QUANTITATIVE RESEARCH

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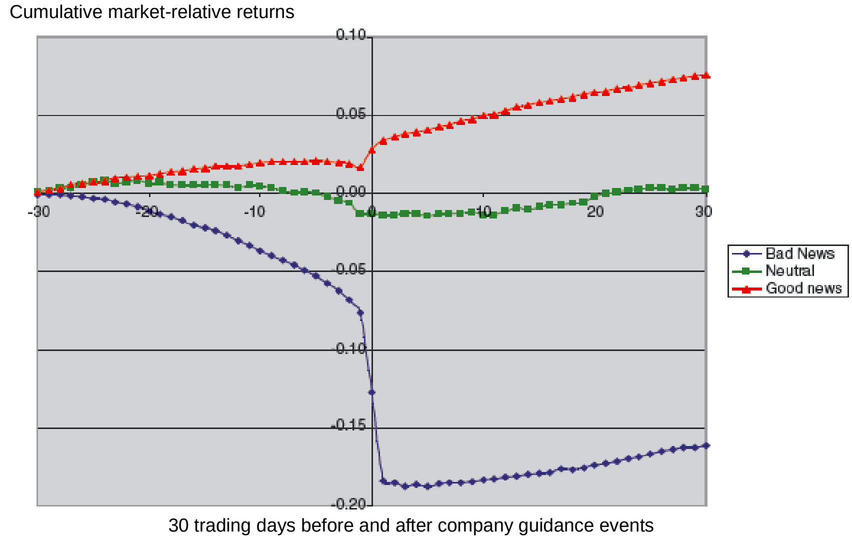
Extracting value from company issued guidance

We highlight a study that is the first of its kind to show when company issued guidance is more accurate than the analyst consensus. Predictability in the way stock prices react to unexpected company guidance provides a new potential source of alpha.

Figure 1: Event study of typical price trends before and after company guidance



SOURCE: DAS, KIM & PATRO, JOURNAL OF BUSINESS FINANCE & ACCOUNTING, 2012

The accuracy of predicted earnings is essential to a wide range of investors who attempt to correctly value the firms they invest in. The fact that 50% of company guidance estimates in a recent study were more accurate than the prevailing analyst consensus forecasts therefore deserves attention.

When are managers more accurate than analysts?

For the first time an academic study sheds light on situations where company issued guidance may be a more accurate predictor of full-year earnings than the consensus of analyst forecasts. According to the study, analysts seem to have an informational advantage in ascertaining the longer-term impact of industry or macro shocks, but this advantage tends to dissipate as the forecast time horizon shortens. Company managers, on the other hand, have an informational advantage when their firms experience difficulties of excess capacity and the associated uncertainty about the future managerial decisions to address their operational problems.

Stock price predictability after company guidance

We highlight another academic study showing predictable trends in stock prices after the issuance of company guidance that surprises the market. Guidance above analyst consensus forecasts leads to positive trends, on average. The effect is quite strong and relatively long lived, allowing large funds to potentially profit from this.

INTRODUCTION

As in our previous note on target prices and analyst recommendations ('Alpha evidence for target prices and analyst recommendations', 25 September 2013), we borrow more ideas from a very insightful series of books by Dr Jeffrey Mishlove, appropriately entitled 'The alpha interface'. In this note we highlight two academic papers referred to in his book.

To both fundamental and systematic quant fund managers, the accuracy of future earnings predictions, and potential surprises and disappointments around earnings realisations, is the 'holy grail' of stock market investing. This paper does not provide the instant gratification of a stock list to buy and sell, but puts forward a fundamental challenge to the way we incorporate and weigh up company guidance estimates when they contend with predictions from fundamental company analysts.

When are analysts more accurate than company guidance?

