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CAMBRIDGE ASSOCIATES LLC

U.S. MARKET COMMENT: REALITY EARNINGS

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(Corporate) American Idyll

Better-than-expected earnings announcements for the first quarter have generated a substantial amount of buzz in financial markets, fueling a 12.2% rally in the S&P 500 from March 11 through April 25. Positive reports have, at least temporarily, allayed worries about the health of Corporate America. Thus far in this confession season, most companies have surpassed consensus growth expectations by a respectable margin, prompting analysts to raise first quarter growth targets to 12% to 14%. This range represents a considerable increase from recent forecasts as low as 7% to 9%, and is certainly much better than 2.2% growth for the year ended in the fourth quarter 2002. These results also make expectations for the 2003 calendar year seem realistic. According to EKN, the consensus currently expects S&P 500 operating earnings to reach $53.82 for 2003, which would represent 15.8% growth for the year (see Tables A and B). Double-digit growth reports are all the more impressive considering they came amid March's steady stream of negative economic news. All the data, it seems, are coming in well below expectations: consumer spending, first quarter GDP growth, capacity utilization, and employment.

However, some of the rosy hue surrounding this upbeat snapshot begins to fade when placed in a slightly longer-term perspective. The 12% to 14% first quarter growth range, while quite respectable, is also substantially lower than the 20.4% growth expected as recently as June 2002. In addition, the $53.82 forecast for the S&P 500 is 17.3% lower than the $65.08 forecast made in January 2002.

America's Most Talented Analyst

Placed in an even longer historical context, investors should count themselves quite fortunate if earnings were to actually bottom or stabilize at current levels. Analysts *always* lower their expectations as the year progresses—there is nothing unusual or alarming about this pattern *per se*. Although 2003 is still quite young, current downward revisions in earnings expectations are on par with or even smaller than past reductions.

Since 1986, analysts have missed actual earnings growth results by an average of 11.0% on a calendar year basis (see Table C). In only three years (1988, 1995, and 1996) did actual earnings equal or surpass projected earnings. In other words, analyst projections exceeded actual earnings 82% of the time. The worst years for analysts were 1986 and 1991 when projections missed their mark by 28.0 percentage points (in 1986, projected 23.2% growth vs. actual -4.8% growth, and 1991, projected 19.8% growth vs. -8.2% actual). The year 2001 was the third worst in the annals of analyst accuracy, when they overestimated actual earnings by 24.5 points (4.9% expected growth vs. actual -19.5%).

Who Wants to be Profitable?

For the second and third quarters, the consensus expects the S&P 500 to grow 6.3% and 13.4%, respectively. Whether or not corporate profits have indeed begun to turn around will largely depend on earnings for the capital-spending sensitive sectors of technology, industrials, and materials sectors. Current growth expectations for these two quarters are

