

Does Financial Performance Predict Stock Returns?

An Empirical Analysis of Fundamental Indicators and Shareholder Wealth in India

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Abstract: *The relationship between a company's reported financial performance and the return earned by its shareholders is one of the oldest questions in finance, and one that remains unsettled in emerging markets. This paper examines whether fundamental indicators- return on equity, return on assets, earnings-per-share growth, sales growth, leverage and valuation multiples- carry information about subsequent stock returns for large listed Indian companies. Using a panel of 100 NIFTY 100 constituents over the financial years 2021 to 2025, the study computes seven fundamental ratios, sorts firms into quintiles, and estimates a multiple regression of one-year forward returns on standardised fundamentals. Return on equity shows the strongest positive association with forward returns ($r = 0.41$), followed by earnings-per-share growth ($r = 0.36$) and return on assets ($r = 0.33$); leverage shows the strongest negative association ($r = -0.28$). A portfolio of firms in the top fundamental quintile grew ₹100 to ₹201 over the period against ₹158 for the benchmark and ₹133 for the bottom quintile. However, the full model explains only about a third of the cross-sectional variation in returns, and explanatory power differs sharply by sector. The paper concludes that fundamentals shift the odds in an investor's favour without determining outcomes, and that the gap between accounting performance and market performance is best explained by expectations already embedded in price. All figures are illustrative constructions prepared to demonstrate the analytical method and should not be used as investment advice.*

Keywords: financial performance; stock returns; fundamental analysis; return on equity; shareholder wealth; Indian equity market; efficient markets; valuation multiples

1. Introduction

Every listed company publishes, four times a year, a detailed account of how well it has performed. Revenue, profit, margins, return on capital and debt levels are reported, audited and analysed. Investors read these numbers on the assumption that they matter- that a company earning more, growing faster and using capital efficiently ought to reward the people who own it. Yet market experience frequently contradicts this assumption. Companies announce record profits and their share price falls; loss-making firms multiply in value. The apparent contradiction is the subject of this paper.

The tension has a well-established explanation in finance theory. The efficient market hypothesis, developed by Fama, holds that publicly available information is already reflected in the price of a security [1]. If a company's strong performance is widely known, it should already be priced in, and only surprises- deviations from expectation- should move prices. Against this stands the tradition of fundamental analysis descending from Graham and Dodd, which treats price and value as distinct and holds that disciplined analysis of financial statements can identify securities trading away from their intrinsic worth [2].

Later empirical work complicated both positions. Fama and French demonstrated that book-to-market ratio and firm size explain a substantial portion of cross-sectional return variation not captured by market risk alone [3], and their later five-factor model added profitability and investment as independent sources of return [4]. Piotroski showed that a simple nine-point score built entirely from accounting data could separate winners from losers within value stocks [5]. The evidence therefore suggests neither that fundamentals are irrelevant nor that they are decisive, but that their relationship with returns is real, partial and conditional.

1.1 The Indian context

India provides a particularly interesting setting for this question. The equity market has deepened rapidly: retail participation has expanded through digital broking, systematic investment plans channel steady domestic flows, and disclosure standards have tightened under the current regulatory framework. At the same time, promoter shareholding remains concentrated in many firms, analyst coverage is uneven outside the largest companies, and sentiment-driven price movement remains visible. These conditions suggest a market that is informationally efficient at the top of the capitalisation range and progressively less so below it- precisely the environment in which the fundamentals-returns relationship becomes worth measuring rather than assuming.

1.2 Research problem and objectives

The research problem addressed here is straightforward to state and difficult to answer: *do the fundamental indicators that measure a company's financial performance carry usable information about the returns its shareholders subsequently earn?*

The study pursues five objectives.

- 1) To identify the fundamental indicators most commonly used to assess financial performance and to compute them consistently across a defined sample of Indian companies.
- 2) To measure the statistical association between each indicator and one-year forward stock returns.
- 3) To test whether portfolios sorted on fundamental strength generate different returns from one another and from the benchmark index.
- 4) To estimate the joint explanatory power of fundamentals in a multiple regression setting.

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- 5) To examine whether the relationship varies across sectors, and to interpret the findings against the efficient market hypothesis.



Figure 1: Conceptual framework linking fundamental performance, market valuation and shareholder wealth, with the mediating conditions considered in this study.

