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Wall Street stock analysts are designated the difficult task of forecasting corporate earnings per share down to the penny months and even years in advance. Many investors use these forecasts to help formulate expectations for earnings and cash flows, which in turn drive stock valuation models. In today's short-term focused markets, it's not uncommon for a stock to rise or fall by material amounts based on how it performs relative to quarterly expectations among analysts. During the following discussion, rather than debate the utility or importance of stock analysts' short-term earnings forecasts in valuing a company, we highlight the inherent biases and unreliability of these figures, how we account for them in our approach to valuation, and the importance of independent investment analysis.

Noisy Numbers: Conflicts of Interest in Wall Street Research

Amidst the stock market craze of the late 1990s, many stock analysts began splitting time between the conflicting roles of stock promoters and client-focused research providers. Employers placed greater emphasis on analysts' ability to generate investment banking business through positive research opinions rather than what truly mattered--forecasting accuracy. Professors Harrison Hong and Jeffrey Kubik attempted to measure the impact forecasting accuracy had on the advancement of analysts' careers by analyzing a large database of both brokerage house employment and earnings forecast histories between 1983 and 2000. After controlling for the accuracy of earnings forecasts, they found that analysts who published optimistic forecasts were more likely to be rewarded in the form of career advancement.¹ Hong and Kubik stated: "Analysts who issue a large fraction of optimistic forecasts on the stocks that they follow are 38% less likely to move down the brokerage house hierarchy and 90% more likely to move up the hierarchy."² While disturbing, this is not surprising considering trading commissions and investment banking fees serve as core revenue sources at brokerage houses. Not only do bullish stock reports promote increased transactions and ensuing trading fees, but they also help maintain cushy relationships with corporate managers that can lead to lucrative investment banking deals.

Hong and Kubik found that analysts experienced more pressure to produce optimistic research opinions when an underwriting relationship existed. The findings also suggested that forecasting accuracy was less important to an analyst's career advancement in the period from 1996 to 2000 than from 1986 to 1995.³ Anecdotally, there are numerous stories of highly regarded analysts being fired or demoted because their research opinions were too pessimistic. In 2001, *60 Minutes II* featured the story of Tom Brown, a former top-ranked bank analyst at Donaldson, Lufkin, & Jenrette or DLJ (now part of Credit Suisse) who claimed he was fired for criticizing one of the bank's clients through his research opinions. Although DLJ denied Brown's claims, this is just one of numerous examples where it appears stock analysts were fired for expressing negative views that failed to promote investment banking relationships.⁴

Building the "Chinese Wall": Attempts to Eliminate Analysts' Conflicts of Interest

On October 23, 2000, the U.S. Securities and Exchange Commission (SEC) took action against the conflicts of interest surrounding stock analysts through a set of rules known as Regulation Federal Disclosure (FD). The rules were designed to eliminate selective disclosure of material nonpublic information by corporations, in turn reducing the incentive for analysts to provide unjust positive research opinions and inflate earnings forecasts to remain in good standing with management. Prior to the regulation it wasn't uncommon for companies to disclose new information at private meetings or on conference calls with select analysts and institutional investors.

¹ Harrison Hong and Jeffrey D. Kubik, "Analyzing the Analysts: Career Concerns and Biased Earnings Forecasts," *The Journal of Finance* 58, no. 1 (2003): 313-351.

² Ibid.

³ Ibid.

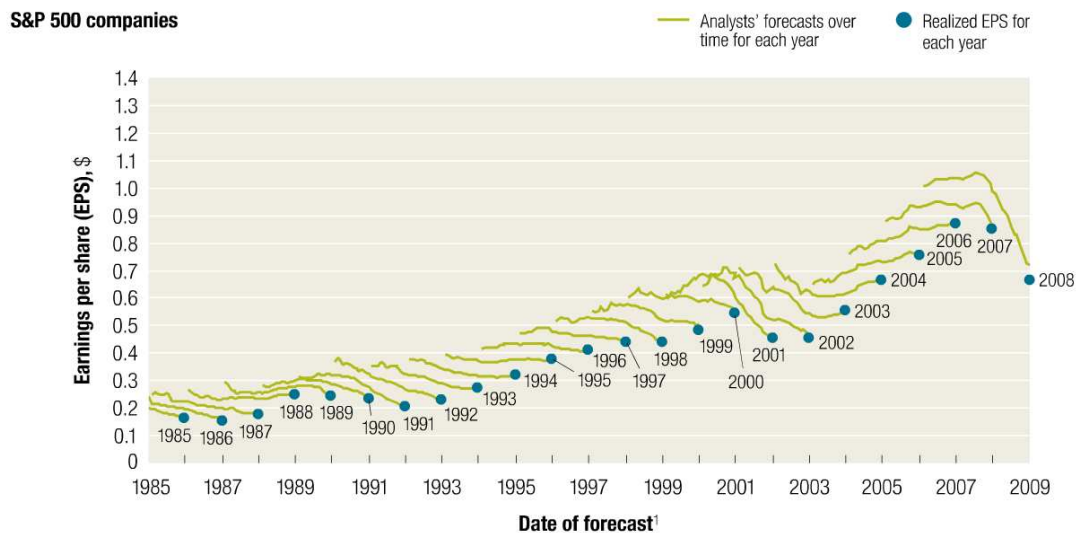
⁴ Tom Brown, interview by Scott Pelley, *60 Minutes II*, CBS News, January 30, 2001.

