

Do Analysts Add Value?

Terms such as “adding value” generally make your gum-line creep back half an inch or so just out of the sheer possibility a management consultant might be on the prowl. Your body’s immune system wants to fire up the buzzword generator and unleash a barrage of “managed bi-directional parallelisms” or “cross-group methodical emulations” in response.

But this a remarkably serious problem in investing, one that has become more acute with the proliferation of indexed products designed to scratch every itch your portfolio might have. Let’s take a simple case in point, one related to the problem posed in this space in March (see, “Integrated Oil Companies And Crude Oil Prices”): You play a commodity-linked sector of the stock market as a proxy for the commodity itself. The sector rises 20%, but the overall market rose more than 20%. You clearly failed to outperform the market, regardless of whatever that commodity did, and no one should pay you a dime for failing to beat your benchmark.

Throw a rock at any conference of investment professionals and you will hit someone talking about “alpha,” the systemic addition of returns to a portfolio. As an aside, this is an excellent use for a rock. The pros never like to put any outperformance in terms of “beta,” or incremental risk relative to a benchmark. The entire investment management industry likes to perpetrate the illusion something can be garnered for nothing, that somewhere there is a magic manager with a magic portfolio capable of giving you risk-adjusted outperformance over time. These people, trading strategies and portfolios exist; it is up to you, dear investor, to find them.

Does Better Information Matter?

How should these managers perform? Secondly, how should you as an individual investor behave if you wish to manage your own investments by selecting individual issues? At the intersection of the answers to these questions lies the presumption better forecasts of fundamental information such as earnings should matter and matter a great deal. Who, after all, would decline a crystal ball if presented therewith?

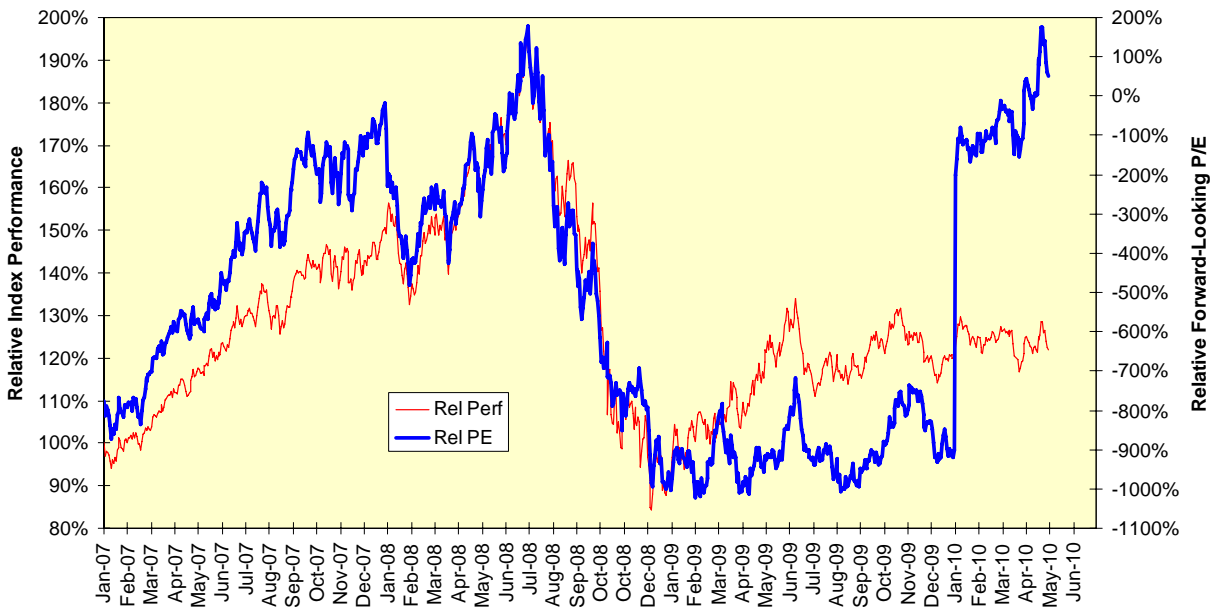
The answer here is a bit astonishing. On a top-down basis relative stock performance and analyst expectations are coincident to each other across sectors. In addition, even if you knew top-down realized earnings two quarters ahead, you would be hard-pressed to arrive at a solid forecast of where equity prices should be. Markets are efficient enough to capitalize changed expectations in the price so quickly the forecasters who generated them are trumped.

