Eventually Met

COMMENTARY
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Given the unpredictability of investment markets and corporate fundamentals, we tend to pay minor heed to generally unreliable guesswork about the future, instead emphasizing the facts of market history. Analyst estimates for corporate earnings provide a fine example of a dataset that one otherwise might think would be usable, driven as it is by crowd-sourced wisdom. Turns out that they're not the most dependable source of real-time information:

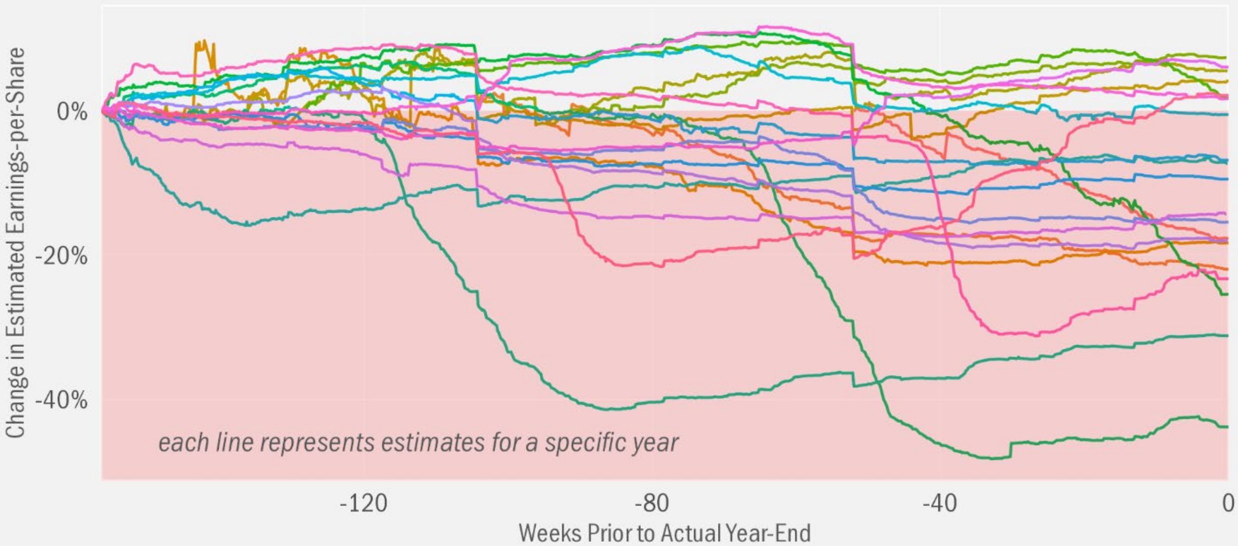
- Early estimates for future corporate fundamentals tend to prove overly optimistic
- While changes in estimates highlight shifts in investor sentiment that could be seen as informative, they probably are at best a lagging indicator
- We think folks with a long-term orientation to their investments should maintain a focus instead on similarly longer-term trends

Curiously Optimistic

Since analyst estimates for corporate earnings can be aggregated at the index level, investors may follow such data to establish expectations for the financial health of the market as a whole. As with most predictions, though, a word of caution is warranted. As we show in Figure 1, analysts tend to provide overly optimistic outlooks for the somewhat distant future (two to three years out), generally reining in those expectations as companies report interim quarterly results. This effect can be seen in the chart, where we show the change in aggregate estimates for all members of the S&P 500 (for which such data are available) for each year since 2001. Each line represents three years-worth of estimates for each calendar year, with estimates for each year beginning three years prior and ending on 12.31 of that year. The fact that most of those lines end lower than where they started—often by a significant amount—suggests we should be wary of placing too much weight on the series.

Figure 1: S&P 500 Index Earnings Estimates

This view exemplifies the challenge of predicting the future. Oftentimes, actual earnings for a particular year can be very different than were estimates 36 months prior. In most cases, optimistic estimates give way to less impressive results



