

How well do investors understand loss persistence?

Discussion

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Overview

- Usefulness of model to investors:
 - Can investors use this earnings prediction model for investment decisions?
- Usefulness of model interpretations to researchers:
 - What do we learn about the earnings process of loss firms and how investors interpret them?
- Where do we go from here:
 - Where does this study fit in the literature and what are the implications for future research?



Investor's Perspective

- What do we want in a prediction model?
 - Do we care about bias or precision?

Full Sample						Post 1990					
Portfolio on FEARN _t	Mean Obs per qtr.	FE _{FEARN}		FE _{Analysts}		Portfolio on FEARN _t	Mean Obs per qtr.	FE _{FEARN}		FE _{Analysts}	
		Mean	STD	Mean	STD			Mean	STD	Mean	STD
1	27.2	0.009	0.066	(0.016)	0.048	1	36.5	0.005	0.075	(0.010)	0.045
2	33.3	0.002	0.050	(0.009)	0.024	2	43.5	0.002	0.054	(0.004)	0.019
3	35.1	0.002	0.038	(0.006)	0.017	3	45.5	0.000	0.044	(0.004)	0.014
4	38.8	0.001	0.029	(0.007)	0.013	4	50.5	0.001	0.032	(0.003)	0.009
5	50.1	(0.006)	0.027	(0.006)	0.014	5	63.7	(0.006)	0.030	(0.002)	0.009

Investor's Perspective

- Trading strategy:
 - Revolutionary, incremental, or neither?
 - Balakrishnan, Bartov, Faurel (JAE, 2010)

Portfolio ranking on $EARN_{t-1}$	$EARN_{t-1}$ BP	$EARN_t$			BHR_{90}	BHR_{180}	BHR_{365}
	Mean	Mean	Median	Std.			
P1	≤ -0.133	(0.220)	(0.194)	0.080	(0.038)	(0.073)	(0.128)
P2-20	> -0.133	(0.028)	(0.017)	0.030	(0.023)	(0.039)	(0.045)
Hedge Return					0.016	0.034	0.083
FM t-stat					-(2.01)	-(3.01)	-(5.39)

Investor's Perspective

- Trading Strategy:
 - Is this implemental?
 - What are the relevant risks?
 - We don't really know.
 - However, we do know some things:
 - We can do better than size.
 - We have to draw the line somewhere.

Portfolio Basics:

- Portfolios formed at end of announcement month
- Returns adjusted for size, B/M, and momentum per Daniel et al. (1997).
- Firms w/ shares \geq \$5 at formation date.

Portfolio ranking on FEARN _t	DGTW BHR ₃₆₅
1	(0.076)
2	(0.042)
3	(0.044)
4	(0.053)
5	(0.024)
Hedge Return	(0.052)
FM t-stat	-(2.95)

Researcher's Perspective

Loss Firms...who are they?

Portfolios	FEARN _t		FE ₁		BHR ₃₆₅	MB	Firm Age		Seasoned	Net Share Issue	
	Mean	STD	Mean	STD			Mean	Median		1yr	2yr
1	(0.110)	0.055	(0.001)	0.084	(0.108)	6.889	6.549	4.469	0.428	0.152	0.272
2	(0.041)	0.008	0.002	0.055	(0.061)	3.268	9.480	7.268	0.558	0.090	0.177
3	(0.020)	0.004	0.002	0.043	(0.048)	2.303	11.543	9.258	0.620	0.064	0.128
4	(0.008)	0.003	0.001	0.032	(0.039)	2.031	12.826	10.278	0.654	0.045	0.094
5	0.010	0.012	(0.006)	0.030	(0.013)	2.350	14.374	12.114	0.692	0.046	0.081

Seasoned: 1 if firm age > 5 years; 0 otherwise

All variables are time-series averages (an avg. of quarterly statistics)

Researcher's Perspective

Equal-weighted BHAR365_{t+1}

	1	2	3	4
Intercept	-0.106 (-3.52)	-0.118 (-3.19)	-0.035 (-1.05)	-0.015 (-0.70)
FEARN_t	0.024 (2.77)	0.019 (1.93)	0.012 (1.29)	0.012 (1.65)
sFirm		0.028 (1.19)	0.008 (0.34)	
sFirm x FEARN_t		0.005 (0.80)	0.004 (0.62)	
NS Issue - 2 yr			-0.029 (-6.57)	-0.028 (-5.68)
Accruals				-0.016 (-6.20)
Earn_t				(0.00) (-0.11)
EP_t				(0.01) (1.59)
MB_t				-0.011 (-2.54)
SUE				0.013 (2.89)
Adj. R-squared	0.3%	0.3%	0.6%	0.9%