We examine a recent paper, 'Do managers always know better? The relative accuracy of management and analyst forecasts' (Hutton, 2012). This is the first paper to compare the informational advantages (relating to a company's future success) between company managers and sell-side analysts, and how this affects their relative forecast accuracy. Even though company managers are experts in understanding their own companies and the industries in which they operate, the author of this paper still finds that, about 50% of the time, analyst consensus forecasts tend to predict full-year company earnings more accurately than the company's own managers.

The author's measure of forecast accuracy is the absolute difference between the forecast (whether it is the IBES consensus analyst forecast or the First Call 'company issued guidance') and actual year-end reported earnings. The dataset ranges between January 2001 and December 2007. The author only considers guidance related to the full financial year end and excludes all guidance issued in the fourth quarter of a financial year.

Company issued guidance normally (89% of the time in the sample) comes as a range and not as a point estimate, and the author normally takes the mid-point of the range as the guidance estimate. Sometimes, however, managers indicate that earnings are expected to be at the low or high end of guidance, in which case the author uses exactly the appropriate low or high end of the given guidance range as the guidance estimate.

The author compares a number of company characteristics between firms in two samples: one where managers predicted earnings more accurately and the other where analysts predicted more accurately. In other words, the analysis is forward-looking in terms of the relative success of analysts versus management forecasts, but backward-looking in terms of company characteristics that were known before the issuance of the company guidance and analyst forecasts.

The results show that analysts tend to have superior prediction ability when company's earnings are very cyclical (ie, when earnings move in line with GDP), when earnings are highly correlated with energy prices or interest rates, when firms are in highly regulated industries (utilities, banks and financials), or when company earnings are highly correlated with their own industries. Analysts seem to have an informational advantage on the longer-term impact of industry or macro shocks, but this dissipates as the forecast time horizon shortens.

According to the paper, company managers have an informational advantage (relating to a company's future prospects) when there is greater uncertainty about their future response to declining or volatile product demand and excess capacity, ie, when fixed costs are high and the company's revenue is volatile from one year to the next, or recently fell below expectations. Managers predict earnings better in loss-making years, when inventories are high, when they issue a point estimate instead of a range (which happens only about 11% of the time) and when their estimate is above the analyst consensus.

Price trends after company issued guidance

Another recent study ('On the anomalous stock price response to management earnings forecasts', Das et al, 2012) shows that profitable trading is possible when acting after unexpected company guidance announcements.

Overall, company guidance in the 10-year data sample is more often negative than positive, even though the disclosure of this information is voluntary in the lead-up to earnings announcements. Company guidance is positive 37% of the time and negative about 46% of the time.

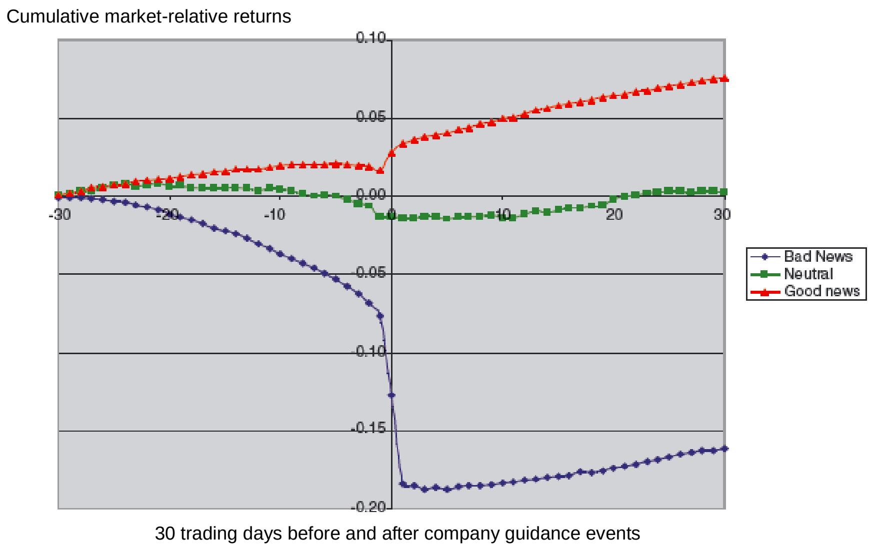
The authors classify guidance announcements – 8,386 US quarterly management earnings forecasts between 1995 and 2004 – as positive when they are more than 1c above the prevailing analyst consensus and negative when more than 1c below consensus (neutral otherwise).

