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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT: EARNINGS PROJECTIONS

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How Bad Are Analysts' Earnings Projections?

Ever since the bubble burst, the financial media have pilloried equity analysts for pulling a fast one over on investors. Like Claude Rains in *Casablanca*, they are "shocked, shocked" to uncover conflicts of interest and forecasts built on not much more than fantasy and fuzzy math. Notwithstanding the bursting of this bubble of popular idealism, the upward bias among analysts and their projections has been around for years. In this discussion, we ignore the important issues related to analysts' use of operating earnings, which tends to overstate earnings, because this was explored in great depth last month.[1] Instead, we focus on quantifying some of this structural exuberance by looking at projected and actual I/B/E/S consensus S&P 500 earnings from several vantage points. We make the following observations.

According to I/B/E/S, the current consensus among analysts expects S&P 500 earnings to total $46.20 in 2001 and $53.17 in 2002 (see Table A) reflecting declines of 17.6% and 5.2%, respectively from the actual earnings level in 2000 ($56.10). Analysts' earnings estimates for 2001 were well above 2000 levels when they were first submitted to I/B/E/S, with 2001 earnings forecasts falling 14.2% from $67.89 in February of 2000 to $58.29 one year later, and another 20.7% to $46.20 as of November 2001. If the consensus estimate for the rest of the year proves to be correct and 2001 earnings are $46.20, their initial estimate will be off by 31.9% and their beginning-of-year expectations will be off by 22.4%.

Similarly, expectations for 2002 began the year at a high level, $68.19, a figure slightly higher than the year-beginning estimate for 2001, as analysts forecasted a V-shaped rebound in earnings after the poor performance in 2001. However, as the year has progressed, estimates have fallen 22.0%, a similar magnitude as the decline in 2001's estimates.

The recent overestimates, while significant, are not extraordinary for analysts. A comparison of analyst consensus S&P 500 earnings estimates at the start of the year to actual earnings reveals that only in three out of the last 15 years did actual earnings equal or exceed projected earnings (see Table B). In other words, analyst projections exceeded actual earnings 80% of the time. The largest disparity was a 30% overestimate in 1991. On average, over the last 15 years projected earnings exceeded actual earnings by 11.6%, ranging from a high of a 30.5% overestimate to a low of a 6.8% underestimate.

Furthermore, since at least 1986 (when our data series begins), analysts never forecasted earnings *growth* to fall, and they were wrong in 1986, 1990, 1991, and 1998—years when actual growth rates

