Earnings Forecasts Made Easy

John Price, PhD
Chairman and Co-Founder
Conscious Investing Pty Ltd

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www.conscious-investor.com/

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In the long run, the value of a stock is a function of its earnings. Anticipated future earnings and current earnings.

Even past earnings influence the price. Consider two companies with the same current earnings and the same earnings forecasts. The company with the higher earnings growth rate for its past earnings will likely command a higher price because of its better track record.

Since there is nothing we can do about past earnings and current earnings, the success of an investment is going to depend heavily on how well we can forecast future earnings.

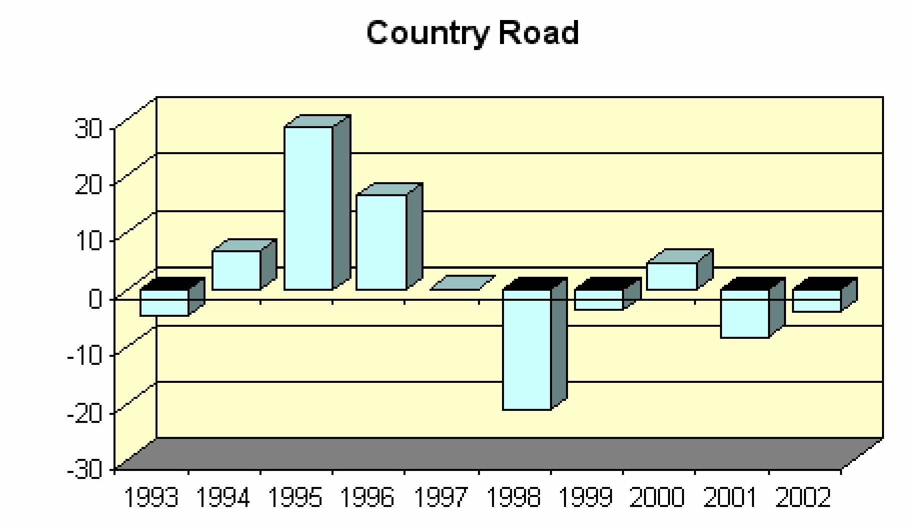
Most investors and investment professionals rely on the forecasts of analysts to make their investment decisions. But this is trying to build an investment portfolio on a very shaky foundation. Crystal ball stuff.

Consider, for example, the following study by Lawrence Brown that was published in the *Financial Analysts Journal* in 1997. Looking at 130,000 forecasts by analysts from 1985 to 1996, he found that the average absolute error was a whopping 91.6 percent. And this was just for the next earnings release which was less than 3 months away.

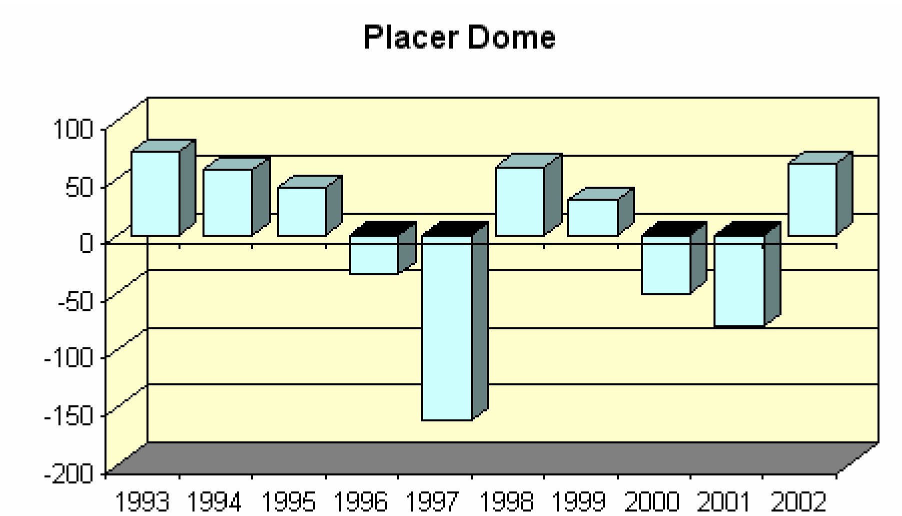
Five year forecasts are much worse. Studies show that analyst forecasts for the growth rate of earnings over the next five years are no better than random.

