Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

No Normal Trends

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What is the normal trend of changes in analyst estimates? Do analysts err on the side of optimism or pessimism? Like many investment questions the best answer is, "it depends."

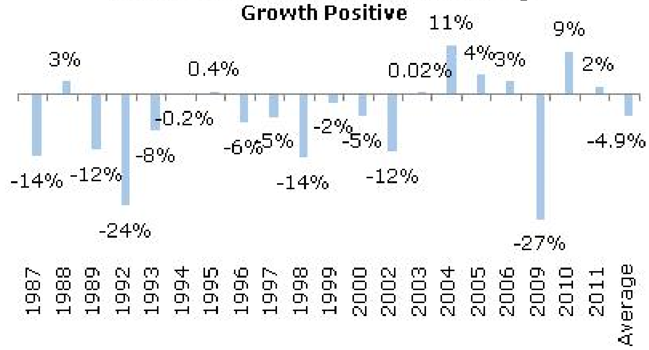
> "There is no such thing as "normal" weather. The proper word is "average," which takes into account not only typical temperatures or events, but also the extremes. Daily readings occur well outside the average, or normal, or what we perceive to be normal. In fact, extremes should be expected." *Gilbert Sebenste, Northern Illinois University Meteorologist*

Like weather, 'normal' trends in analyst earnings estimates do not exist. Exhibit #1 gives a snapshot of the range of earnings revision trends between 1985 and 2012. The average is for S&P 500 earnings to end the year -11% lower than estimates at the beginning of the year. However, the range of outcomes is quite large. The worst year was in 2008, when actual earnings were about half of what analysts were estimating at the beginning of the year. At the other end of the spectrum, companies delivering better than expected earnings tend to not exceed analysts' expectations by such extremes. The best relative earnings performance was in 2004, where the aggregate earnings ended 11% above estimates at the beginning of the year.

Exhibit #1: Difference Between Actual and IBES Estimated Earnings at Beginning of Each Calendar Year (1985-2012)

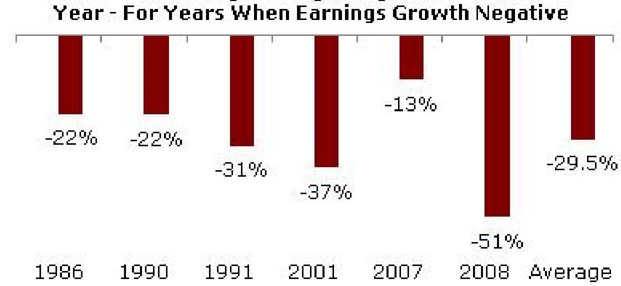
Exhibit #2 illustrates the years when year-over-year earnings were rising. The average difference between the beginning of year estimates and actual was still -5%, which means that on average analysts were still overly optimistic. But the average is not a reflection of normal. There were eight of the years when analysts proved too conservative and companies exceeded the beginning of year estimate. To say the norm is for analysts to be too optimistic would be a misstatement of the range of historic outcomes. On the other hand, there have been thirteen years where earnings were positive but companies delivered less than was originally expected. In two of them, 1992 and 2009, actual earnings were substantially lower than originally estimated. A more reasonable conclusion might be that there is a slightly higher probability that analysts will be overly optimistic than not during positive growth years, but the magnitude of their inaccuracy depends on a multitude of events unfolding throughout the year.

Exhibit #2: Difference Between Actual and IBES Estimated Earnings at Beginning of Each Calendar Year - For Years When Earnings Growth Positive



With 2008 being such a slippery slope it would be easy to assume the meltdown that year had an inordinate impact on the averages. In fact, Exhibit #3 shows the years when year-over-year earnings growth was negative. Analysts were always too confident in company's earnings power at the beginning of the year. In fact, 2008 was not the outlier that one might originally think. In 2001, companies delivered earnings that were -37% lower than analysts expectations at the beginning of year, and in 1991, they missed by -31%. The best result was a -13% miss, which was of a greater negative magnitude than the best positive magnitude of +11% for years when year-over-year earnings were rising. The average drop of estimates for all negative growth years was a very painful -30%. Clearly, analysts have proven to be inaccurate in estimating when earnings are going to decline and by how much.

Exhibit #3: Difference Between Actual and IBES Estimated Earnings at Beginning of Each Calendar Year - For Years When Earnings Growth Negative



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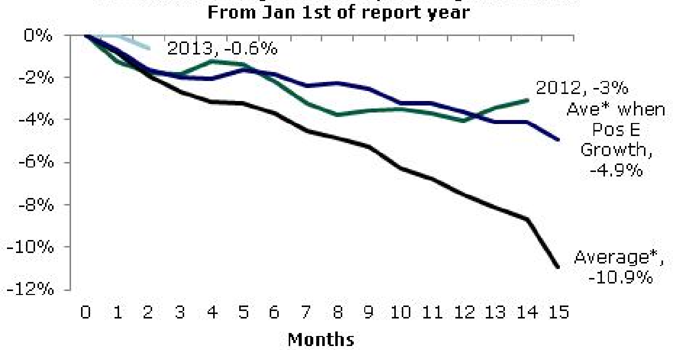
So how are current earnings trends playing out? Last year was considered by many investors to be a very bad year for downward revisions. Surely, it must be in the lower quadrant of historic experiences. Yet, Exhibit #4 shows that it was actually better than average, with aggregate earnings only missing beginning estimates by a modest -3%. That is a good lesson in perception and reality. The perception was that earnings trends were a disaster, but they really were not bad compared to history. While 2013 is just getting started, revisions for the year have been pretty minor and the current aggregate estimate is only -0.6% lower than at the beginning of the year. It would be premature to draw any conclusions about the current year from movements so far in earnings estimates. Yet, one should not be too concerned that the trend is negative. When market pundits report in a very concerned tone a negative earnings trend, keep in mind that there are many examples of years where similar patterns resulted in positive outcomes.

Exhibit #4: Change in IBES Op Earnings Estimates From Jan 1st of report year



* averages of years 1985 - 2012

While it is human nature to try to identify what is normal in the investment world and compare your current experience to that benchmark, this study concludes that it is a next to impossible task to apply that thought process to aggregate earnings estimate trends. About the only consistent relationship in the data is that in years when year-over-year earnings growth proves to be negative that analysts have always been too optimistic. That is not overly surprising considering that with most years experiencing positive earnings growth, analysts are justifiably biased to expect positive outcomes. It might be tempting to say that on average actual earnings will be less than currently estimated by Wall Street. But that again would be a generalization, and subject to a wide range of outcomes. The direction of earnings trends are very important to our earnings driven stock selection, but using those trends to project the absolute level of aggregate earnings delivered is very difficult and not a key component to our process.