Regulation FD was followed by the Sarbanes-Oxley Act of 2002, which among other things attempted to eliminate the conflicts of interest between stock analysts and the investment banking and brokerage businesses. Stock analysts now had to disclose all conflicts of interest to investors, were not allowed to own stock in the companies they covered, and could not receive compensation tied to investment banking and brokerage services. On December 20, 2002, as part of the Global Analyst Research Settlement (GARS), a host of major financial institutions had to pay fines totaling \$1.435 billion for allowing excessive conflicts of interest to prosper between research and investment banking departments. GARS also attempted to prevent future conflicts of interest by physically separating the research and banking departments.

Professors Armen Hovakimian and Ekkachai Saenyasiri tried to quantify the effects of the new regulations on analysts' forecasts by studying trends in the accuracy of their earnings forecast during the period from 1996 to 2006.⁵ To analyze the accuracy of the forecasts, they calculated the monthly forecast bias for twenty-six monthly periods leading up to the fiscal year-end. Hovakimian and Saenyasiri defined forecast bias as: "the difference between the mean of all forecasts made in a particular month for a particular company and a particular fiscal year and the realized EPS, scaled by the stock price and multiplied by 100."⁶ The results demonstrated a walk-down trend where the forecast bias declined as the fiscal year-end approached. In other words, analysts tended to start with optimistic forecasts before revising them downward over the forecast horizon once more information was disclosed and uncertainty declined. For example, in 1999, the forecast bias twenty-four months before the fiscal year-end stood at 1.6, falling to 0.4 thirteen months prior, and 0.0 two months ahead of the fiscal year-end. Hovakimian and Saenyasiri found that Regulation FD made analysts less dependent on insider information, and reduced their need to favor management through inflated earnings forecasts as a result. What's more, they stated that the mean forecast bias declined significantly upon the implementation of the Global Analyst Research Settlement in late 2002. While the regulations removed some of the conflicts of interest among analysts, inherent biases remain, witnessed through the continued presence of a walk-down trend.⁷

In a *McKinsey Quarterly* article, McKinsey consultants Goedhart, Raj, and Saxena analyzed the accuracy of analysts' forecast since the previously mentioned regulations were implemented in the early 2000s. They found that on average, analysts were too optimistic, slow to incorporate changes in the economic environment, and more likely to make forecasting errors during periods of economic contraction. Exhibit 1 demonstrates the walk-down trend that plagues many analysts' earnings forecasts. It is easy to see the initial optimism in analysts' forecasts, followed by a gradual reduction leading up to the fiscal year-end. In few instances do the actual earnings per share exceed analysts' forecasts. That said, during recessionary periods such as 2001 and 2008, the walk-down trend is most severe, demonstrating the authors' view that analysts are slow to account for economic changes.⁸

Exhibit 1: Off the mark



¹Monthly forecasts.

Source: Thomson Reuters I/B/E/S Global Aggregates; McKinsey analysis

⁵ Armen Hovakimian and Ekkachai Saenyasiri, "Conflicts of Interest and Analyst Behavior: Evidence from Recent Changes in Regulation." *Financial Analysts Journal* 66, No. 4 (2010): 96-98.

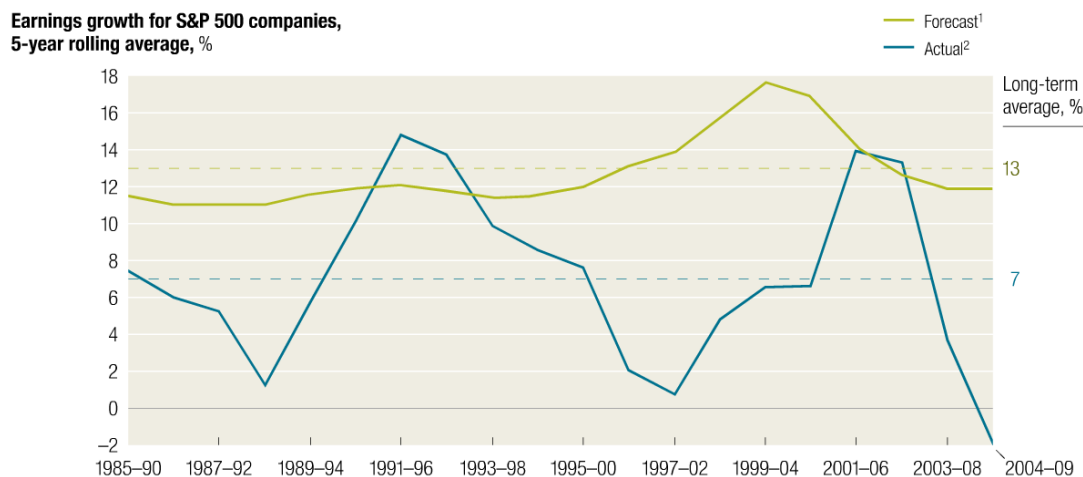
⁶ *Ibid.*, 101.

