

# Barron's Online

Monday, February 24, 2003

## EDITORIAL COMMENTARY .....

### "Just Say No"

End the tyranny of the earnings estimate

By **CHRISTOPHER WHALEN**

**THE CHIEF EXECUTIVE** of a semiconductor-equipment manufacturer recently declared: "I have 50% confidence in three sets of projections for 2003." Like many of his peers in the semiconductor capital-equipment sector, this CEO has no clear idea what sales or profitability will be next year-or next quarter. But almost a dozen Wall Street analysts have managed to publish specific revenue and earnings estimates for the company going out two years.

Meanwhile, Washington and Wall Street hunt witches among analysts, investment bankers and hedge-fund managers. Even if they move analysts into separate business units away from the surviving investment bankers, little will change. What is needed instead is to get research analysts out of the business of predicting the future.

Michael Belkin, a former Salomon Brothers quantitative analyst who has an independent-research business and publishes the Belkin Report, says the basic problem with sell-side research starts with economic estimates. "The chief economist of XYZ Investment Bank puts out a bogus growth number for GDP next year," says Belkin. "The chief investment strategist for that bank then imputes an inflated growth rate for a given industry, based on the phony GDP estimate. The stock analyst then takes these two bad numbers, puts them into an Excel spreadsheet, and comes up with double digit earnings growth for a given stock as far as the eye can see."

The use of research analysts as stock touts, not the influence of investment bankers, is the rotten heart of Wall Street's business. One of the major tools used to stimulate trades, the earnings estimate, is supposed to be Wall Street's shorthand summation of all known and supposed factors about a given stock. The earnings estimate has become an instrument for equity equivalent to what credit ratings are to bonds. Both retail investors and professionals often use earnings estimates to make trading decisions.

#### **Weak Foundation**

Earnings estimates are easily manipulated. Corporate executives always seem to have a penny in the cookie jar to help meet or beat the consensus view of a company's earnings performance. Pressure to meet earnings expectations has been a factor in pushing many corporate executives to commit unethical, even illegal acts, such as manipulation of financial results, manufacturing fictitious sales and other types of fraud.

Assuming that stock analysts aren't in possession of material, nonpublic information, how could any earnings estimate ever be taken as anything more than informed speculation? Yet earnings estimates have acquired a life of their own and often generate more attention from the media and analysts than a company's actual financial results.

The broadcast media, led by CNBC and Bloomberg, seek to attract viewers and subscribers, even when no real news exists. They hawk company earnings estimates as though these conjectures were facts inscribed in stone. When a company actually reports its results, radio and TV journalists don't report that sales were up X percent, but instead recount breathlessly that the company beat analyst estimates. Print journalists, many of whom watch the TV the way they used to watch the stock ticker, have adopted the TV definition. They say that if bunk moves the market it's important, even if it's bunk.

Estimates used to be more than just guesses. For many years, veteran analysts and columnists extracted insider dope from company CEOs, leaking financial results before the information was widely and fairly disseminated, as required by federal law. Today, in the dreamy age of Regulation "Fair Disclosure," the earnings game continues, although the winks and nods and off-the-record confirmations have been replaced by carefully lawyered "guidance" distributed by company officials and their consultants. If a company has problems, sell-side analysts receive detailed guidance from managers, then lower their estimates so that the company still can beat the Street.

### **Reduced Visibility**

Cisco Systems CEO John Chambers made a buzzword out of the term "visibility" when he first conceded that his company's management lacked it. That was in January 2001, and he hasn't gotten it back yet. Given the obscure outlook for the tech sector, Cisco will provide only one quarter of guidance to the analysts. But there are some 40 sell-side shops following this stock that publish specific revenue and earnings estimates through 2004. Of these far-sighted analysts, more than half rank Cisco a "buy" or "strong buy." The consensus estimate for 2003 is for revenue to be flat, 10% growth in 2004.

Maybe the U.S. economy, or its network-equipment sector, will grow 10% in 2004, but surely 2% growth is just as "visible." No matter. Sell-side analysts are able to constantly adjust their forward-looking estimates downward or upward to intersect with reality. Media cover these changes as news, forgetting to note that the analysts are admitting that they were wrong before and are probably wrong again.

At honest casinos, gamblers make money only if they correctly guess the turn of a card or a pair of dice. If sell-side analysts earned their living on the accuracy of their year-ahead forecasts, rather than by issuing reams of research that brokers can use to stimulate commissions and investment-banking fees, most of them would quickly move into another line of work.

The cure for Wall Street's addiction to earnings estimates doesn't involve further legislation or regulation. It was the false security of regulation and accounting rules that perverted the notion of independent research and created the opportunities for Enron, WorldCom, Arthur Andersen and their playmates. But if regulation isn't the solution, what is the cure for the earnings-estimate madness? The answer lies with the financial industry and the companies that have the most to lose from the crisis of investor confidence. If they want to preserve and enhance the markets in the U.S., they can change the way analysts investigate and report on public companies.

Wall Street should give up explicit stock recommendations or earnings estimates in favor of providing basic information. Facts are the alternative to crystal-ball gazing nonsense; that is, analysis based upon a company's current and past performance and industry trends. By focusing on facts rather than pie-in-the-sky financial models, analysts can return to a more objective role in the marketplace, that of reporter and researcher rather than court jester and whore.

### **Corporate Responsibility**

But the shoe fits best on the other foot. Companies are responsible for their numbers, and the best change would be for companies themselves to stop providing earnings guidance and management time to analysts. If all public companies follow the examples of Coca-Cola and AT&T and end formal guidance to the sell-side analyst rat pack, the quantity of research would fall, but the quality would improve considerably. Similarly, media outlets could end the transmission of earnings estimates or move such information to the sports section -- next to the horse-racing results -- where such information truly belongs.

Aristotle said that extreme forms of democracy -- like the earnings-estimate bazaar -- can be tyrannical if they are lawless, arbitrary or against the public interest. The Securities Acts were attempts to prevent the perceived tyranny of the robber barons, but instead they created a market where speculation masquerades as research and insider-dealing thrives under the protection of industry self-regulation and "Fair Disclosure."

It takes just a few honest executives to start a revolution. How about it, James Morgan, chief executive of Applied Materials? How about it, Samuel Palmisano, CEO of IBM? How about you, John Chambers, President and CEO of Cisco Systems? Will you join Douglas Daft, the chief executive of Coca-Cola, and take the pledge to cease providing earnings guidance to research analysts? If a few more big companies were to take the "no guidance" pledge and push for broader change in Wall Street research practices, the rest of corporate America and Wall Street might follow. Without legislation, regulation or any input from Washington, the companies that raise capital in the markets can take back control over the business of investing and give all investors -- professionals and individuals alike -- a fairer shake in the bargain. As Nancy Reagan said so well about other drugs, "Just say no."

---

Christopher Whalen is a principal of Ramberg, Whalen & Co., an independent research firm.

---

Editorial Page Editor Thomas G. Donlan receives e-mail at [tg.donlan@barrons.com](mailto:tg.donlan@barrons.com)<sup>1</sup>.

**URL for this article:**

<http://online.wsj.com/barrons/article/0,,SB1045870064673112503,00.html>

**Hyperlinks in this Article:**

(1) <mailto:tg.donlan@barrons.com>

**Copyright © 2003 Dow Jones & Company, Inc. All Rights Reserved.**

**Printing, distribution, and use of this material is governed by your Subscription Agreement and copyright laws.**

**For information about subscribing, go to <http://wsj.com>**