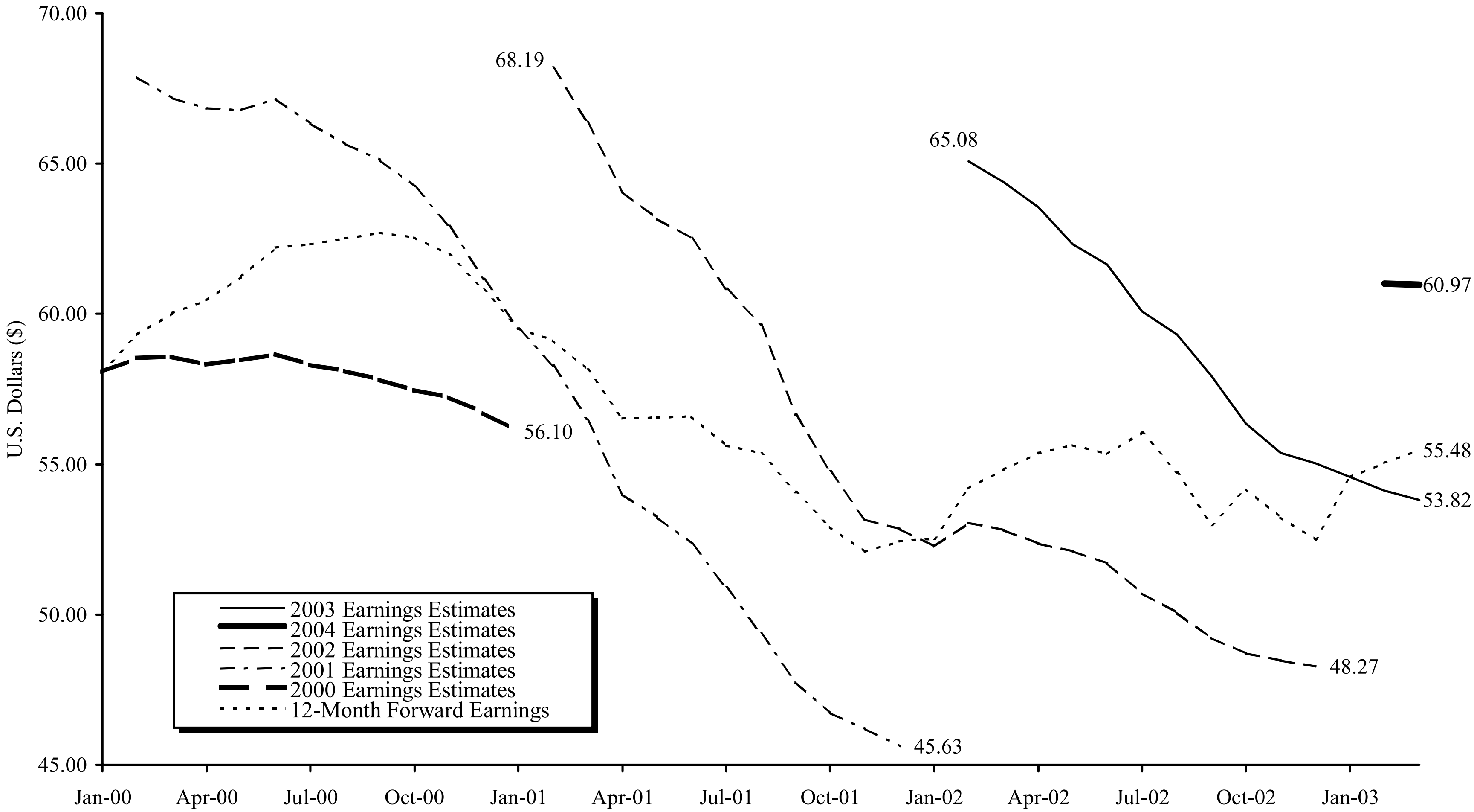
25.7% and 66.1% for technology, -8.3% and 8.5% for industrials, and -3.1% and 20.5% for materials. If earnings announcements exceed expectations for the second quarter and meet (or surpass) the aggressive forecasts for the third quarter, they will point to improving trends in capital spending.

Survivor: Wall Street

A final observation concerns the persistence of the practice of beating analyst projections. Contrary to daily media reports of financial scandals, deceit, and conflicts of interest, the game of "guiding" analyst projections to levels that subsequently allow corporations to beat their earnings expectations has *not* been thoroughly discredited. The apparent persistence of this practice suggests that bullish sentiment refuses to die. We reiterate our position that investors try to winnow out the daily noise, stick to their policy portfolios, and vote analysts off the island.

Table A

I/B/E/S EARNINGS ESTIMATES



Sources: Ehrenkrantz King Nussbaum, Inc. and Thomson Financial.