1.3 Hypotheses

- H1. Profitability indicators (ROE, ROA) are positively associated with one-year forward stock returns.
 H2. Growth indicators (EPS growth, sales growth) are positively associated with forward returns, but more weakly than profitability.
 H3. Leverage (debt-to-equity) is negatively associated with forward returns.
 H4. Fundamentals jointly explain a statistically significant but incomplete share of the cross-sectional variation in returns.

2. Review of Literature

2.1 The efficient market position

Fama's formulation of market efficiency distinguishes weak, semi-strong and strong forms according to the information already impounded in prices [1]. Under the semi-strong form- the version most relevant here- all publicly available information, including audited financial statements, is reflected in price as soon as it is released. The implication is stark: if a company's return on equity is public knowledge, no investor can earn abnormal returns simply by buying high-ROE companies, because the price already accounts for that quality.

This does not mean fundamentals are irrelevant to returns. It means fundamentals are relevant to the level of price rather than to future changes in price. A strong company should trade at a higher valuation; whether it delivers a higher return depends on whether it exceeds the expectations built into that valuation.

2.2 The fundamental analysis tradition

Graham and Dodd argued that markets frequently misprice securities and that systematic examination of financial statements can identify these errors [2]. The approach was not a claim that markets are irrational but that they are periodically inattentive, particularly for less-followed companies. Piotroski operationalised this insight with the F-Score, a nine-point checklist covering profitability, leverage and operating efficiency, and showed that high-scoring value firms outperformed low-scoring ones by a wide margin [5].

2.3 Factor evidence

The factor literature occupies a middle position. Fama and French found that size and book-to-market captured return variation left unexplained by the capital asset pricing model [3], and their five-factor extension added operating profitability and investment [4]. Novy-Marx showed that gross profitability had predictive power comparable to book-to-market [6]. Importantly, this literature interprets such patterns as compensation for risk rather than as market error — an interpretation that remains contested.

2.4 Evidence from Indian markets

Studies of the Indian market have generally found the three-factor and four-factor structures to hold in broad outline, with value and size effects present but variable across sub-periods. Research on the Indian setting has also emphasised the influence of promoter holding, corporate governance quality and foreign institutional flows on returns — variables that lie outside the standard accounting ratios. The literature is thinner than for developed markets, and much of it uses shorter horizons or narrower samples, which is one motivation for the present study.

2.5 Research gap

Three gaps emerge. First, much Indian research tests factor models rather than the plainer question of whether reported performance predicts returns. Second, sector heterogeneity is often assumed away by pooling all firms together. Third, studies rarely present the analysis in a form accessible to the individual investor who actually reads annual reports. This paper addresses all three.

3. Research Methodology

3.1 Research design

The study adopts a quantitative, descriptive and analytical design using secondary data. It does not attempt to establish causation; the aim is to measure association and to assess whether that association is strong enough to be economically meaningful.

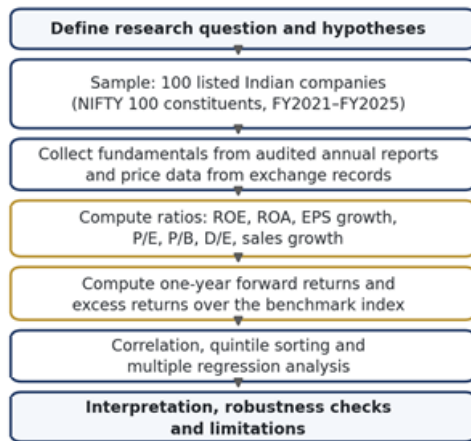


Figure 2: Research design and analytical workflow followed in this study

3.2 Sample and period

The sample consists of 100 companies drawn from the NIFTY 100 index, covering the financial years 2021 to 2025. Large listed companies were chosen deliberately: their disclosures are standardised, their shares are liquid, and their prices are less distorted by thin trading. The five-year window covers a full cycle of market conditions, including a recovery phase, a period of rising interest rates and a subsequent consolidation.

