BARCLAYS
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INVESTORS

Forecasting Earnings:
A Commentary
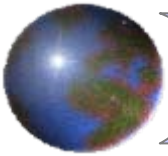
by

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What I learned…

- **Hire Dorron**

  It's much easier than trying to digest all the stuff in his talk.

- **Next time he is presenting, give him more time**

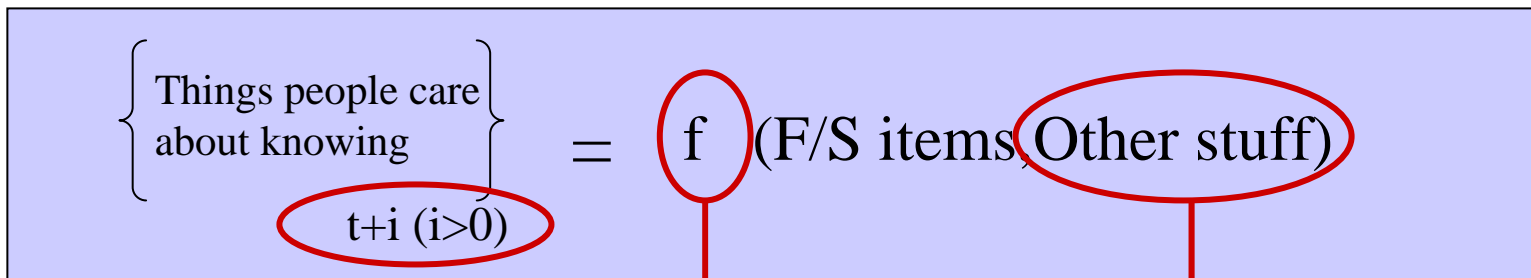 *This talk is like an adolescent, it is still growing.*

  Lots of good stuff here, but it may be not easy to see the forest for the trees.

- **I should keep this short**

  When you stand between Dorron Nissim and Richard Sloan, you should get up, put up, and shut up. FAST.

FSA: A Broad Perspective

$$\left\{ \begin{array}{c} \text{Things people care} \\ \text{about knowing} \\ t+i \ (i>0) \end{array} \right\} = f \ (\text{F/S items, Other stuff})$$

Economic outcomes of consequence to people:

• Stock returns

• Δ Risk (e.g., Credit spreads)

• Bankruptcies, prob. of fraud, corporate actions (M&A, SEO etc.), analyst revisions, index membership, implied vol., delistings, cost-of-capital, executive compensation
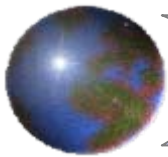
• Future earnings

Theory:

• Valuation

• Agency

• Others

Often contextual: Based on accounting knowledge and economic insight

Often interdisciplinary:

• Finance

• Economics

• Psychology

• Marketing

• Corporate Strategy

On earnings forecasting…

- ## Why earnings?

  Pros: It's objective and available, others seem to care about it.

  Cons: It is not that correlated with changes in firm value; why not something like change in analyst revisions, or ΔV (e.g., Liu and Thomas)? Book value?
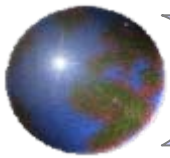
  Next period's earnings is likely to be related to what I truly care about, but can we specify a more interesting target variable?

  What is the economic decision of most interest?

- ## What earnings?

  Should it be Operating? Core? NOPAT? Comprehensive? (Why?)

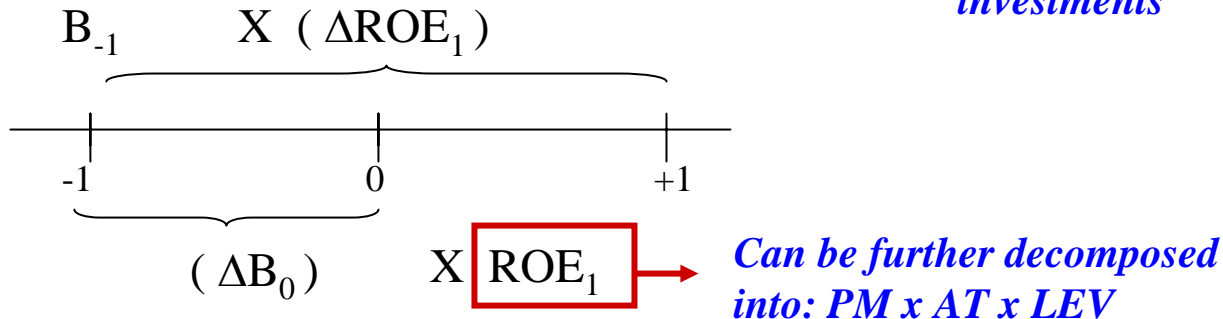 *Should it be scaled? RONA? ROE? (Why?)*

On earnings forecasting…

- **This is a useful decomposition:**

1. The Change in ROE on existing capital base

$$EPS_1 - EPS_0 = (ROE_1 - ROE_0) \times BVPS_{-1}$$
$$+ ROE_1 \times (BVPS_0 - BVPS_{-1})$$

The EPS Surprise

2. The return (ROE) on new investments

$B_{-1} \quad X \; (\Delta ROE_1)$

-1   0   +1

$(\Delta B_0) \quad X \; ROE_1$

Can be further decomposed into: PM x AT x LEV

What are the economic drivers of this EPS surprise? Do markets participants know about it?
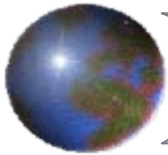
A few other things…

- ## Deeper contextual analysis

  There is a need to fill the gap between large sample one-size-fit-all studies, and single firm analyses

  To get down deeper get into individual industries: understand the economic drivers, sources of competitive advantage and risk, and how they are reflected in the financial statements

- ## Looking ahead

  FSA is COOL! It is a vibrant interdisciplinary pursuit with lots of applications. Many opportunities.

  But… we need to maintain perspective, and contextualize the exercise in the broader context of information economics