Prices trend strongly upwards after positive guidance, likely because of investors' tendency to initially under-react to good news, a common explanation for price momentum anomalies. The authors observe a large negative initial price impact and subsequent gradual positive drift after below-consensus guidance. It seems that investors initially over-react to bad news, causing the subsequent positive price momentum from about three days after a negative guidance announcement. Finally, neutral company guidance does not lead to significant price trends in their back tests.

Figure 2 is an excerpt from the paper showing results from their event study, with cumulative abnormal returns (relative to a size-weighted US market index) beginning 30 trading days before and ending 30 trading days after the day of guidance (day zero on the x-axis refers to the day of guidance). The chart indicates that stocks with positive guidance tend to beat the market by 1.7% on average in the two days post guidance, and by 4.2% between two days and 30 days after positive guidance is issued. This is a very strong result for a trading strategy that allows more than a full day for implementation. The result is also statistically very significant.

In their sample, bad guidance stocks underperform the market on average by 10.7% in the first two days after guidance, but then recover 2.2% on average between two and 30 days after negative guidance is issued (although the latter result is not very robust). Neutral guidance stocks beat the market by an average of 1.5% over 30 trading days, but the result is very weak statistically.

Figure 2: Event study of price effects before and after issued company guidance



SOURCE: DAS, KIM & PATRO, JOURNAL OF BUSINESS FINANCE & ACCOUNTING, 2012

The authors also perform robustness tests with equally weighted investment portfolios for stocks with good guidance. Their portfolios generate an average of 2.13% return over 30 trading days, entering positions at the close of the day after guidance is issued. This result is independent of market beta, size, value and price momentum. The average of quoted bid-ask spreads at the time of implementation is 1.03% (median = 0.65%), which is low enough to allow for profitable trading. The annualised return, after deducting the average bid-ask spread, for firms with good company guidance is 9.2%.

Further robustness tests indicate that companies' trading profits are not explained away by other known anomalies such as temporary increases in systematic risk, information leakage before earnings announcements, or post-earnings announcement drift.

Conclusion

From the empirical findings highlighted in this report, there is new evidence of the investment value that company guidance estimates provide. These analyses may help us discern when company guidance should be taken at face value as the best estimate or, at other times, perhaps with a pinch of salt.

The market clearly does pay attention to company guidance announcements and whether they contradict consensus expectations. The reaction to unexpected new information from company managers tends to be impounded in stock prices with a significant delay, making it possible to potentially trade profitably after some guidance announcements with a holding period up to 30 trading days.

REFERENCES

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Hutton, AP, Lee, LF, and Shu, SZ (2012) 'Do managers always know better? The relative accuracy of management and analyst forecasts', Journal of Accounting Research, 50(5), 1217-1244.

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OUTPERFORM: The stock's total return is expected to exceed a relevant benchmark's total return by 5% or more over the next 12 months.

NEUTRAL: The stock's total return is expected to be within +/-5% of a relevant benchmark's total return.

UNDERPERFORM: The stock's total return is expected to be below a relevant benchmark's total return by 5% or more over the next 12 months.

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Sector

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NEUTRAL: The industry, as defined by the analyst's coverage universe, is expected to perform in line with the relevant primary market index over the next 12 months.

UNDERWEIGHT: The industry, as defined by the analyst's coverage universe, is expected to underperform the relevant primary market index over the next 12 months.

TRADING BUY: The industry, as defined by the analyst's coverage universe, is expected to outperform the relevant primary market index over the next 3 months.