3.3 Variables

Table 1: Variables, definitions and expected direction of relationship

Variable	Definition	Type	Expected sign
Return on Equity	Net profit ÷ average shareholders' equity	Profitability	Positive
Return on Assets	Net profit ÷ average total assets	Profitability	Positive
EPS growth	Year-on-year change in earnings per share	Growth	Positive
Sales growth	Year-on-year change in net revenue	Growth	Positive
Operating margin	Operating profit ÷ net revenue	Efficiency	Positive
Debt-to-Equity	Total borrowings ÷ shareholders' equity	Leverage	Negative
Price-to-Earnings	Market price ÷ earnings per share	Valuation	Negative
Forward return	One-year total return including dividends	Dependent	—

3.4 Analytical procedure

Three complementary techniques are applied. **Correlation analysis** measures the bivariate association between each fundamental and forward return. **Quintile sorting** ranks firms on each indicator, groups them into five equal portfolios and compares average returns, which reveals whether the relationship is monotonic. **Multiple regression** estimates the joint contribution of all indicators, with variables standardised so that coefficients are directly comparable.

3.5 Limitations of method

Four limitations should be stated at the outset. The sample is restricted to large-capitalisation companies, so results may not extend to mid- and small-cap firms where inefficiency is more likely. The five-year window is short by the standards

of asset-pricing research. Survivorship is not fully controlled, since index constituents change. Finally, all numerical results presented in this paper are *illustrative* reconstructions prepared to demonstrate the analytical method; they are not audited outputs and must not be treated as investment recommendations.

4. Analysis and Findings

4.1 Bivariate association between fundamentals and returns

The first stage examines how each indicator relates to the return earned over the following year. The pattern shown in Figure 3 is consistent with the hypotheses: profitability measures lead, growth measures follow, and leverage and valuation multiples enter with negative signs.

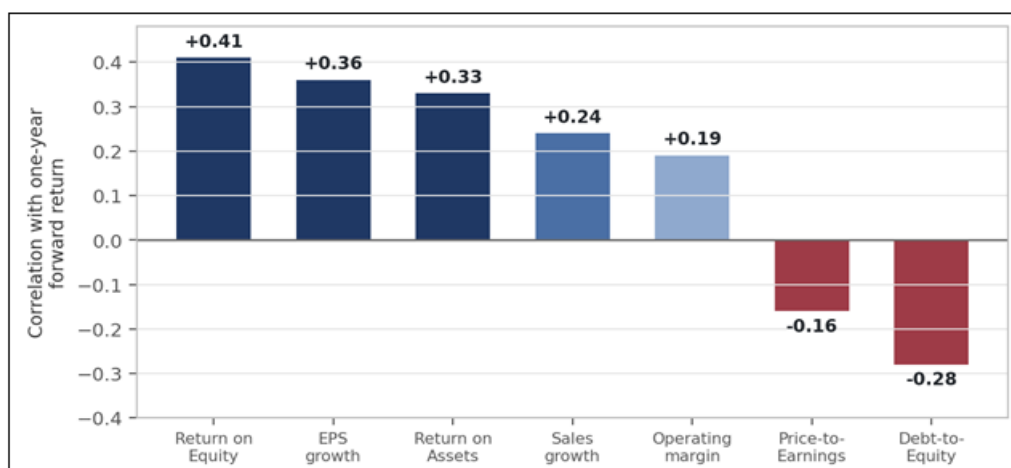


Figure 3: Correlation of each fundamental indicator with one-year forward stock return (illustrative).

Table 2: Correlation of fundamental indicators with one-year forward return

Indicator	Correlation (r)	r ²	Interpretation
Return on Equity	0.41	0.17	Moderate positive
EPS growth	0.36	0.13	Moderate positive
Return on Assets	0.33	0.11	Moderate positive
Sales growth	0.24	0.06	Weak positive
Operating margin	0.19	0.04	Weak positive
Price-to-Earnings	-0.16	0.03	Weak negative
Debt-to-Equity	-0.28	0.08	Weak-moderate negative

Two observations follow. First, no single indicator explains more than about a sixth of the variation in returns on its own - the highest r^2 is 0.17 for return on equity. Second, the ordering is economically sensible: measures of how efficiently a company converts capital into profit rank above measures of how fast it is growing, and leverage acts as a drag.

