When Perfect Isn't Good Enough

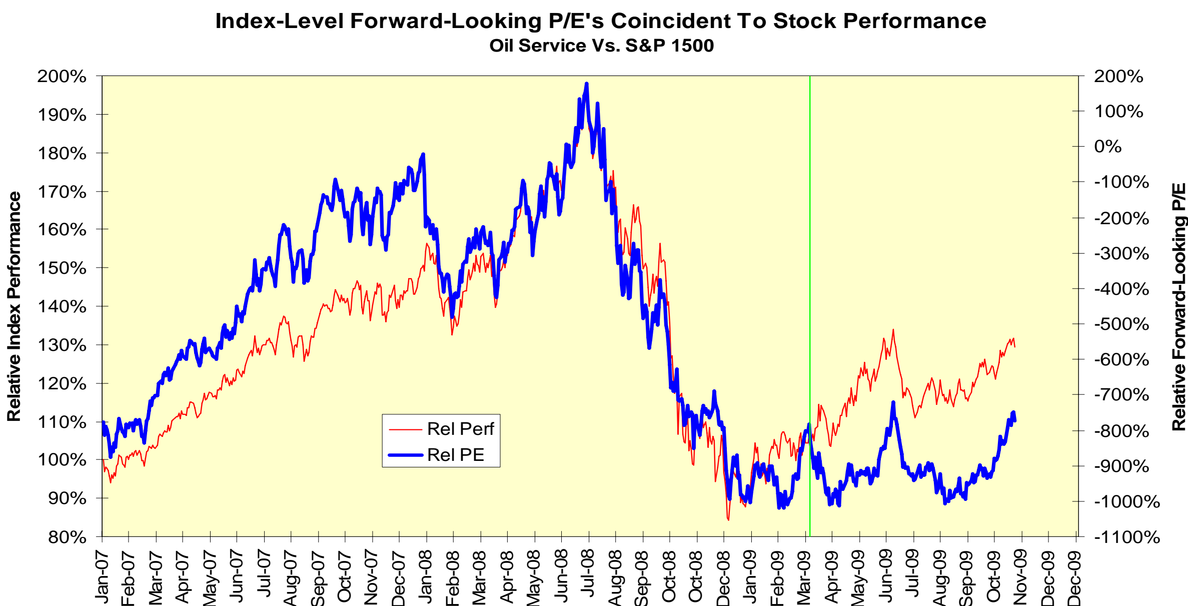
I mentioned two points in passing last Thursday regarding the earnings forecasting business. First, "I have demonstrated on a top-down basis how relative stock performance and analyst expectations are coincident to each other across sectors." Second, "…even if you knew top-down realized earnings two quarters ahead, you would be hard-pressed to arrive at a solid forecast."

Much to my astonishment, not everyone in the nation's fundamental analyst community agreed wholeheartedly. But as I concluded, "Restated, this is a tough business." My intentions were to emphasize how efficient markets capitalize changed expectations in the price so quickly they tend to neutralize the forecasters who generated them.

A longstanding postulate of mine is "**A credible forecast is inherently self-defeating**." I arrived at this conclusion in the late 1970s and early 1980s from watching Henry Kaufman, then of Salomon Brothers, issue one bearish interest rate forecast after another. As traders believed him during this long bear market for bonds, they would either postpone their lending or accelerate their borrowing in response. The shift in behavior pulled the bearish forecast from the future into the present and made it increasingly difficult for the forecast of higher interest rates to be true.

Analyst Value-Added

First, let's take a case study of analyst expectations in one sector, oil services. The history of the forward-looking P/E ratio for the Philadelphia Oil Service Sector index (OSX) relative to that of the S&P Supercomposite index can be created and mapped against the OSX' relative total return. Do the analysts' collective expectations look as if they lead relative performance? No, at best they are a coincident indicator.



Worse still, take a look at how slow the analysts were to raise their relative forward-looking P/E numbers after the March 2009 low. They were slow to raise them until after the sector took off, and then they cut them between June and August 2009 after relative performance faded. Now they are in the process of upgrading the forward-looking P/E numbers after the OSX has gained steadily vis-à-vis the broad market for two months.

Most of us are quite adept at chasing the market and our tails on our own and really do not need professional help to do so. The argument I made in June about whether an analyst is adding value or simply batting the breeze is affirmed in this case.

