Commentary on Forecasting Earnings

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by

Richard G. Sloan
Ross School of Business
University of Michigan

Opening Thoughts

- *"Our Graham & Dodd investors, needless to say, do not discuss beta, the capital asset pricing model or covariance among securities. The investors simply focus on two variables: price and value."*
- *Warren E. Buffett*

Some General Observations

- Forecasting the future financial statements of business enterprises is (in my opinion) the most important activity in finance.
- Academic researchers have been slow to develop systematic body of knowledge in this area
  - Finance academics obsessed with EMH, asset pricing theory and associated statistical analyses
  - Accounting academics have traditionally viewed this area as outside their realm
- Finance practitioners have not done a good job of developing a systematic body of knowledge in this area
  - Concerns with proprietary information
  - Agency costs of financial intermediation

What Do We Know?

- Sell-side analysts’ forecasts are more accurate than simple time-series models
- Sell-side analysts forecasts contain systematic biases that can be identified through fundamental analysis
- Stock prices act as if investors do not anticipate the systematic biases in sell-side analysts forecasts (the buy-side isn’t doing much better than the sell-side)

Future Opportunities and Challenges

- Still much low hanging fruit in the systematic application of fundamental analysis to the forecasting of earnings and stock returns
- Finance academics will claim back their turf as the EMH and asset pricing theory paradigms wind down
- Accounting academics knowledge of the underlying accounting principles and procedures will provide us with a competitive niche
- Current march toward fair value accounting will make earnings forecasting much more challenging