Analyst Forecasts: How to Read Between the Lines

By Shellie Karabell, Editor-in-Chief

Accurate financial information is critical to investors. But is consistency more important than accuracy? And what's the trade-off for investors?

Analyst A covers technology; he always reports true earnings for his companies but consistently subtracts three cents from his forecast for the bottom line or EPS. Analyst B always reports true earnings but sometimes adds two cents to his EPS forecast, sometimes subtracts a penny. Which one should investors prefer?

"What we find," says INSEAD Associate Professor of Accounting and Control **Gilles Hilary**, "is investors react more, on average, to a consistent forecast than to an accurate forecast. Therefore, investors should prefer Analyst A because he delivers forecasts which are more useful: they are a predictable transformation of realised earnings."

Hilary discussed his research paper, Analyst Forecasting Consistency, which reviews analyst data from 1994-2006 in an interview with INSEAD Knowledge in Fontainebleau recently. The paper is soon to be published in the Journal of Finance and was co-authored with Charles Hsu of the Hong Kong University

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of Science and Technology.

“We found indeed that this consistency is what the markets prefer.” And consistent forecasts (that is, those for which the forecast error is “predictable”) move the markets more, Hilary’s study of some 2,500 listed companies shows.

Bias or Consistency?

But Hilary points out this “consistency” is hard to achieve in reality: it means maintaining close ties with management to obtain information before quarterly results are made public. The price you pay to obtain this information is the systematic bias in your forecast. “There’s this game going on between analysts and firms where firms help analysts to form the right price expectations as to what the actual earnings will be, but in return the analyst would then lower their estimates,” he opines. “We don’t necessarily mean there is an actual conversation (of this sort) but essentially this is what’s going on.”

Being consistent is also a good career move for an analyst. Hilary’s research shows that analysts who deliver more consistent forecast errors (for example, that “deliberate” under-estimate of three-cents mentioned above) have “greater ability to move prices, even after controlling for the effect of stated accuracy.” Then there’s the popularity factor: the more institutional investors demand “consistency”, the more in demand are those analysts issuing such forecasts; and the more likely they are to be named to the annual list of All-Star Analysts, to appear on TV, be quoted in the media, retain good positions at top financial firms…

New Regulations?

Present-day market regulators have scrutinised factors which may lead analysts to issue systematically less accurate forecasts – that is, to favour “consistency” over “accuracy” in the interests of “fairness”. But Hilary points out that new regulations, while perhaps curbing the above-mentioned bias, favouring “accuracy” over “consistency”, also water down the overall report. “Regulations have had the effect of reducing the biases, but the consequence of that has been also to reduce the accuracy and the informativeness of the analyst forecasts,” he says. “So on the one hand,

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regulators are very concerned with issues like ‘fairness’; on the other hand, the sophisticated investors are getting information that is lower quality, in which case the price may be affected: the share price might not reflect the true value of the firm.”

And the small investor?

It’s a win-win situation for analysts and the companies they analyse: “Firms like to beat a nice forecast,” Hilary points out. “And at the end of the day, as long as everybody understands what’s going on that’s fine.” Therein lies the rub. Sophisticated institutional investors have figured this out and can see through the “predictability”; but the smaller retail investor may not.

To this group, Hilary cautions, read the small print in the reports. “Don’t get fixated on the EPS forecast itself. Try to understand what the incentives are for the analyst; and extract as much information as you can, so you’re not at a competitive disadvantage versus the sophisticated players.”

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