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 AND SELECTED SECTOR EARNINGS GROWTH EXPECTATIONS FOR 2003

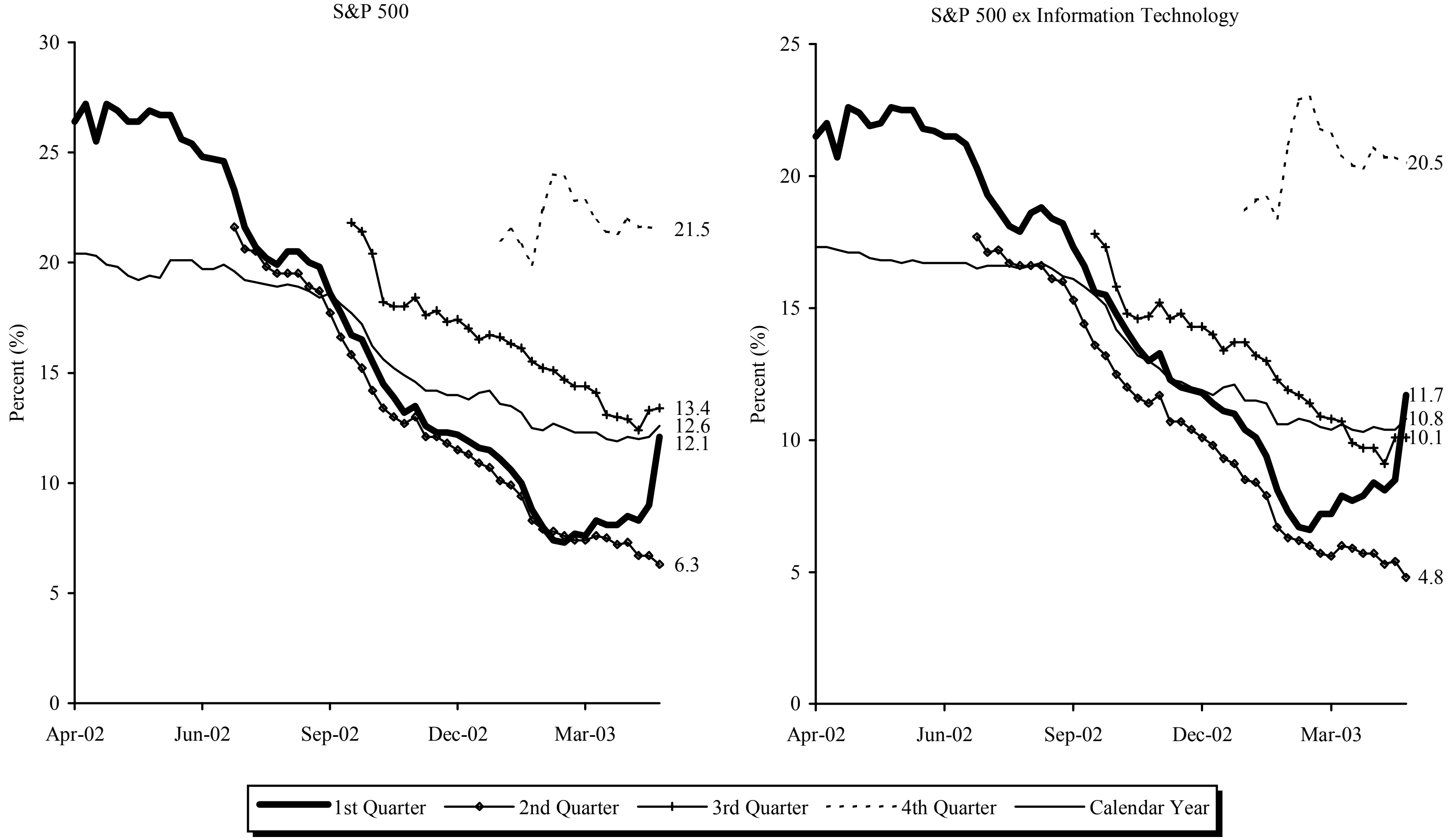
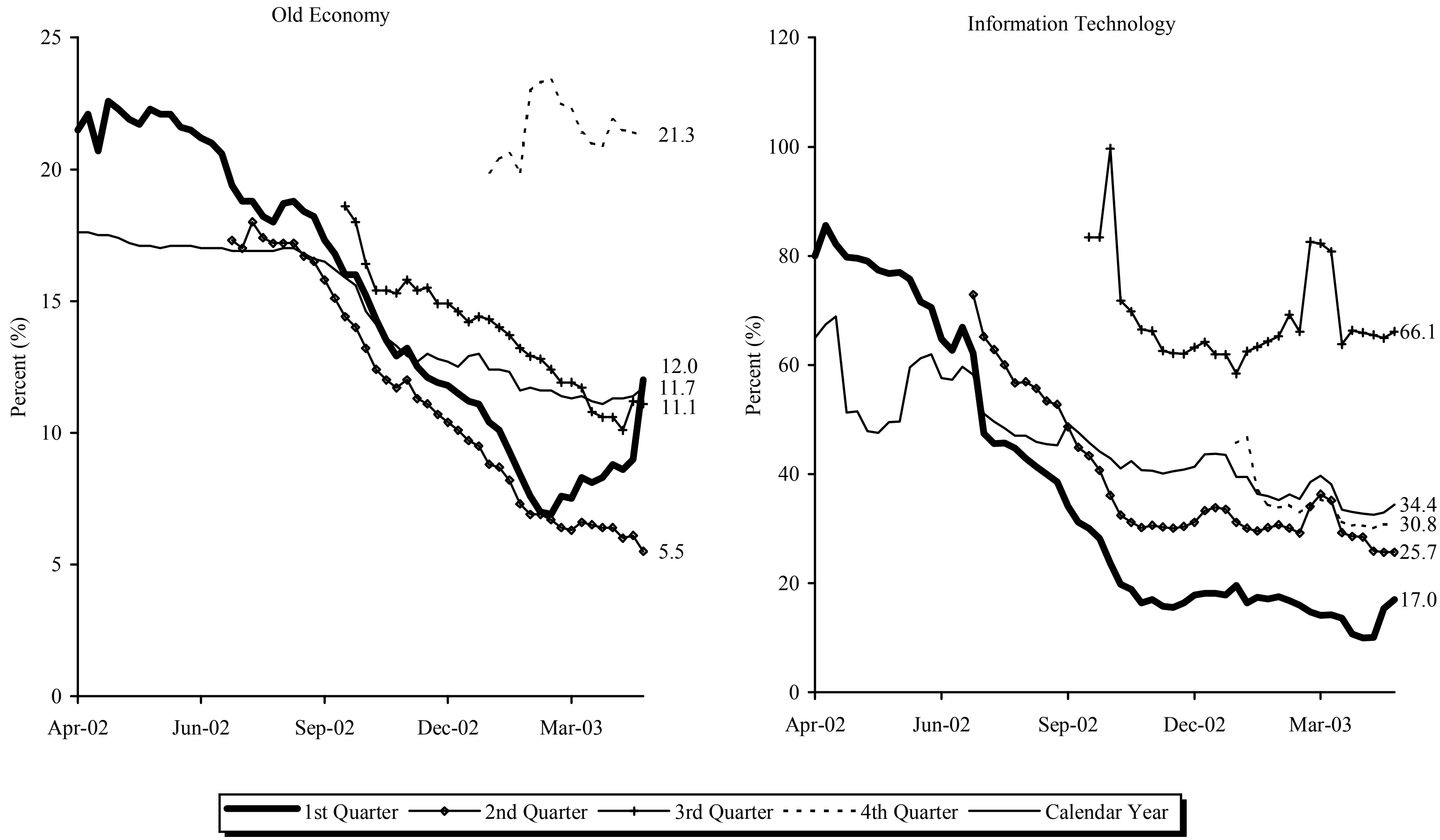