The difficulty is that analysts are starting behind the eight ball. They are assigned a group of companies and told to forecast their earnings. Unfortunately the earnings of many companies have companies more ups and downs and twists and turns than the Great Ocean Road.

Companies such as Country Road, the clothing wholesaler and retailer, have such a high level of earnings instability that it is really impossible to make any reasonable forecast for its earnings. You can see this in following chart with earning per share careering between a high of 25 cents to a loss of 25 cents.

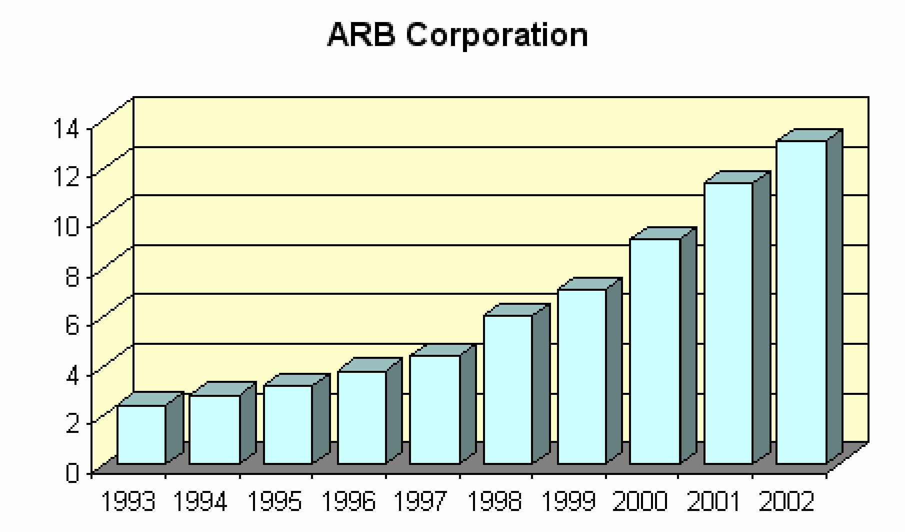


The same drunken path applies to the earnings per share record for the gold mining company Placer Dome Inc.



As investors we do not have this problem. No one tells us which companies to analyze. We have 1,600 companies to choose from so why not turn the problem around and focus on those companies about which we can have most confidence?

Consider, for example, ARB, the manufacturer of equipment and services for four-wheel drive and off-road vehicles. You can see on the chart how smoothly earnings have been growing over the years.



Of course, no one is likely to go through every stock in the market looking for companies with earnings that grow like this.

This is where STAEGR® enters, a new test I developed for my investment software Conscious Investor®. It measures the stability of earnings growth from year to year and expresses it as a percentage. The maximum figure of 100% represents earnings that go up, or down, by the same percentage each year.

The calculations are designed to place more emphasis on the stability of the growth of earnings over recent years. Special adjustments are made for negative earnings, for extreme outliers, and for earnings near zero.

With a single test it is possible to run through thousands of examples looking for those desirable companies with earnings that grow constantly year after year. Finding these companies gives you an investment edge because you can have so much more confidence in how their earnings will grow in the future. Also, all this is done without having to rely on forecast made by analysts.

Research on STAEGR

Of course, the proof is in the eating. We need to test just how well STAEGR helps us in making reliable forecasts of earnings.