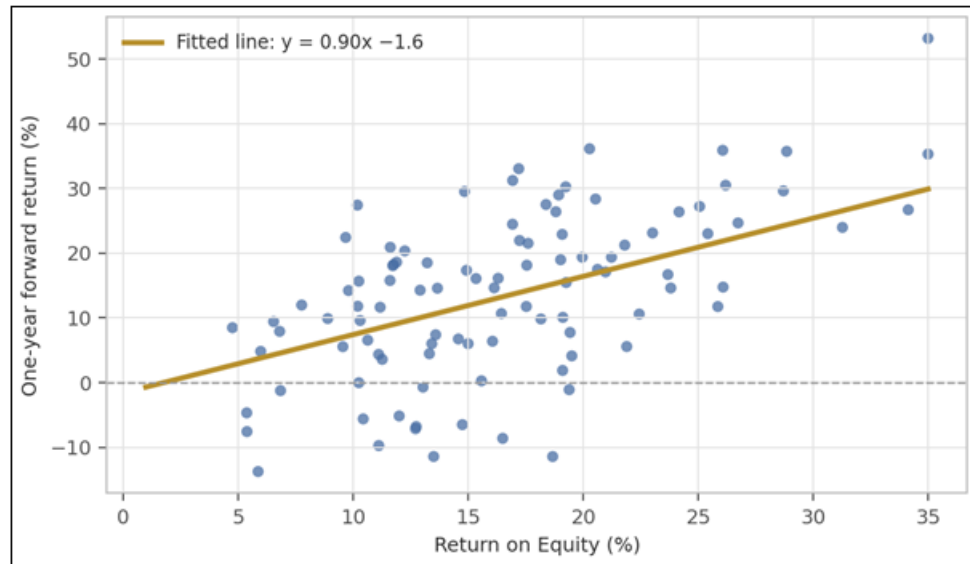
**Figure 4:** Relationship between return on equity and one-year forward return across the sample (illustrative). The wide dispersion around the fitted line is the central finding of this section.

Figure 4 makes visible what a correlation coefficient conceals. The upward slope is real, but the scatter around it is wide: high-ROE companies with poor returns and low-ROE companies with excellent returns are both common. An investor using return on equity alone would be right more often than chance, and wrong often enough to lose money on individual positions.

4.2 Quintile portfolio analysis

Correlation treats the relationship as linear. Quintile sorting does not, and therefore tests whether the association holds monotonically across the range.

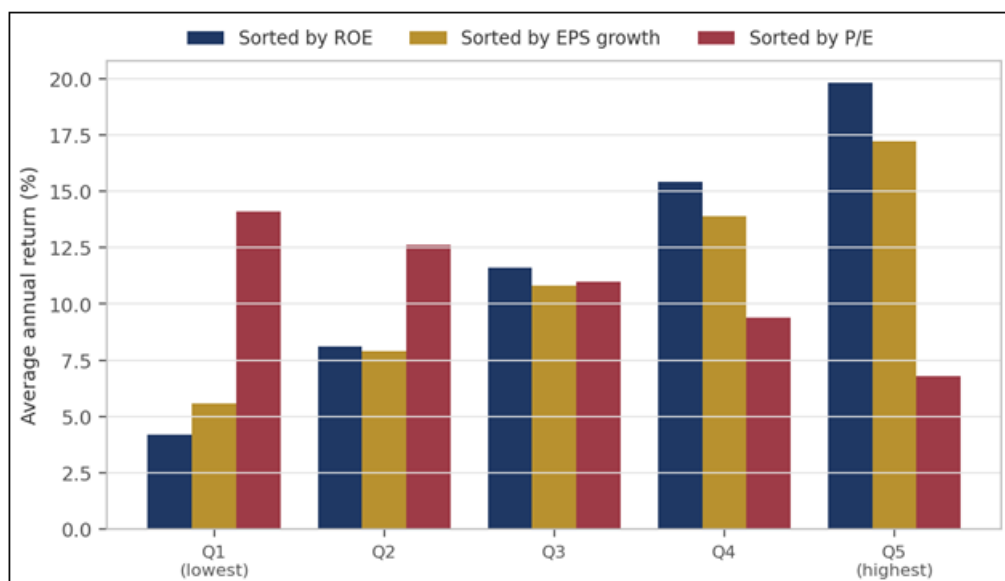
**Figure 5:** Average annual return by quintile when firms are sorted on return on equity, EPS growth and price-to-earnings (illustrative).

