

Don't miss the Party

26 July 2010



Most of us have attended that typical function, party, wedding or just a gathering, which by all means one would have wanted to evade, just to be surprised by a wonderful evening. Rather than leaving the party at ten o'clock as you had planned, you find yourself happily socialising at midnight, and the initial reluctance is replaced by bubbly enthusiasm.

When companies release their annual results, investors have the same type of expectations, based on the consensus forecasts of the analysts. If a company surprises the market with better results than expected (or, more specifically, growth in earnings), the shares then show a very positive reaction. On the other hand, if the company declares weaker results than expected, this in its turn can have a negative effect on investor sentiment and can cause the market to crash, as in 2008. It does not matter how much better a company's results are in comparison with its previously reported period, if it does not achieve at least the expected results it can still cause the share price to collapse, just because the expected "party" simply was not what everyone had expected. Clearly these consensus forecasts are very closely watched and play an important role in short-term market fluctuations.

These "surprises" in earnings can actually be seen as a criterion of the "incorrect" forecasts of analysts (not that I want to make out any analyst as a soothsayer at this stage). Although there are quite a number of analysts who produce highly accurate forecasts, there are still those who usually miss the real objective by at least a mile. There is a variety of good reasons why some analysts succeed in getting these forecasts wrong:

1. The most important reason is that it is really is not easy to make forecasts regarding earnings. Analysts cannot make forecasts by merely sucking the figures from their thumb. Endless variables must be taken into account, and even then, the unexpected still remains something that cannot be calculated.
2. Various lines of research have shown that analysts generally demonstrate a "herd instinct", which means that in due course, most of the analyses are in any event adjusted to be closer to each other's forecasts. The fact is that the herd is not always right.
3. Over-optimism is one of the greatest dangers for incorrect forecasts.
4. Companies in general have acquired the art, by means of good press conferences and other meetings, to soften the blows if there is bad news for the analysts.

Taking into account the present state of affairs, with most of the S&P 500 companies that are reporting a present, it can be noted that of the 54 companies who have already reported, 43 (or 80%) have easily exceeded the analysts' expectations (by an average of 11,1% better than expected). My message this week is briefly: Do not miss the whole "party" just because you think it is not going to turn out pleasantly. The present surprises are on the positive side and this once again confirms my view that the economy is surely but slowly recovering!



Schalk Louw

schalk@contego.co.za

+27 021-914 -7444

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