TRADING SELL: The industry, as defined by the analyst's coverage universe, is expected to underperform the relevant primary market index over the next 3 months.

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Recommendation Framework #2 **

Stock

OUTPERFORM: Expected positive total returns of 10% or more over the next 12 months.

NEUTRAL: Expected total returns of between -10% and +10% over the next 12 months.

UNDERPERFORM: Expected negative total returns of 10% or more over the next 12 months.

TRADING BUY: Expected positive total returns of 10% or more over the next 3 months.

TRADING SELL: Expected negative total returns of 10% or more over the next 3 months.

Sector

OVERWEIGHT: The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of +10% or better over the next 12 months.

NEUTRAL: The industry, as defined by the analyst's coverage universe, has either (i) an equal number of stocks that are expected to have total returns of +10% (or better) or -10% (or worse), or (ii) stocks that are predominantly expected to have total returns that will range from +10% to -10%; both over the next 12 months.

UNDERWEIGHT: The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of -10% or worse over the next 12 months.

TRADING BUY: The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of +10% or better over the next 3 months.

TRADING SELL: The industry, as defined by the analyst's coverage universe, has a high number of stocks that are expected to have total returns of -10% or worse over the next 3 months.

*** This framework only applies to stocks listed on the Korea Exchange, Hong Kong Stock Exchange and China listings on the Singapore Stock Exchange. Occasionally, it is permitted for the total expected returns to be temporarily outside the prescribed ranges due to extreme market volatility or other justifiable company or industry-specific reasons.*

Corporate Governance Report of Thai Listed Companies (CGR). CG Rating by the Thai Institute of Directors Association (IOD) in 2012.

AAV – not available, **ADVANC** - Excellent, **AEONTS** – Good, **AMATA** - Very Good, **ANAN** – not available, **AOT** - Excellent, **AP** - Very Good, **BANPU** - Excellent , **BAY** - Excellent , **BBL** - Excellent, **BCH** – not available, **BCP** - Excellent, **BEC** - Very Good, **BGH** - not available, **BJC** – Very Good, **BH** - Very Good, **BIGC** - Very Good, **BTS** - Excellent, **CCET** - Good, **CENTEL** – Very Good, **CK** - Very Good, **CPALL** - Very Good, **CPF** - Very Good, **CPN** - Excellent, **DELTA** - Very Good, **DTAC** - Very Good, **EGCO** – Excellent, **ERW** – Excellent, **GLOBAL** - Good, **GLOW** - Very Good, **GRAMMY** – Excellent, **HANA** - Very Good, **HEMRAJ** - Excellent, **HMPRO** - Very Good, **INTUCH** – Very Good, **ITD** – Very Good, **IVL** - Very Good, **JAS** – Very Good, **KAMART** – not available, **KBANK** - Excellent, **KK** – Excellent, **KTB** - Excellent, **LH** - Very Good, **LPN** - Excellent, **MAJOR** - Good, **MAKRO** – Very Good, **MCOT** - Excellent, **MINT** - Very Good, **PS** - Excellent, **PSL** - Excellent, **PTT** - Excellent, **PTTGC** - Excellent, **PTTEP** - Excellent, **QH** - Excellent, **RATCH** - Excellent, **ROBINS** - Excellent, **RS** – Excellent, **SAMART** – Excellent, **SC** – Excellent, **SCB** - Excellent, **SCC** - Excellent, **SCCC** - Very Good, **SIRI** - Good, **SPALI** - Very Good, **SRICHA** – not available, **SSI** – not available, **STA** - Good, **STEC** - Very Good, **TCAP** - Very Good, **THAI** - Excellent, **THCOM** – Very Good, **TICON** – Very Good, **TISCO** - Excellent, **TMB** - Excellent, **TOP** - Excellent, **TRUE** - Very Good, **TTW** – Very Good, **TUF** - Very Good, **VGI** – not available, **WORK** – Good.