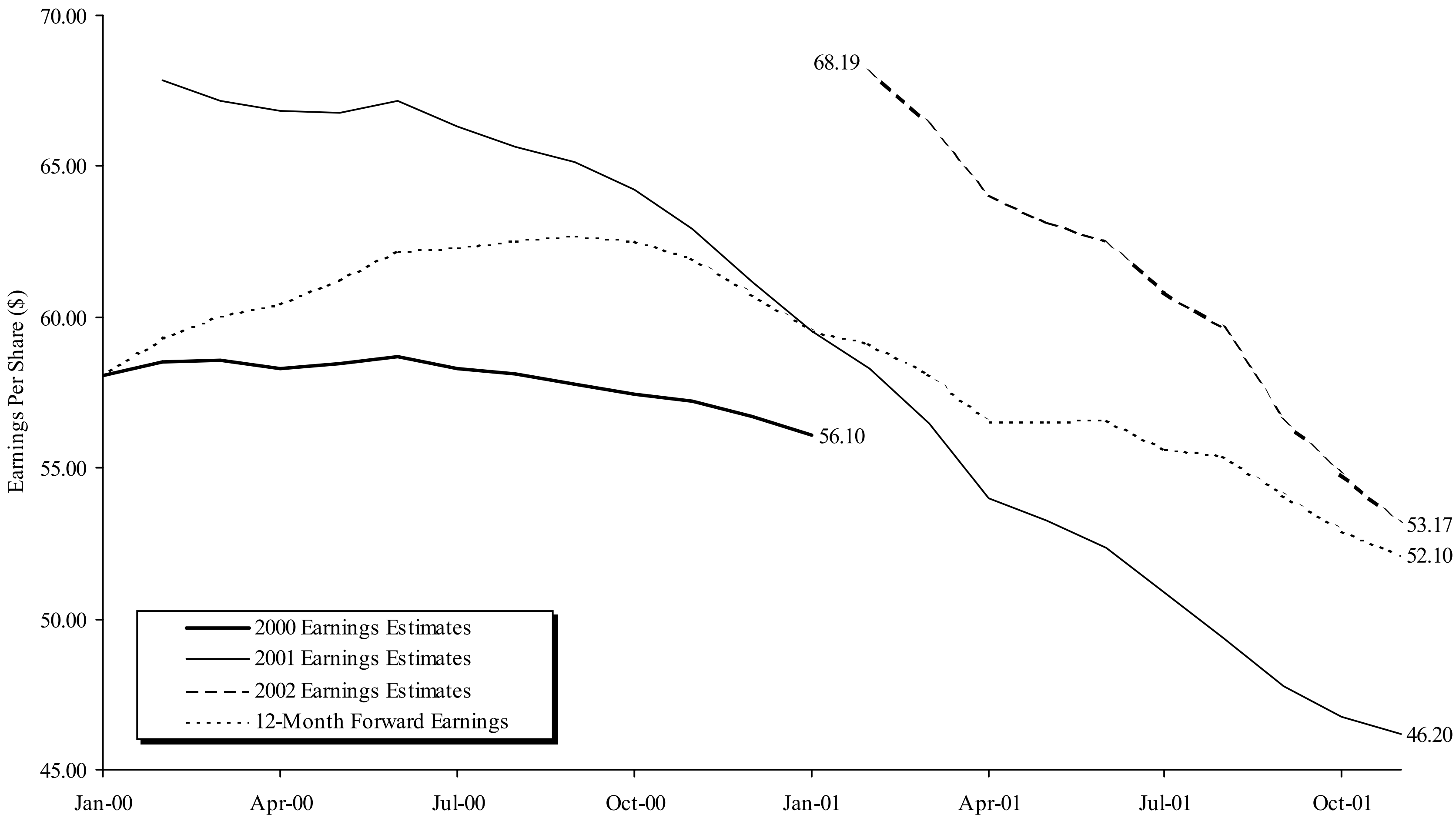
[1] See our November 2001 report, *Writing Down Current U.S. Equity Valuations.*

dropped into negative territory (see Table C). Moreover, for these four years of negative actual earnings growth, analyst estimates were not even in the same ballpark, with overestimates of 29%, 25%, 30%, and 15%, respectively.

Therefore, investors should exercise caution in valuing equities on the basis of forward earnings expectations, as they persistently include an upward bias. Current price-earnings ratios on 12-month forward earnings projections are 21.9, which is high even when compared to historical forward price-earnings ratios, which have averaged 13.3 since 1978.