A credible forecast is inherently self-defeating. The key word here is “credible.” A widely followed forecaster, one of the many self-proclaimed gurus in this business, might issue a forecast for, say, higher interest rates six months from now. Rational lenders who hear this should postpone their lending; rational borrowers should accelerate their borrowing and lock in today’s lower rates. The intersection of these actions pulls the six month-ahead forecast into the present and defeats the original forecast entirely. Oddly enough, a non-credible forecaster, one whose utterances were ignored by all, would not trigger this self-defeating response and thus would stand a greater likelihood of being correct...and of becoming the next guru destined to fail.

Analyst Value-Added

We can illustrate the phenomenon of analyst expectations in one sector, oil services. The historical forward-looking P/E ratio for the Philadelphia Oil Service Sector index (OSX) can be compared to that of the S&P Supercomposite index. This can then be mapped in Chart 1 against the OSX’s relative total return. Analysts’ collective expectations are at best a coincident indicator of relative total return.

**Chart 1: Index-Level Forward-Looking P/E's Had Been Coincident To Stock Performance
Oil Service Vs. S&P 1500**



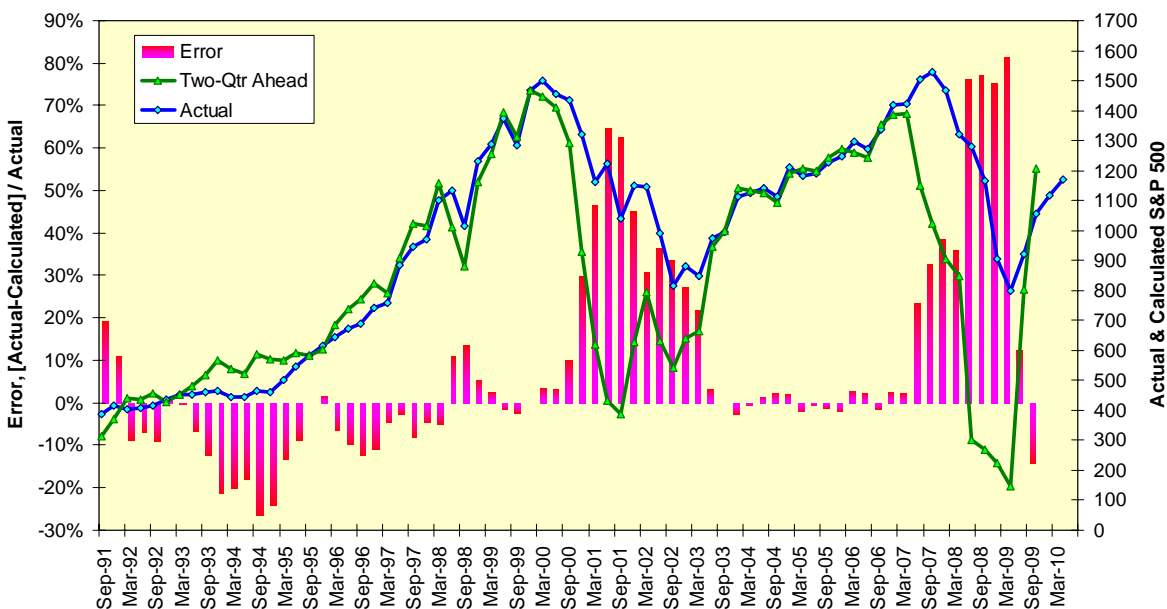
Moreover, the analysts were slow to raise their relative forward-looking P/E numbers after the March 2009 market low. Even worse, they raised them quickly once the sector took off, and cut them between June and August 2009 after relative performance faded. Worse, look at the huge series break at the start of 2010 as forward-looking estimates for the broad market jumped relative to those for the OSX. This is the sort of chasing-one's-tail behavior most of us are quite capable of without professional assistance.

Using Perfect Forecasts

Now let's ask the seemingly self-answering question whether perfect foresight would be an advantage. While there are many different definitions of earnings, we will use earnings per share before extraordinary items.

Let's assume you knew what these earnings would be for the S&P 500 two quarters hence. If we multiply this perfect forecast by the contemporaneous forward-looking P/E ratio for the S&P 500, a very distinct pattern emerges in Chart 2. Note the pattern of the forecast errors in the red columns; the actual S&P 500 stays much higher than the P/E estimate multiplied by future realized earnings during bear markets. Had the P/E multiple of 20.24 at the end of the third quarter of 2009 been applied to the actual earnings of \$59.66 per share, the S&P 500 would have been at 1207.52 at the end of March 2010 instead of 1169.43.

