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Perspectives on Corporate Finance and Strategy

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No executive would dispute that analysts’ forecasts serve as an important benchmark of the current and future health of companies. To better understand their accuracy, we undertook research nearly a decade ago that produced sobering results. Analysts, we found, were typically overoptimistic, slow to revise their forecasts to reflect new economic conditions, and prone to making increasingly inaccurate forecasts when economic growth declined.¹

Alas, a recently completed update of our work only reinforces this view—despite a series of rules and regulations, dating to the last decade, that were intended to improve the quality of the analysts’ long-term earnings forecasts, restore investor confidence in them, and prevent conflicts of interest.² For executives, many of whom go to great lengths to satisfy Wall Street’s expectations in their financial reporting and long-term strategic moves, this is a cautionary tale worth remembering.

Exceptions to the long pattern of excessively optimistic forecasts are rare, as a progression of consensus earnings estimates for the S&P 500 shows (Exhibit 1). Only in years such as 2003 to 2006, when strong economic growth generated actual earnings that caught up with earlier predictions, do forecasts actually hit the mark.
Exhibit 1  
Off the mark

With few exceptions, aggregate earnings forecasts exceed realized earnings per share.

Exhibit 2  
Overoptimistic

Actual growth surpassed forecasts only twice in 25 years—both times during the recovery following a recession.

1 Analysts’ 5-year forecasts for long-term consensus earnings-per-share (EPS) growth rate. Our conclusions are same for growth based on year-over-year earnings estimates for 3 years.

2Actual compound annual growth rate (CAGR) of EPS; 2009 data are not yet available, figures represent consensus estimate as of Nov 2009.

Source: Thomson Reuters I/B/E/S Global Aggregates; McKinsey analysis
Less giddy

Capital market expectations are more reasonable.

This pattern confirms our earlier findings that analysts typically lag behind events in revising their forecasts to reflect new economic conditions. When economic growth accelerates, the size of the forecast error declines; when economic growth slows, it increases. So as economic growth cycles up and down, the actual earnings S&P 500 companies report occasionally coincide with the analysts’ forecasts, as they did, for example, in 1988, from 1994 to 1997, and from 2003 to 2006.

Moreover, analysts have been persistently overoptimistic for the past 25 years, with estimates ranging from 10 to 12 percent a year, compared with actual earnings growth of 6 percent. Over this time frame, actual earnings growth surpassed forecasts in only two instances, both during the earnings recovery following a recession (Exhibit 2). On average, analysts’ forecasts have been almost 100 percent too high.

Capital markets, on the other hand, are notably less giddy in their predictions. Except during the market bubble of 1999–2001, actual price-to-earnings ratios have been 25 percent lower than implied P/E ratios based on analyst forecasts (Exhibit 3). What’s more, an actual forward P/E ratio of the S&P 500 as of November 11, 2009—14—is consistent with long-term earnings growth of 5 percent.

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1 P/E ratio based on 1-year-forward earnings-per-share (EPS) estimate and estimated value of S&P 500. Estimated value assumes: for first 5 years, EPS growth rate matches analysts’ estimates then drops smoothly over next 10 years to long-term continuing-value growth rate; continuing value based on growth rate of 6%; return on equity is 13.5% (long-term historical median for S&P 500), and cost of equity is 9.5% in all periods.
2 Observed P/E ratio based on S&P 500 value and 1-year-forward EPS estimate.
3 Based on data as of Nov 2009.
Source: Thomson Reuters I/B/E/S Global Aggregates; McKinsey analysis

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This assessment is more
reasonable, considering that long-term earnings growth for the market as a whole is unlikely to differ significantly from growth in GDP, as prior McKinsey research has shown. Executives, as the evidence indicates, ought to base their strategic decisions on what they see happening in their industries rather than respond to the pressures of forecasts, since even the market doesn’t expect them to do so.

1 Marc H. Goedhart, Brendan Russell, and Zane D. Williams, “Prophets and profits,” mckinseyquarterly.com, October 2001.
2 US Securities and Exchange Commission (SEC) Regulation Fair Disclosure (FD), passed in 2000, prohibits the selective disclosure of material information to some people but not others. The Sarbanes–Oxley Act of 2002 includes provisions specifically intended to help restore investor confidence in the reporting of securities’ analysts, including a code of conduct for them and a requirement to disclose knowable conflicts of interest. The Global Settlement of 2003 between regulators and ten of the largest US investment firms aimed to prevent conflicts of interest between their analyst and investment businesses.
3 The correlation between the absolute size of the error in forecast earnings growth (S&P 500) and GDP growth is −0.55.
4 Our analysis of the distribution of five-year earnings growth (as of March 2005) suggests that analysts forecast growth of more than 10 percent for 70 percent of S&P 500 companies.
5 Except 1998–2001, when the growth outlook became excessively optimistic.
6 We also analyzed trends for three-year earnings-growth estimates based on year-on-year earnings estimates provided by the analysts, where the sample size of analysts’ coverage is bigger. Our conclusions on the trend and the gap vis-à-vis actual earnings growth does not change.
7 Market-weighted and forward-looking earnings-per-share (EPS) estimate for 2010.
8 Assuming a return on equity (ROE) of 13.5 percent (the long-term historical average) and a cost of equity of 9.5 percent—the long-term real cost of equity (7 percent) and inflation (2.5 percent).
9 Real GDP has averaged 3 to 4 percent over past seven or eight decades, which would indeed be consistent with nominal growth of 5 to 7 percent given current inflation of 2 to 3 percent.