Table A

I/B/E/S EARNINGS ESTIMATES

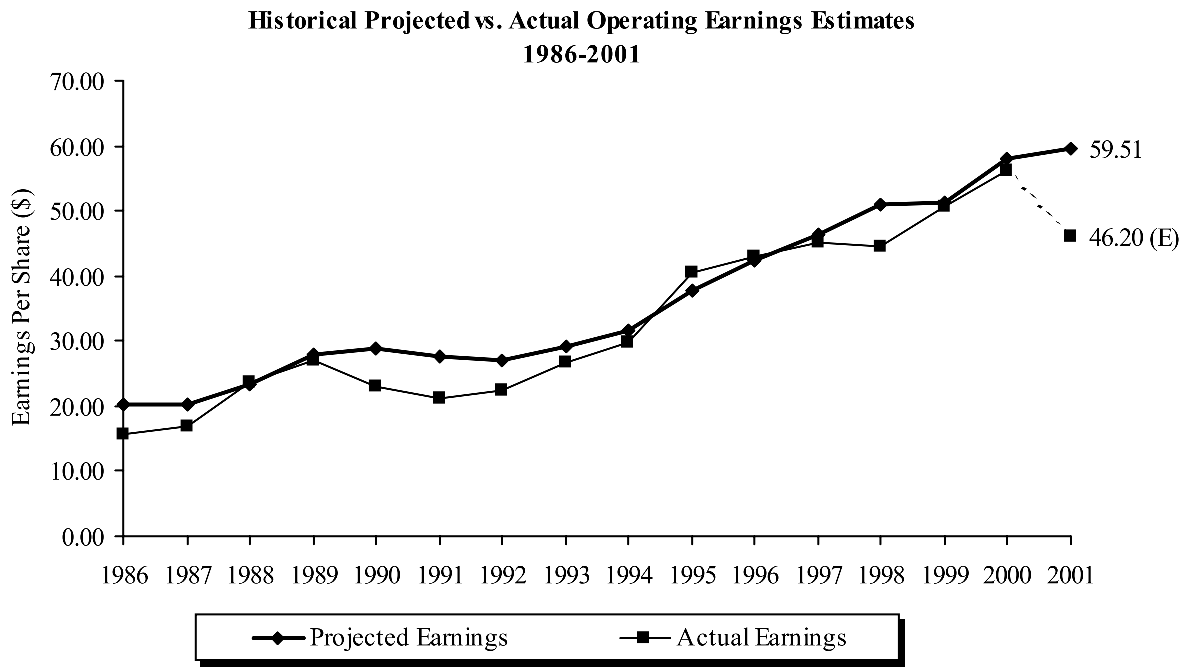


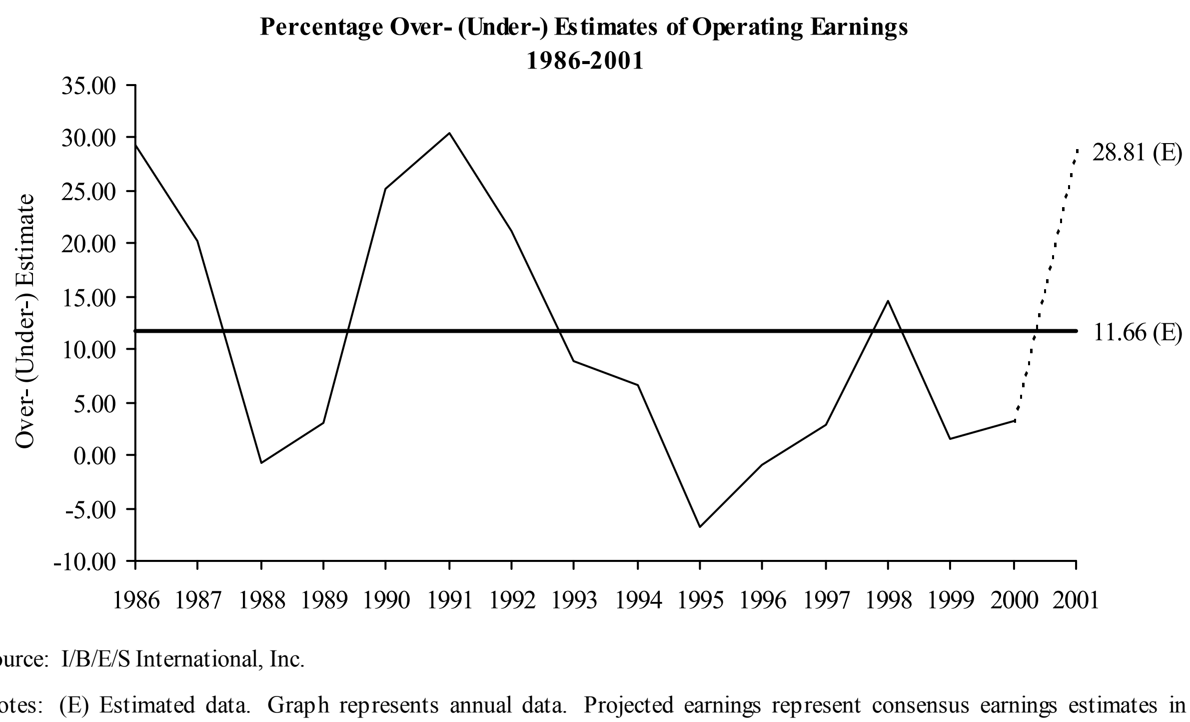
Source: I/B/E/S International, Inc.

Note: The beginning values for the 2000, 2001, and 12-month forward earnings estimates are $58.09, $67.87, and $58.09, respectively.

