

Comments on Analyst Earnings Forecasts

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Antecedents of analyst research

- Modeling expected earnings
 - We want to understand the earnings-return relationship; for this, we want to know when and how expected earnings change.
- Economic forecasting
 - We want to understand the forecasting process, and how we might improve it.

Conventional criteria for evaluating forecasts

- Unbiased: $E[\text{Err}] = 0$
- Accurate: $\min. E[|\text{Err}|]$ or $E[\text{Err}^2]$
- Efficient: $\text{corr}(\text{Err}_t, \text{Err}_{t-1}) = 0$

Assumptions embedded in those criteria

Observations of Err_t :

- come from a single, stable distribution;
- are independent draws; and
- are representative of the population.

Insights into analyst behavior

- Adaptive – to changes in a company's operations, economic shocks, other analysts' forecasts
- Selective – of which companies to follow, whether to report, when to report
- Strategic – in currying mgt. favor, seeking brokerage & investment banking business, seeking reputation

Breakdown in applying conventional criteria to analysts

- Adaptive => not identical process, not independent
- Selective => not representative
- Strategic => not identical process

Context-appropriate criteria

- Are analyst earnings forecasts useful in valuation?
- Can analyst earnings forecasts (and a suitable valuation model) identify mispriced securities?
- Does analyst disagreement reveal uncertainty that affects the cost of capital?

Same breakdown in inferences

- Analysts' adaptive, selective, strategic behavior determines, in part, the quality and range of their forecasts, and the set of firms for which we can make such assessments.
- Ignoring their strategic behavior can impair inference, but more importantly leads to less interesting research questions.

Further questions related to earnings & forecasting

- Do analysts understand accounting? Do they need to?
- What information (accounting and non-accounting) do analysts use?
- What new information do analysts produce?
- Does accounting influence analysts' real decisions?

Conclude

- Analysts play an interesting role in producing and distributing information.
- Their behavior and decisions affect the information they produce and distribute.
- Earnings forecasting probably isn't the most interesting thing they do; but it has provided interesting evidence about some of their behaviors and decisions.