Regression Basics:

1. All variables quintile ranked; range 0-4
2. sFirm: 1 if firm age > 5yrs; 0 otherwise
3. Two-way cluster (firm/quarter)



Researcher's Perspective

- What do we learn?
 - Loss firms are primarily young, growth firms that have recently issued equity.
 - Alternative explanations for return pattern:
 - Investor's don't understand the earnings processes of young firms.
 - Differences in opinion (Miller 1977)
 - Information uncertainty

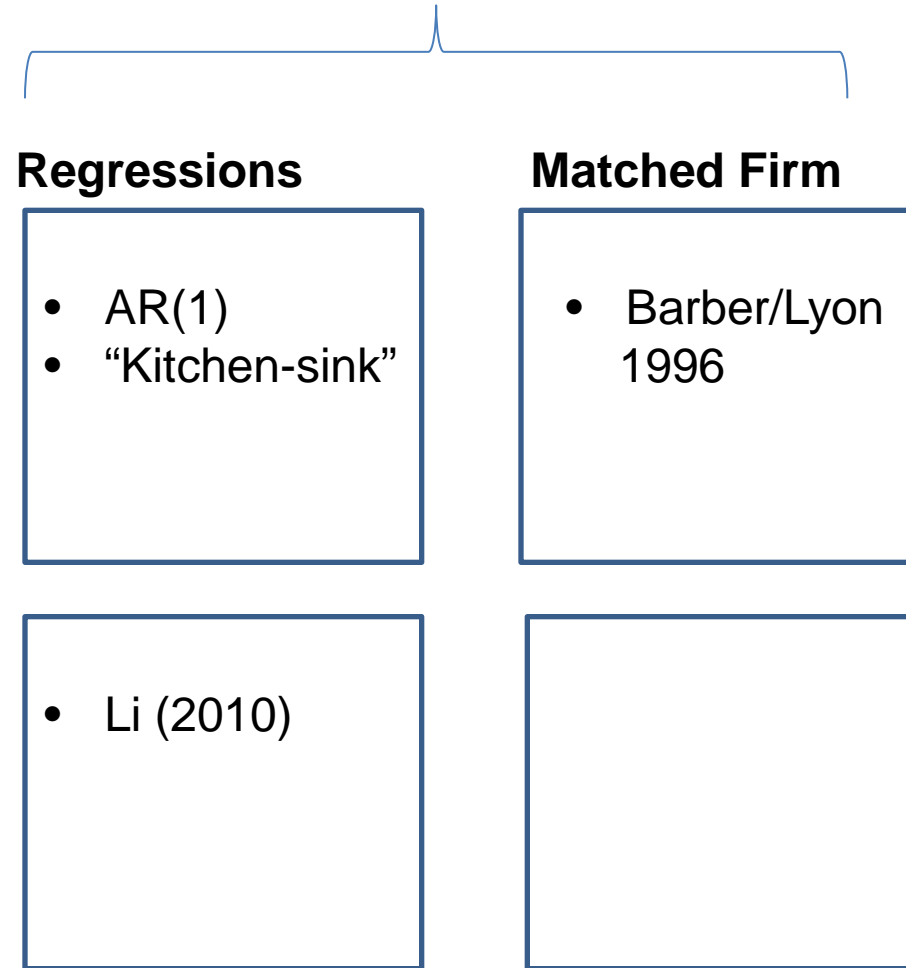


Where do we go from here?

- Is this just an explanation shift?
 - Sort of...but it provides structure for understanding how the world works.
 - A large percentage of loss firms are young firms.
 - Young firms tend to have more uncertain earnings processes.
 - Young, growth-oriented, loss firms have **distinct** earnings processes from seasoned, value-type loss firms.

Where do we go from here?

Econometric Form Continuum



General

Regressions

Matched Firm

- AR(1)
- “Kitchen-sink”

- Barber/Lyon 1996

- Li (2010)

Char.
Specific

Economic
Form
Continuum



Summary

- Interesting idea, intriguing empirical results
 - Precision is important in earnings prediction models, not just unbiasedness.
 - Consider competing hypotheses a bit more thoroughly. Empirical results are contributive to other literatures.
 - Future research on earnings prediction may want to consider examining characteristic-specific earnings models (as done in Li 2010).