Table B

S&P 500 ACTUAL AND PROJECTED I/B/E/S CONSENSUS OPERATING EARNINGS





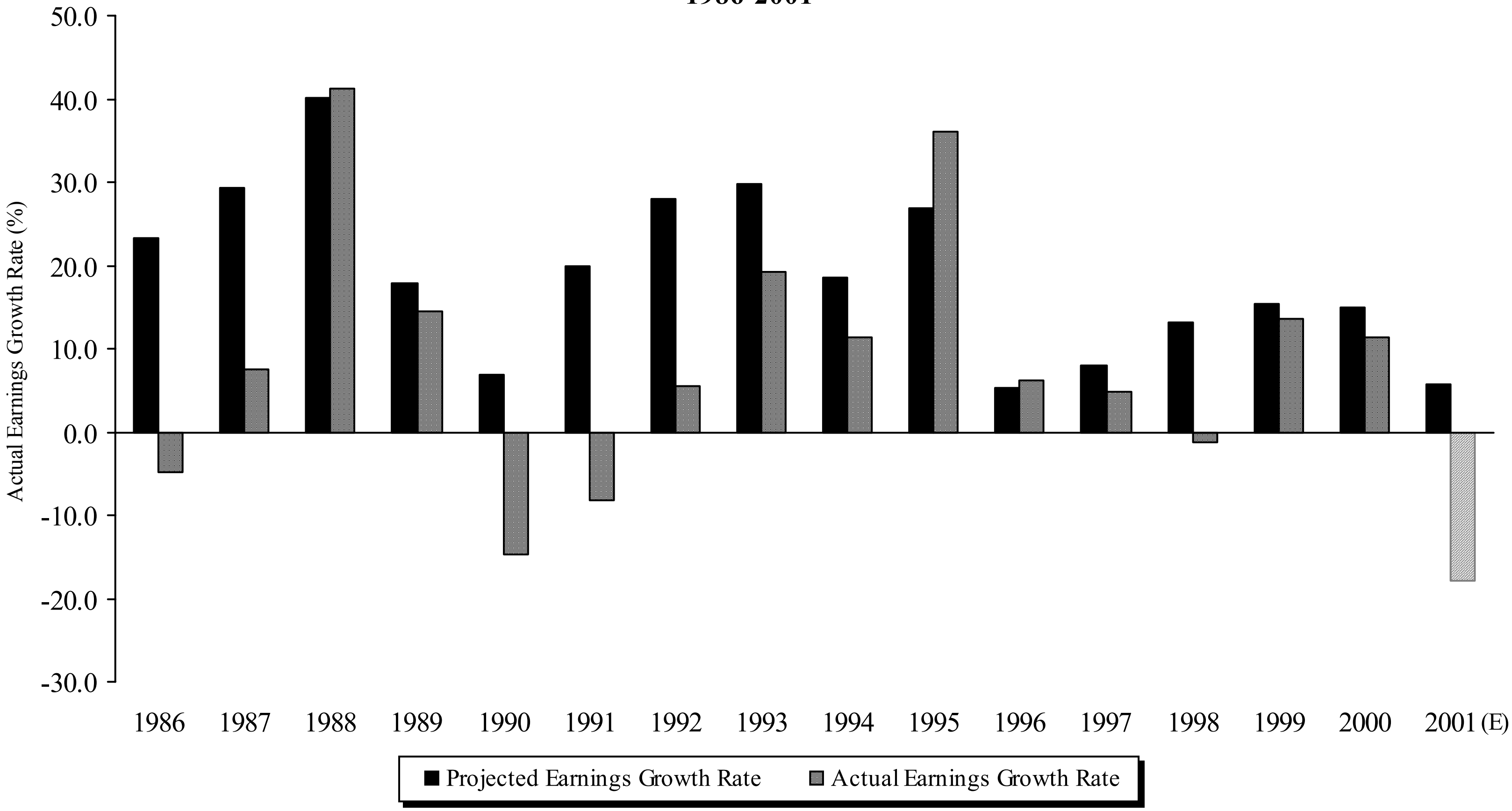
Source: I/B/E/S International, Inc.

Notes: (E) Estimated data. Graph represents annual data. Projected earnings represent consensus earnings estimates in January for each year. Dashed line in the top graph represents the 2001 calendar year earnings estimate reported by I/B/E/S in November 2001. This estimate is included in the 2001 estimated overestimation illustrated by a dashed line in the bottom graph.

Table C

S&P 500 ACTUAL AND PROJECTED I/B/E/S CONSENSUS OPERATING EARNINGS GROWTH RATES

1986-2001



Source: I/B/E/S International, Inc.

Notes: (E) Estimated data. Projected Earnings Growth is based on consensus earnings estimates in January for each year. 2001 actual earnings growth is the 2001 calendar year earnings estimate reported by I/B/E/S in November 2001.