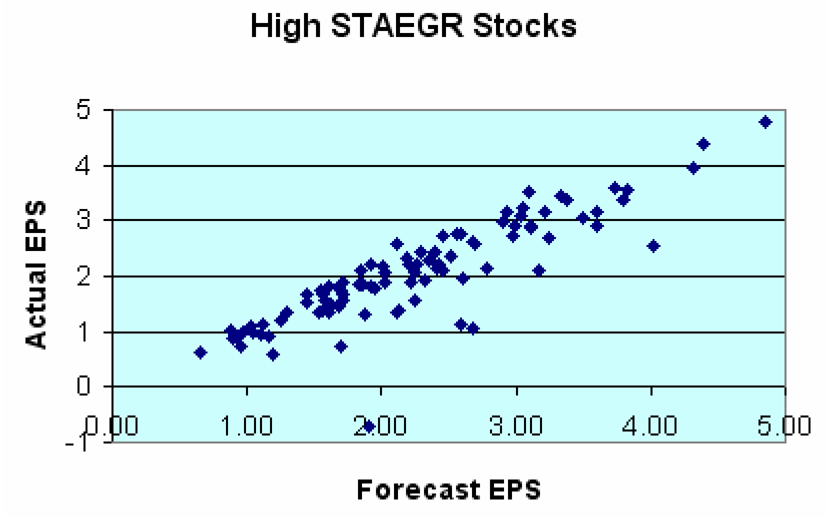
I considered all the companies with eleven years of earnings data from 1992 to 2002 inclusive.[1] Next I divided the companies into ten groups ranging from those with the highest STAEGR over the ten years from 1992 to 2001 to those with the lowest STAEGR over this period. In each case the STAEGR was calculated using earnings per share EPS.

[1] The data used for this research is from the Valueline group of 1700 USA companies. Similar results hold for Australian companies.

Using the ten years of data from 1992 to 2001 I forecast what the EPS would be for 2002 if they continued to grow at the same rate. Finally the forecast EPS were compared with the actual EPS in 2002.

In other words, we are trying to see how well past EPS predicted future EPS.

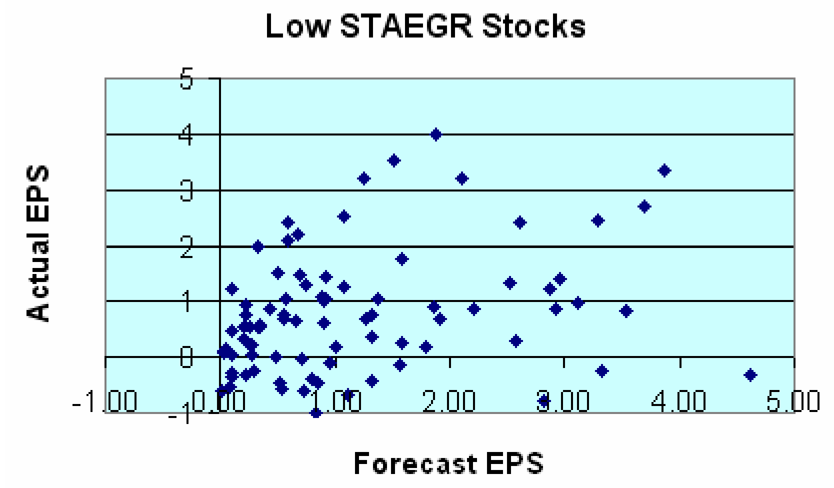
The result of most interest to us was for the stocks with the highest level of STAEGR. As can be seen in the following chart, past growth rates of EPS allowed very accurate forecasts of future earnings.



The fact that the points lie very close to a line shows that the actual EPS were very close to the values that were forecast. Obviously something very important for investors.

In contrast, the accuracy of the predictions for the stocks with lowest STAEGR was useless with no worthwhile accuracy. They were no better than random.

This can be seen in the following chart where the points are randomly scattered.



The study shows that you can have more confidence that earnings will continue to grow in the fuutre at the same rate as they grew in the past for stocks with a high level of STAEGR.

Here are some of the companies with the highest levels of STAEGR.

Name	STAEGR
McGuigan Simeon Wines	97.20%
ARB Corporation	97.00%
Westfield Holdings	94.30%
APN News and Media Ltd	93.50%
Hills Industries	93.50%
The Australian Gas Light Company	92.60%
Nufarm	92.50%
Foodland Associated	91.70%
Coca-Cola Amatil	91.40%
Leighton Holdings	89.80%
CSL	89.80%
Wesfarmers	89.60%
Pacifica Group	89.40%
Harvey Norman Holdings	88.40%
Campbell Brothers	87.40%
Rural Press	87.00%
Perpetual Trustees Australia	86.20%
Ridley Corporation	85.50%

It is important to recognize that STAEGR is a means of helping make more accurate forecasts of earnings. It does not say whether a particular stock is a worthwhile investment or not.

But having confidence in any forecasts using STAEGR is a good first step. It is just one of the proprietary tools in Conscious Investor to help you find those great companies selling at attractive prices.