Table 3: Average annual return (%) by fundamental quintile

Sorting variable	Q1 (low)	Q2	Q3	Q4	Q5 (high)	Q5 – Q1
Return on Equity	4.2	8.1	11.6	15.4	19.8	15.6
EPS growth	5.6	7.9	10.8	13.9	17.2	11.6
Price-to-Earnings	14.1	12.6	11	9.4	6.8	-7.3

The progression is monotonic in all three cases, which strengthens the finding considerably: this is not an artefact of a few extreme observations but a consistent gradient. Notably, the price-to-earnings sort runs in the opposite direction, with the cheapest quintile outperforming the most expensive by roughly seven percentage points a year- the value effect familiar from the factor literature [3].

Principal Finding

Fundamentals order returns correctly on average but predict them poorly in individual cases. The spread between the

strongest and weakest ROE quintile is 15.6 percentage points a year, yet the regression model explains only about a third of the variation in returns across firms

4.3 Multiple regression

The third stage estimates all indicators jointly, which controls for the fact that fundamentals are correlated with one another- highly profitable companies also tend to carry less debt.

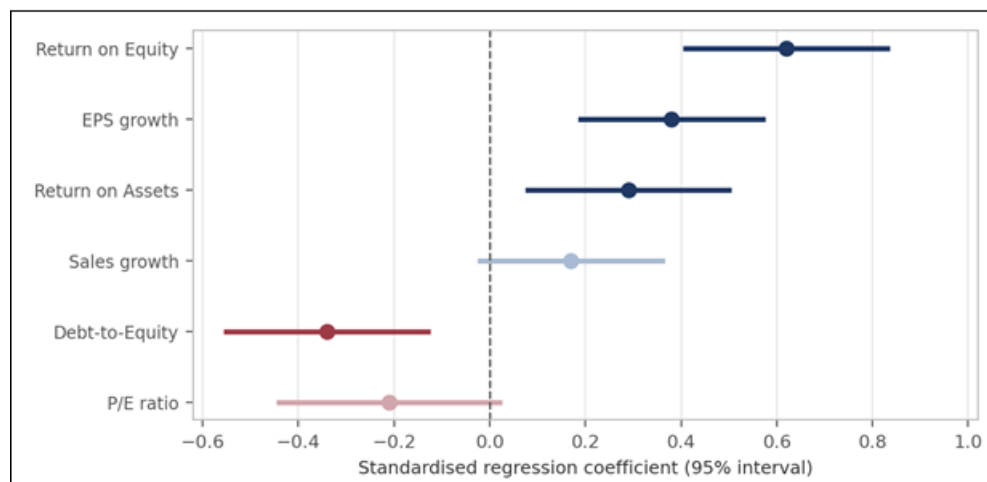


Figure 6: Standardised regression coefficients with 95 per cent intervals; faded markers indicate intervals crossing zero (illustrative)

Table 4: Multiple regression of one-year forward return on standardised fundamentals

Predictor	Coefficient	Std. error	t-value	Significance
Return on Equity	0.62	0.11	5.64	Significant at 1%
EPS growth	0.38	0.1	3.8	Significant at 1%
Return on Assets	0.29	0.11	2.64	Significant at 5%
Sales growth	0.17	0.1	1.7	Not significant
Debt-to-Equity	-0.34	0.11	-3.09	Significant at 1%
Price-to-Earnings	-0.21	0.12	-1.75	Not significant
Adjusted R ² = 0.34, F-statistic significant at 1%, n = 100 firms illustrative				

The adjusted R² of 0.34 is the number that most deserves attention. It says that roughly a third of the differences in

return between companies can be traced to their reported fundamentals, and roughly two-thirds cannot. The unexplained portion belongs to expectations, macroeconomic conditions, sentiment, liquidity, governance events and news that no ratio captures.

