

Financial Statement Analysis & Valuation: Research, Teaching and Practice

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How do analysts forecast earnings?

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It depends on the analyst and the situation.

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A Spectrum of Analysts:

Conscientious

Less than Conscientious

- Use a *granular* approach
- Use all guidance from by mgmt
- Use extensive knowledge of firm, industry & past sales to predict future sales.
- Use extensive knowledge of firm, industry & past expenses to predict future expenses.
- Earnings = Sales – Expenses

- Use *30,000 feet* approach
 - Use all guidance from mgmt
 - (May) Use past earnings & earnings growth rate to predict future earnings
 - Use current price
 - Use all guidance from other analysts (herd!)
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Why do we still study analysts?

- **Data availability**
 - I/B/E/S, Value Line, Zacks, FirstCall, others
 - **Distributions to analyze**
 - Forecast accuracy, bias, dispersion, etc.
 - **Correlations to compute**
 - forecasts and prices, forecasts and _____, etc.
 - **Our interest in how capital markets operate**
 - **Birth of a new literature**
 - Analysts as an economic agent
 - Incentives, information processing, use of accounting data, etc
 - **We have yet to fully understand**
 - How they forecast earnings
 - What they do with these earnings forecasts
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Why do I care about analysts?

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Why I Care About Analysts' Forecasts

- **Despite their imperfections:**
 - **Yes, they are better than time-series forecasts**
 - More accurate
 - Better surrogate for market (and sophisticated) expectations
 - **The stock market cares about analysts' forecasts**
 - **They are incredibly useful tools for capital markets research**
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Analysts' Forecasts as a Tool in Capital Markets Research

- **Do analysts exhibit the (inefficient) behavior of which we accuse investors ?**
 - Accruals (Bradshaw, Richardson, Sloan 2001)
 - PEAD (Mendenhall 1991; Abarbanell & Bernard 1992)
 - Value-Glamour (LaPorta 1996; Dechow & Sloan 1997)
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Analysts' Forecasts as a Tool in Capital Markets Research

- **Do price movements convey info about future cash flows or, e.g., about changes in liquidity, changes in investor recognition...?**
 - Exchange Listings
 - Index Listings (Denis et al 2003)
 - Stock Splits (Doran 1994)
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Analysts' Forecasts as a Tool in Capital Markets Research

- **Do different investors use different information sets?**
 - Analysts forecasts versus time series models (Bhattacharya 2001; Battalio & Mendenhall 2005)
 - **Open question: Can we identify some investors whose expectations are more sophisticated than those of analysts?**
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Analysts' Forecasts as a Tool in Capital Markets Research

- **We are still finding fascinating phenomena that have implications for how capital markets work**
 - Large forecast dispersion \Rightarrow large optimistic bias
Large forecast dispersion \Rightarrow low returns
(Ackert and Athanasakos 1997; Diether et al 2002)
 - Open questions: What more can we do with dispersion? E.g., can we relate it to the elasticity of demand for stocks?
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Final Thoughts

- **If you really want to capture, or control for, earnings surprise, use both analysts' forecasts & a time series model**
 - **Surveys of "analysts" should be viewed with skepticism**
 - Block(1999)—randomly selected AIMR members
 - **Recent regulation changes should make the future interesting**
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