Chart 2: Current Top-Down Forward-Looking P/E And Two Quarter-Ahead EPS



As you usually learn more from your mistakes than from your successes, let's take a look at the forecast errors. They were negative for much of the early and mid-1990s; in a gently rising bull market, top-down forward-looking P/E multiples tend to be too low. Restated, earnings grow faster than expected in such an environment. And, of course, the forecast errors are massively high during bear markets as earnings collapse.

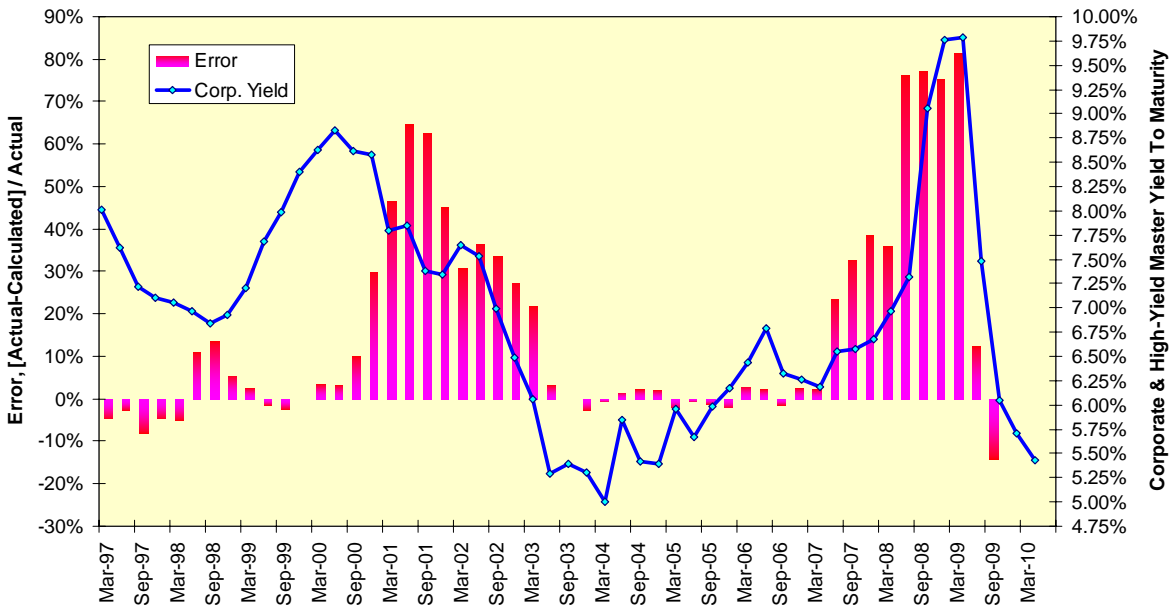
When do the errors oscillate around zero? Take a look at the bubble markets of 1998-1999 and 2003-2007. Even though we classify our collective behavior as irrational during bubbles, the P/E estimates tend to be more in line with future realized earnings than during other market conditions. It may seem quite odd, but analysts do a better job of forecasting earnings during the allegedly irrational bubble periods than during any other market conditions.

The Yield Factor

Is there any market-derived factor behind this bias (would this question be posed if the answer was, "No")? As the theoretic value of a stock is the discounted stream of future dividends, we should look to the discount factor, the cost of capital for corporate bonds. This, more than anything else, explains why even perfect two quarter-ahead earnings forecasts will not get you to the price of the stock index.

We can map the corporate bond rate as measured by the Merrill Lynch Corporate & High-Yield Master index against the forecast error in Chart 3. These yields fall for a while before future earnings decline. The lower discount rate increases the present value of a dollar of earnings and allows P/E multiples to expand.

Chart 3: The Role Of Corporate Bond Yields In Analysts' Misses



Therefore, while it may be possible for analysts to forecast earnings correctly, as an entity their most accurate estimates occur not during quiet bull markets wherein they are pessimistic or bear markets wherein they are wildly optimistic, but rather in bubbles. Then if they get the earnings forecast right, they would have to get the future changes in the cost of capital right to derive the proper risk multiple for earnings. As the corporate bond rate swings about on many factors, including credit quality, monetary policy and the shape of the yield curve, the analysts face an impossible task.

Should we condemn them as a group for not forecasting a dynamic system with multiple feedback loops correctly? No, not at all. The problem is not their inability to do the impossible; the problem is our persistence in asking them to do the impossible. As long as forecasters are paid by inquirers who should know better but do not, they will continue doing their best and adding little value in the process. This is some business.