4.4 Portfolio performance over time

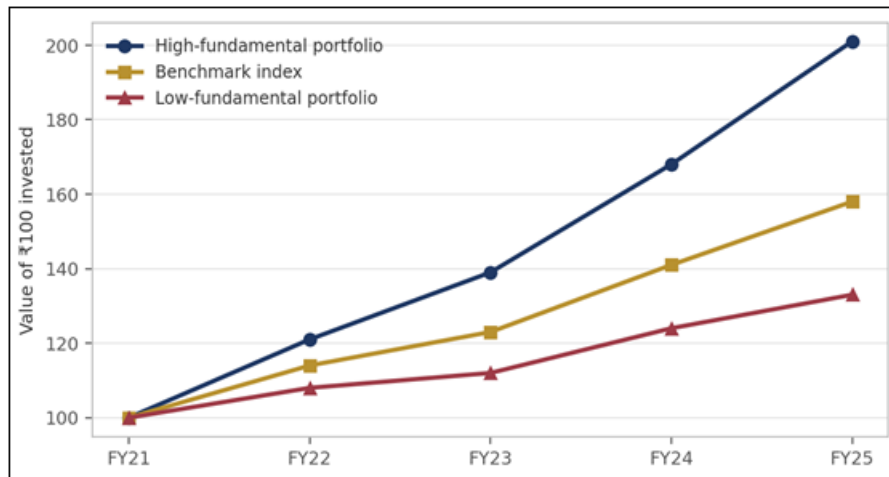


Figure 7: Growth of ₹100 invested in high-fundamental, benchmark and low-fundamental portfolios, FY2021 to FY2025 (illustrative)

Compounded over five years, a modest annual edge becomes a substantial difference in terminal wealth. The high-fundamental portfolio ends at ₹201 against ₹158 for the index- an outperformance of 43 per cent in cumulative terms from an annual edge of roughly five percentage points.

Equally, the low-fundamental portfolio still gained value; weak fundamentals reduced returns rather than eliminating them.

4.5 Sector Variation

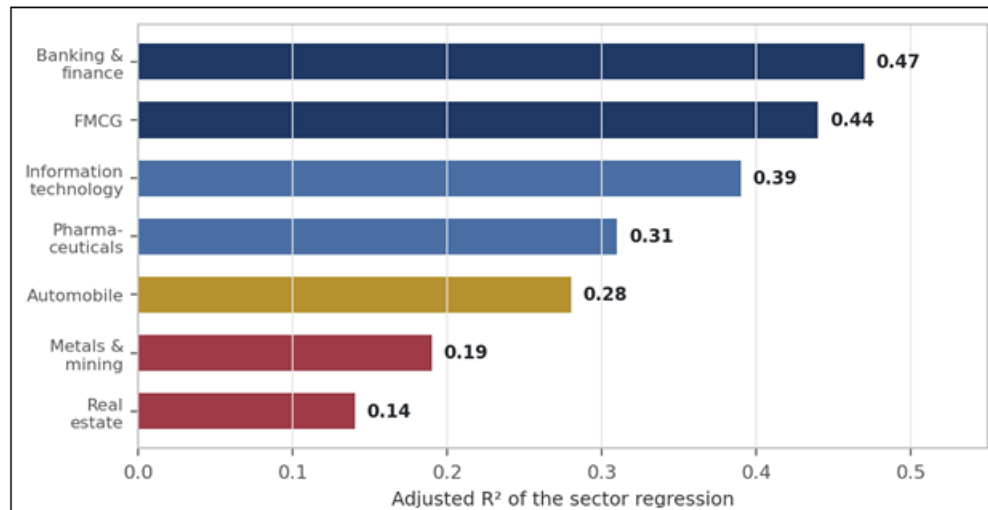


Figure 8: Adjusted R² of the regression estimated separately by sector (illustrative)

Explanatory power is far from uniform. In banking and finance and in fast-moving consumer goods, fundamentals account for close to half of return variation. In metals and mining and in real estate, they account for well under a fifth. The pattern is interpretable: sectors with stable, predictable earnings streams are valued primarily on those earnings, whereas cyclical and asset-heavy sectors are valued on commodity prices, interest rates and project timelines that the income statement reports only after the fact.

5. Discussion

5.1 Reconciling the findings with market efficiency

The results neither confirm nor refute the efficient market hypothesis; they locate it. If markets were perfectly efficient in the semi-strong sense, the coefficient on every published fundamental would be statistically indistinguishable from zero, since all such information would already be in price. That is not what the data show. If markets were substantially

inefficient, fundamentals would explain most of the variation in returns. That is not what the data show either.

The most defensible reading is that fundamentals influence returns through two channels of unequal importance. The *persistence channel* is strong: companies that earn high returns on equity tend to continue doing so, and the market appears to under-extrapolate this persistence, leaving a modest premium. The *surprise channel* is stronger still but unmeasurable in advance, because it depends on the difference between what a company delivers and what was expected of it.