⁷ *Ibid.*, 103-105.

⁸ Marc Goedhart, Rishi Raj, and Abhishek Saxena, "Equity analysts: Still too bullish," *mckinseyquarterly.com*, April 2010.

Exhibit 2 highlights how seldom actual earnings growth exceeds analysts' expectations. Goedhart, Raj, and Saxena state, "analysts have been persistently overoptimistic for the past 25 years, with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth of 6 percent." It is worth noting that the 10 to 12 percent growth range excludes growth estimates for the period from 1998 to 2001 because the authors believed the growth outlook became excessively optimistic. Regardless, the graph shows that actual earnings growth only exceeded forecasted growth in two periods during the 25-year time horizon, which both coincided with economic recoveries following a recession.⁹

Exhibit 2: Overoptimistic



¹Analysts' 5-year forecasts for long-term consensus earnings-per-share (EPS) growth rate. Our conclusions are same for growth based on year-over-year earnings estimates for 3 years.

²Actual compound annual growth rate (CAGR) of EPS; 2009 data are not yet available, figures represent consensus estimate as of Nov 2009.

Source: Thomson Reuters I/B/E/S Global Aggregates; McKinsey analysis

Slipping Through the Cracks: Inherent Biases are Here to Stay

Although a number of solutions have been enacted to help solve the problem of analyst independence, it's not likely biased forecasts will disappear. David Swensen, chief investment officer at Yale University, wrote: "Wall Street research suffers from a number of significant problems: it comes from conflicted sources, tends to represent consensus positions, and enjoys wide distributions." Swensen also went on to say: "Analyst earnings estimates tend to hug the consensus. Going out on a limb, while occasionally rewarding, places the analyst's reputation at risk."¹⁰ The focus of this paper thus far has dealt with the optimism associated with analysts' estimates and research opinions, but in many cases management works to lower short-term consensus estimates to levels the company can easily exceed (i.e. managing expectations).

Quarterly earnings results have little impact on a company's long-term value, but can influence stock prices over the near-term. By controlling for an estimate of a firm's fundamental value, professors Ron Kasznik and Maureen McNichols demonstrated that companies that consistently meet or beat consensus expectations garner a valuation premium that grows over time.¹¹ Considering many executives receive a large portion of their compensation in the form of stock options or restricted units, it is not surprising that some try to manage short-term earnings expectations to boost their company's stock price.

During my time as a stock analyst at a previous employer, I quickly came to grips with the concept of earnings management. There was an instance where my earnings per share forecast stood as the high estimate among the figures included in the consensus forecast. Although the estimate was less than 15% above the top end of management's guidance, the company felt it noteworthy enough to contact me to discuss my justification for having such a bullish forecast. It may seem counterintuitive for a company to criticize an analyst for being too optimistic about their earnings potential, but when the company is working to manage short-term earnings expectations to beatable levels, it's a harsh reality. This experience also demonstrates the pressure analysts face when deviating from consensus expectations, in turn impeding their ability to think independently.

⁹ Ibid.

¹⁰ David F. Swensen, *Pioneering Portfolio Management* (New York: The Free Press, 2000). 199.

¹¹ Ron Kasznik and Maureen F. McNichols, "Does Meeting Expectations Matter? Evidence from Analyst Forecast Revisions and Share Prices," *Journal of Accounting Research* 40, No. 3 (2002): 727-759.

Turning Face Value into Fair Value (or True Value)

At AMI, we view stock analysts' earnings forecasts and brokerage research as a whole with a high degree of skepticism and only use it as a secondary resource. When researching a company, we begin our analysis by rigorously digging through the company's financial statements and other publicly disclosed documents. Next, we work to gain a better understanding of the company's operations and strategy by reading past news articles and talking with industry contacts, competitors, and management. Once we have formulated our own opinion of the company, we estimate what we think the company is worth using a variety of valuation methods. Only after we've developed our own thesis do we reference brokerage research. We believe this independence allows us to avoid the group thinking that frequently plagues many investors and can result in poor investment decisions.

Conclusion

In no way should one discount how difficult it is to forecast long-term or even short-term earnings, rather through this discussion we've highlighted some of the biases inherent in Wall Street's forecasts. As long-term investors we place little emphasis on short-term earnings expectations given the volatility, aforementioned biases, and herd mentality associated with the figures. That said, it's important for investors to account for analysts' forecasting biases when valuing companies, otherwise they can fall victim to inflated earnings expectations that drive stock prices above their intrinsic value. Investors also must recognize the importance of thinking independently to avoid the biases in Wall Street research that extend beyond the realm of earnings estimates.

Only after we've developed our own thesis do we reference brokerage research. We believe this independence allows us to avoid the group thinking that frequently plagues many investors and can result in poor investment decisions.