thanks to previous profitable years. It demonstrates a company's ability to generate profits from shareholders' equity (also known as net assets or assets minus liabilities).

ROE shows how well a company uses investment funds to generate growth. Return on equity is useful for comparing the profitability of companies within a sector or industry.

Investors generally are interested in company's that have high, increasing returns on equity.

Formula

Return on Equity = Net Income / Average Common Shareholder's Equity

Notes:

Average Common Shareholder's equity excludes preferred stock.

YCharts uses trailing 12 month net income and average of past five quarters of book value of shareholder's equity when calculating ROE. This differs from the common textbook formula ROE = Net Income / ((Beginning Shareholder's Equity + Ending Shareholder's Equity)/2).

Why we differ:

Economically, the theory is that you want to determine how much income the company is earning from each dollar of equity invested in the firm, and by using only the beginning and ending equity, the investor misses anything that may have happened in the middle of the fiscal year.

A quick example will show the limitations of the textbook method:

Imagine that a company has the following quarters of information (it's a stylized

Related Terms

Net Income

Return on Capital

Sustainable Growth Rate

example for illustration):

Q1:
Net income: $100
Equity at beginning of Q1: $1000

Q2:
Net income: $100
Equity at beginning of Q2: $2000 (unlikely, but the company could have issued new shares worth $1000 during the course of the quarter)

Q3:
Net Income: $100
Equity at the beginning of Q3: $2000

Q4:
Net Income: $100
Equity at the beginning of Q4: $2000
Equity at the end of Q4: $2000

If we calculate ROE based on the textbook method, ROE = $400/(($1000 + $2000)/2) = 26.67%, but this misses the fact that equity was $2000 for the majority of the year. This is because the textbook ROE assumes that the change in equity occurs exactly at the midpoint of the two reporting dates (that is the effect of an equal weighted average of beginning and ending values of equity in the denominator).

Calculating ROE based on our method, ROE = $400/(($1000 + $2000 + $2000 + $2000 + $2000)/5) = 22.22%. Our method recognizes that the change in equity occurred during the first quarter, and hence penalizes the company because it was working with a larger equity base throughout the majority of the year.