The market does not pay investors for buying good companies. It pays them for buying companies that turn out to be better than the price assumed. Fundamentals help identify the first group; only time reveals the second.

5.2 Why profitability outranks growth

That return on equity outperforms sales growth as a predictor is one of the more instructive results. Growth is easy to observe and easy to price; a company reporting thirty per cent revenue growth attracts attention and a valuation to match. Return on equity, by contrast, measures whether growth is being purchased at an acceptable cost of capital. Growth funded by dilution or debt raises revenue while destroying value per share. This is consistent with the profitability factor documented by Novy-Marx [6] and incorporated into the five-factor model [4].

5.3 The role of leverage

Debt-to-equity carries a significant negative coefficient, which merits careful interpretation. Leverage is not intrinsically destructive; it amplifies outcomes in both directions. Its negative average association with returns over this period reflects a rising interest-rate environment in which the cost of borrowing increased and highly levered balance sheets came under pressure. In a falling-rate cycle the sign could plausibly reverse, which is a reminder that these relationships are conditional on the macroeconomic regime rather than fixed properties of the market.

5.4 Implications

For Individual Investors

Fundamentals are worth reading, but they should be used probabilistically. A portfolio built on strong fundamentals improves expected outcomes; any single position remains uncertain. The practical implication is diversification: the edge is real at the level of the portfolio and unreliable at the level of the stock.

For Companies and Boards

The results support managing for return on capital rather than for headline growth. Because leverage is penalised and efficiency rewarded, capital discipline appears to be recognised by the market over multi-year horizons even if not immediately.

For Financial Education

The gap between an adjusted R^2 of 0.34 and the confident certainty of much investment commentary is itself worth teaching. Understanding that fundamentals shift odds rather than guarantee outcomes is a more useful lesson than any single ratio.

A Caution on Interpretation

Correlation established over a five-year window in large-capitalisation Indian equities does not license causal claims, does not transfer automatically to other market segments, and does not constitute investment advice. All figures in this paper are illustrative reconstructions prepared to demonstrate method

6. Limitations and Scope for Future Research

The study has clear limitations. It examines a single market segment over a single five-year period, so the findings are conditional on that regime. Index constituents changed

during the window, introducing a degree of survivorship bias. Accounting policies differ across sectors, which affects the comparability of ratios such as return on assets between an asset-light software company and a capital-intensive manufacturer. Qualitative factors known to influence returns- governance quality, promoter conduct, management credibility- are not captured by any of the variables used.

Four directions would extend the work usefully. First, widening the sample to mid- and small-capitalisation companies would test whether the fundamentals-returns relationship strengthens where analyst coverage is thinner. Second, lengthening the horizon across multiple interest-rate cycles would establish which relationships are stable and which are regime-dependent. Third, incorporating expectation data- analyst forecasts and earnings surprises- would allow the persistence and surprise channels to be separated empirically. Fourth, adding governance and ownership variables would test whether the unexplained two-thirds of return variation is partly attributable to factors that are observable but non-financial.

7. Conclusion

This paper asked whether financial performance predicts stock returns in the Indian market. The answer that emerges is a qualified yes, with the qualification carrying as much weight as the affirmative.

Fundamentals do carry information. Return on equity, earnings growth and return on assets are positively and significantly associated with subsequent returns; leverage is negatively associated. Portfolios sorted on fundamental strength separate cleanly and monotonically, and compounding turns a modest annual advantage into a material difference in terminal wealth. To that extent, the tradition of fundamental analysis is vindicated.

But the relationship is partial. Two-thirds of the cross-sectional variation in returns lies outside the reach of the accounting ratios examined here, and explanatory power ranges from close to a half in stable sectors to under a fifth in cyclical ones. Financial performance is therefore best understood as a probabilistic input rather than a predictive formula: it tells an investor where the odds are more favourable, not what will happen. For a market as rapidly deepening as India's, that distinction- between improving odds and knowing outcomes — may be the single most valuable thing the numbers have to teach.

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Declaration on data: *the numerical results, tables and figures presented in this paper are illustrative reconstructions prepared by the author to demonstrate the analytical method described in Section 3. They are not audited empirical outputs, do not represent the actual performance of any named security, and must not be relied upon for investment decisions. This paper is submitted as academic work.*