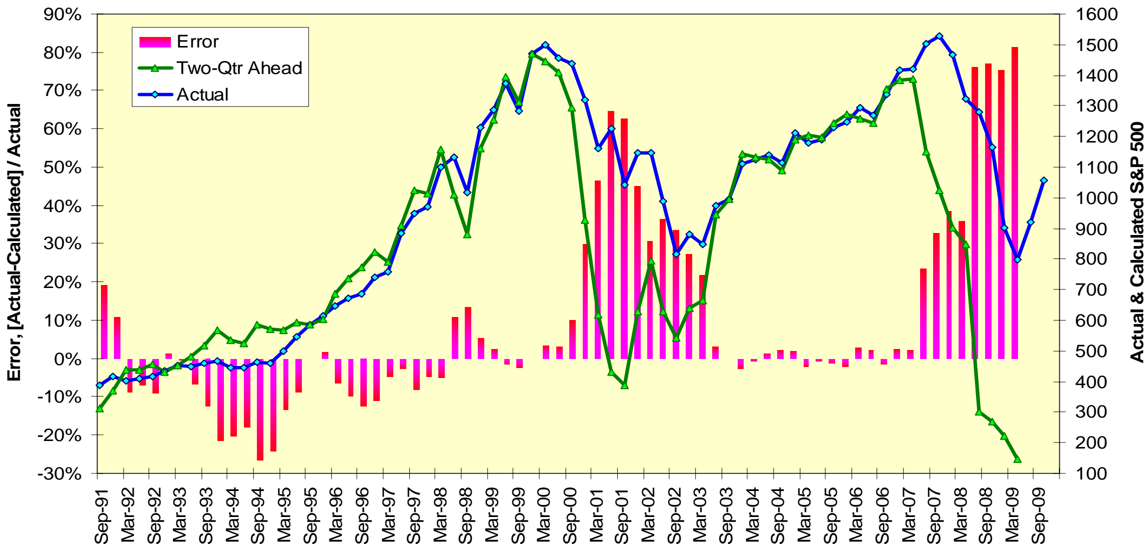
Pricing Earnings

Now let's shift to the generalized case of top-down earnings and whether perfect foresight would be an advantage. This clearly is a huge subject, and I will apologize in advance for simplifying the case. In addition, let's stipulate in

Clintonian fashion there is no single definition of earnings; we will use earnings per share before extraordinary items.

If we multiply the actual earnings realized two quarters hence by the current forward-looking P/E ratio for the S&P 500, a very distinct pattern emerges. 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 12.8 at the end of the first quarter of 2009 been applied to the actual earnings of $11.53 per share, the S&P 500 would have been at 147.58 at the end of September instead of 1057.08.

This extreme bias helps explain why my analysis one week before the March low and based on such collective estimates was still negative. Yes, it is better to learn from your errors rather than act as if they never happened.

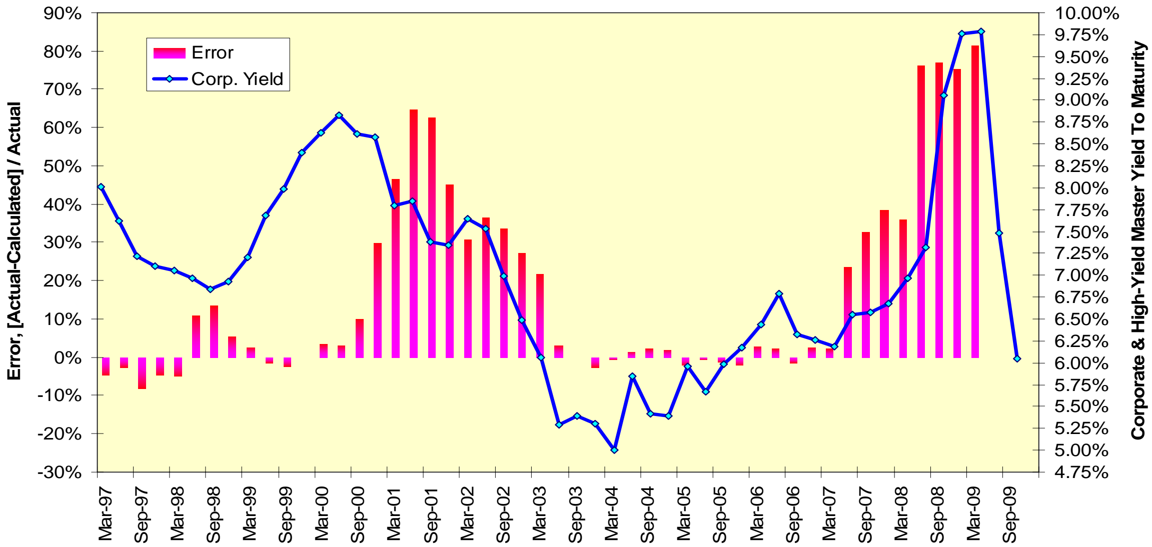


The forecast error was negative for much of the early and mid-1990s; in a gently rising bull market, top-down forward-looking P/E multiples tend to be too low. Restated, earnings grow faster than expected in such an environment.

When do the errors oscillate around zero? Take a look at the bubble markets of 1998-199 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 then than during other market conditions. Why do we pretend to hate bubbles when we are so good at them?

The Yield Factor

Finally, we should mention the principal cause behind the bias and the reason why perfect earnings information will not get you to the right answer: Earnings must be discounted by their interest rate cost of capital (not the ten-year Treasury note some use; you and I cannot borrow at the Treasury rate). The corporate bond rate as measured by the Merrill Lynch Corporate & High-Yield Master index falls while before future earnings decline; this lower discount rate increases the present value of a dollar of earnings and allows P/E multiples to expand.



There we have it: Analysts as a collective entity change their estimates along with the market, 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. Moreover, if they get the earnings forecast right, they would still have to get the future changes in the cost of capital right.

No one has a crystal ball that good, and if they did, they probably would start issuing those inherently self-defeating credible forecasts. This really is a tough business.