
Falling in Love Again—Analysts' Estimates and Reality

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An important factor investors use to evaluate stocks for investment is earnings per share. Many investors focus obsessively on EPS, comparing actual reported numbers with estimates and acting aggressively on the results. A comparison of monthly earnings estimates and actual earnings for 399 companies from 1982 through 1992 showed that, on average, estimated first month earnings were 57.1 percent higher than actual earnings. Estimates of full-year earnings made in the final month of the fiscal year still overestimated reported results, by 11.9 percent. Most of this overestimation bias was from companies that had been forecast to have positive earnings but actually had negative earnings. Market participants should factor in innate overestimation biases when making stock valuation judgments.

Earnings per share (EPS), in addition to providing a measure of a company's profitability, can be used in conjunction with a company's P/E to determine a target price for the company's stock. Commonly, this determination is accomplished by estimating a stock's normalized P/E and then, using an EPS estimate as the denominator, deriving an estimated future price per share.

EPS estimates, therefore, are crucial in stock valuation, both in simple approaches such as the P/E model described above and in more complex models such as the dividend discount model (DDM), which uses earnings and dividend forecasts to derive an expected return for a given stock.

Academic research shows that positive earnings surprises often presage future positive surprises plus superior stock performance, and the converse is true as well. Research also shows that upward revisions in earnings estimates by analysts often lead to positive price performance and downward revisions lead to future underperformance.

Sometimes stock prices seem to react in almost a knee-jerk fashion to earnings announcements. Many companies reporting higher-than-expected EPS numbers see an immediate short-term run-up in stock price. Conversely, companies reporting disappointing earnings often see their stocks bat-

tered. Because EPS appears to play such a large role in investors' minds and actions, the accuracy of EPS estimates is a matter of more than passing interest.

ACTUAL VERSUS ESTIMATED EARNINGS

Zacks Investment Research data base of analyst estimates was used as the source of actual and estimated monthly earnings information on 399 companies: 251 with fiscal years ending in September, 101 with fiscal years ending in October, and 47 with fiscal years ending in November. The data were for 1982 through 1992. To ensure uniformity, within each fiscal year, we analyzed only those companies with a first- and last-month estimate, as well as an actual earnings figure. Companies in the study were widely diversified over market sectors and industries. The number of analysts following each company was also examined to identify any possible relationship between accuracy of earnings forecasts and amount of analyst coverage.

The results of the comparison of estimated and actual earnings for the sample period are shown in Table 1. On average, first-month estimated earnings were 57.1 percent higher than actual earnings. Furthermore, even though analyst estimates tended to decline during the course of the year, as shown in Figure 1, estimates of full-year earnings made in the final month of the fiscal year still overestimated reported results by 11.9 percent.

A large proportion of the overestimation bias

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Table 1. Comparison of Actual and Estimated Earnings

Item	Fiscal Year End			Weighted Average
	Sep.	Oct.	Nov.	
Number of companies	251	101	47	NA
Excess of first estimate over actual earnings	60.3%	52.7%	49.2%	57.1%
Excess of first estimate over last estimate	40.9	38.5	36.9	39.8
Excess of last estimate over actual earnings				
All companies	13.2	10.5	8.1	11.9
Companies reporting profitable results	2.2	2.1	5.1	2.5

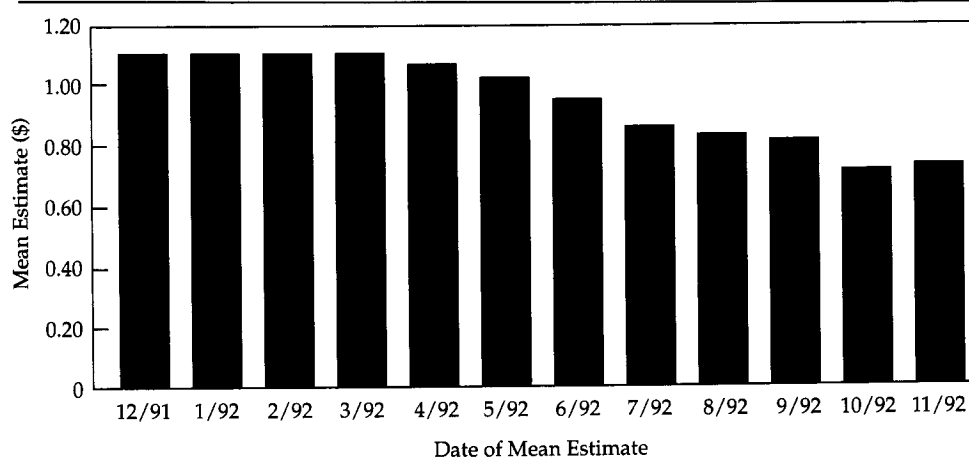
Note: NA = not applicable.

Table 2. Spearman Rank Correlations, October Sample

Year	Coefficient
1992	-0.697
1991	-0.806
1990	0.188
1989	-0.285
1988	-0.503
1987	0.345
1986	-0.079
1985	0.636
1984	0.273
1983	-0.394
Average	-0.132

Note: A correlation of +1.0 would mean that the smaller the number of analysts the greater the accuracy. A correlation of -1.0 would signify that the greater the number of analysts the higher the accuracy.

Figure 1. Monthly Earnings Estimates, November Fiscal Year, 1992



came from companies forecast to be profitable that actually reported losses, sometimes because of extraordinary charges during a given year. Omitting these companies from the sample reduced the overestimation for the final month to 2.5 percent.

Spearman rank correlation was used to examine whether the number of analysts following a company had any correlation with the accuracy of earnings estimates. As Table 2 shows, no consistent relationship was found between analyst coverage and overestimation bias.

POSSIBLE EXPLANATIONS

A downward trend in earnings estimates as the year progresses makes sense, because analysts accumulate company-reported quarterly earnings

figures throughout the year and fine-tune their estimates accordingly. Still, the magnitude of the overestimation bias—greater than 10 percent, despite proximity to the end of the fiscal year—was a surprise. This discrepancy implies that investors who rely too heavily on earnings estimates might introduce substantial error into their own valuation judgments and target stock prices.

This overestimation bias might have many explanations, including

- a tendency for analysts to “fall in love” with their stocks. A cursory survey of Wall Street stock recommendations shows that buy recommendations far outnumber sell-and-hold recommendations.

- a skewing of analysts' views by the many research reports published by investment houses that also engage in investment banking activity. Analysts' employers, and consequently analysts, do not like issuing negative or critical reports on their firms' investment banking clients, which could affect future relationships with those clients.
 - the possibility that companies seeing negative commentary about themselves might cut off an analyst's lines of communication in the future in response to what they perceive to be adverse reporting.
- These three factors may at least partially ex-

plain what appears to be a behavioral bias toward overoptimism in earnings research.

IMPLICATIONS FOR INVESTORS

The value of a company's stock depends on its future cash flows, the bulk of which come from earnings. Earnings estimates, therefore, are a vital component in stock valuation. Academic research has shown that, for most investors, consensus estimates are an efficient starting point, because deriving their own best estimates is an expensive, time-consuming, and error-prone task. The lesson from this study, however, is that market participants should take analysts' innate overestimation biases into account when making stock valuation judgments.