Table B (continued)

S&P 500 AND SELECTED SECTOR EARNINGS GROWTH EXPECTATIONS FOR 2003



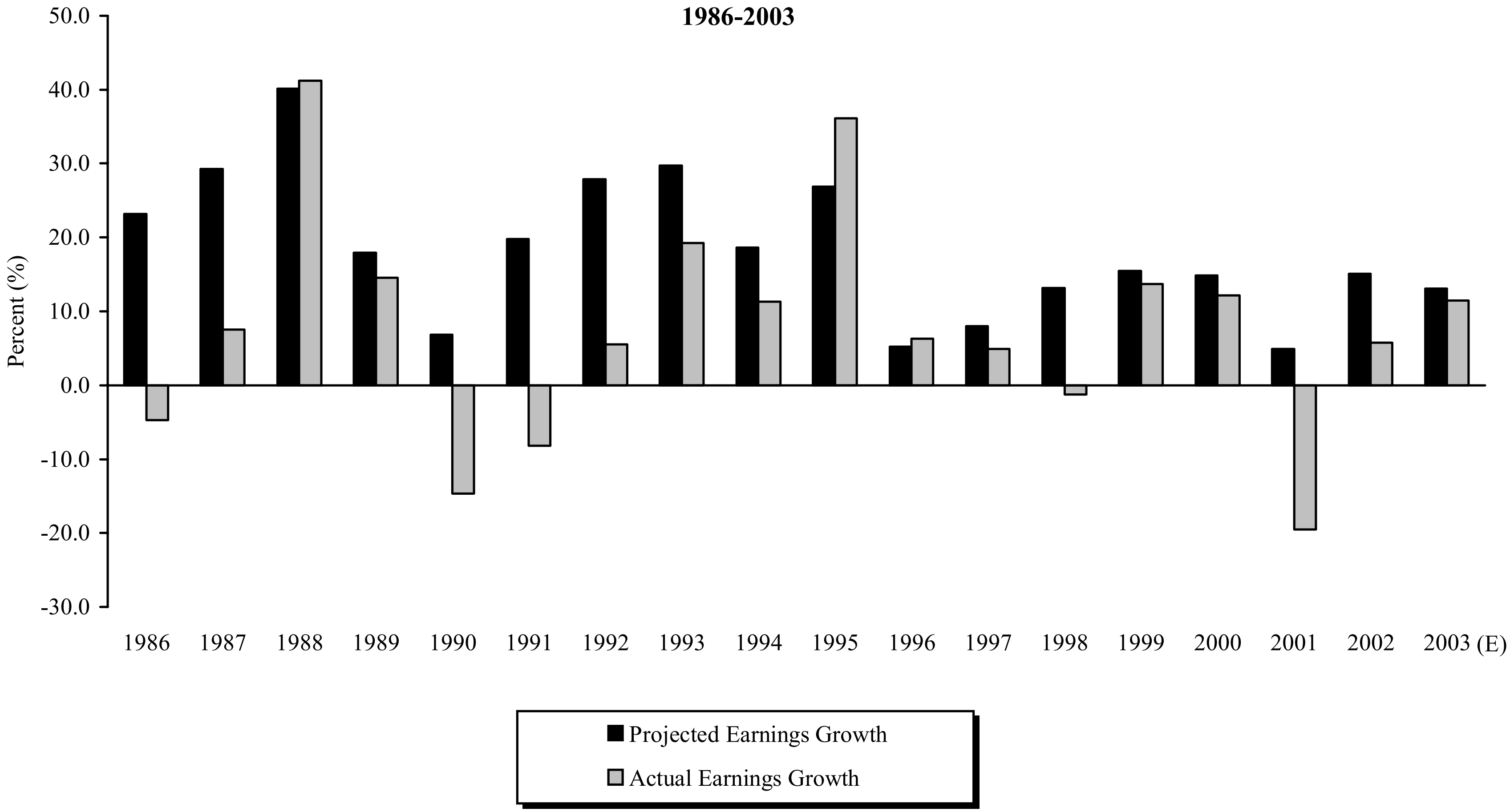
Sources: Morgan Stanley Research and Thomson Financial First Call.

Note: The Old Economy sector consists of the S&P 500 excluding the Information Technology and Telecommunication sectors.

Table C

S&P 500 ACTUAL AND PROJECTED EARNINGS GROWTH

1986-2003



Sources: Ehrenkrantz King Nussbaum, Inc. and Thomson Financial.

Notes: Projected earnings growth is based on consensus earnings estimates in January for each year. Actual earnings growth for 2003 is the 2003 calendar year earnings estimate reported in March 2003.