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Gauges of Trend

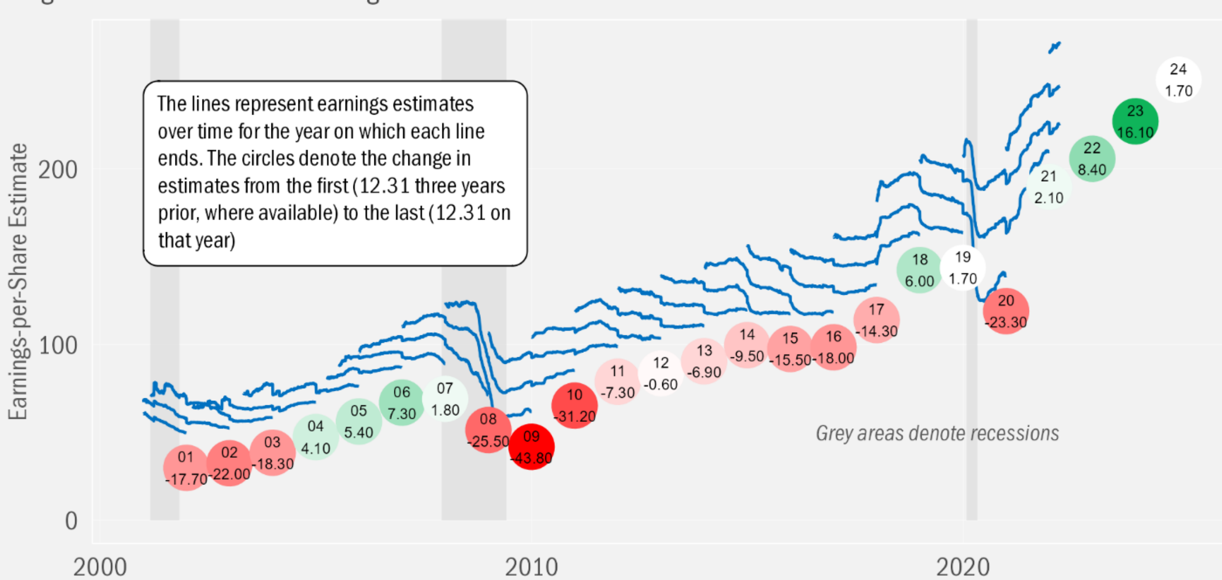
Estimates tend to approximate the eventual truth as times goes on. This trend tends to hasten in the last three quarters of each year as the full-year data include a greater proportion of actual reported results (e.g., estimates for full-year 2020 results presented in August 2020 likely include two quarters of actual results and two quarters of estimates). Further, as analysts have ongoing conversations with the executives of the companies they cover, these executives may provide guidance to the analysts to pull estimates closer to the company's own. And, more simply, it's generally easier to choose sunshine or rain today than it is to forecast what the weather will be a week from now.

Actual results still can catch analysts and investors wrong-footed, though. Often announced along with news that such-and-such company reported results that beat analyst expectations are the positive gains the stock saw as a result of the surprise. Same in the opposite direction, with earnings misses often seeing disappointed investors selling shares. Those individual beats and misses aren't all that valuable. After all, failure to estimate demonstrates lack of foresight, while the reaction is hard to catch real-time or in advance. Neither are super-valuable the changes over time that analysts make to their estimates for individual company earnings based on additional insight they may gather from their own work, from the efforts of their peers and from discussions with company management and other industry participants.

Still, that does not mean that analyst estimates are without any value. In Figure 2, we see those same data we offered in the prior chart but laid out across time. The big dots show the year for which the data are being given along with the change from the initial (three year-prior) estimate at the end of the year in question. We still see that same tendency to be overly optimistic early on—lots of red dots expressing a final estimate below the initial one. But what's interesting is how the green dots, which represent years for which early estimates proved too pessimistic, tend to cluster during periods coming out of recessions. And it's not just the end result that may be informative; sharp shifts in trends in those long squiggles for each year—the quickly bottoming estimates we saw in the early part of 2020, for example—may be indicative of a turning point in investor sentiment and market performance.

Figure 2: S&P 500 Index Earnings Estimates

Even though the initial estimates generally prove too optimistic, the longer-term upward march in earnings support a longer-term orientation to investing



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Part of a Mosaic

When collected at the market level, then, analyst estimates may be incorporated into a dashboard of metrics to potentially gain insight into broader trends in macroeconomic activity and investor sentiment. Not that we think investors should base specific investment decisions on such information, as such shifts are hard to spot in real time. And even when sharp turns in sentiment appear, it's hard to know if the shift in trend will prove durable. One need only look at the short zig-then-zag at the start of the present war in Ukraine and a similar presumably COVID-related U-turn in early 2021 to see how placing too much emphasis on such data can poorly serve an investor using the indicator to time markets.

Despite the finding that these sorts of historical views generally provide only might-have-been-valuable-at-the-time insight, we do tend to believe such data may be helpful in explaining longer-term historical trends. For example, they may help to explain the "why" of portfolio performance, in that more durable shifts can be seen as coinciding with changes in market trends. In this way, they represent certain behavioral aspects of market activity that otherwise may be difficult to capture.

Perhaps the better news from the data, zooming out even further, when we look at Figure 2 in its entirety, we see a picture of sometimes halted, but otherwise longer-term positive U.S. corporate earnings growth. We, of course, do not need the analyst estimates for that view, as we could simply look at actual reported results. But all the shifts along the way help to reinforce the idea that, while patience may be required when it comes to investments in equities, that patience has tended to have been rewarded through time.

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