Fundamental Analysis and Stock Returns in Stable Emerging Economies: Evidence From Saudi Arabia

This study extends the share price-accounting variables research to the stable but information inefficient market of Saudi Arabia. It investigates the relationship between annual stock returns and fundamental accounting variables for 51 non-financial companies and 11 banking sector companies trading on the Saudi Arabian Stock Exchange during the last decade of the twentieth century. Earlier studies on the relationship between accounting variables and stock price performance in the United States and other developed countries relied on the capital asset pricing model. However, other studies show significant relationships between stock returns and fundamental accounting variables. Use of fundamental accounting variables in explaining stock returns is particularly important in capital markets not advanced enough for the application of the capital asset pricing model.

The Saudi Arabian economy is largely oil dependent. However, agriculture is important for the maintenance of a national food production base; electricity provision is vital for around the clock electricity, especially during the worst times of the summer desert heat; a vibrant cement sector is essential for housing, other real estate and infrastructure development; the hospitality industry is paramount for pilgrims and tourists to Arabian attractions; a solid banking sector is needed to support the oil economy and to help finance economic diversification. Thus, a properly functioning capital market is necessary for raising capital to diversify the economy and to involve a larger pool of participants in the economy. Usefulness of the required accounting disclosures by firms trading on the Saudi Arabian Stock Exchange will help to legitimize their required provision and increase confidence in the operation of the stock market.

By using correlations between fundamental variables and returns and by regressing returns on fundamental variables as well as on factors identified from factor analysis, significant relationships between returns and some fundamental variables were found for some years but not repeatedly enough to replicate the results for fundamental variables in other emerging economies. Results on a year-by-year basis were improved by use of factor analysis, but the direction and significance of factors are not stable enough for generalizations to be made. These results highlight the fact that differences in underlying economies will lead to differences in the variables most relevant to investor profitability. Also, since most Saudi companies have very large family holdings, owners may have access to relevant information other than the formal disclosures required by the stock market regulators.