How to validate a return predictor

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This short essay summarizes research on return predictors using the manager sentiments developed by Jiang, Lee, Martin, and Zhou (2019) as an example. The data source is here. I build on the author's code on another paper on return predictability.

There are some steps to evaluate a new predictor of stock return. The first step is to execute in-sample tests, examing whether the coefficient is significant. The next step is to check the magnitude of the out-of-sample R square. The encompassing test will compare this predictor with existing predictors, showing whether this predictor has significant information superiority.

The interpretation has two dimensions. We want to know how much utility this predictability can bring to the investors. So Rapach, Ringgenberg, and Zhou (2016) measures the utility for a mean-variance investor by calculating the CES. The natural question about the source of return predictability. VAR decomposition can show whether the predictability is from cash flow or discount rate.

REFERENCES

Jiang, F., J. Lee, X. Martin, and G. Zhou (2019). Manager sentiment and stock returns. *Journal of Financial Economics 132*(1), 126–149.

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