

## **A Misguided Strategy**

By Gene Epstein

811 words

19 February 2007

[Barron's](#)

21

English

(c) 2007 Dow Jones & Company, Inc.

Should publicly traded companies guide Wall Street about their quarterly earnings? Or should they allow investors and analysts to guide themselves?

The answer, according to two studies -- both coincidentally called "To Guide or Not to Guide?" -- is that providing guidance is almost always better than not doing so. One of the studies is a February 2006 report by Lawrence Rand, founding partner of the New York investor-relations firm Kekst & Co. The other is a research paper published this month by finance professors Joel Houston and Jennifer Tucker of the University of Florida and Baruch Lev of New York University.

A publicly traded company is legally required to report earnings every three months. And in a market that trades on expectations, these figures inevitably excite intense interest before they're released. Many companies don't provide guidance, but most of the biggest do. And if a company that has been offering direction ends the practice, investors get nervous.

Observes Rand: "A company cannot relieve itself of the market's short-term expectations by ending the practice of corporate guidance." Says Lev: "Analysts will forecast quarterly earnings, whatever a company does. Guidance is a way to make those forecasts more accurately reflect subsequent earnings."

A case against guidance recently published in The Wall Street Journal acknowledged this point, but wondered whether companies actually have "a better handle on the numbers than the analysts" do. At Barron's request, Tucker researched this very question. Not surprisingly, she found that companies do tend to have a better handle. First Call earnings guidance is sorted according to whether analysts' consensus forecast was higher, lower or in line with the firm's own estimate. In 53% of the over 27,000 cases Tucker examined, the guidance deemed the consensus too high or too low. She found that, 70% of the time, the guidance was correct and, half the time, analysts revised their forecasts within two days to jibe with it.

What happens to companies that stop providing quarterly guidance? In their research paper, Lev and his collaborators tracked 222 companies that stopped doing so from 2002 through 2005's first quarter, after having offered guidance routinely. They found that these firms had had weak profits and an increasingly poor record of meeting or beating analysts' forecasts. They also found that, once guidance was halted, fewer analysts covered the stock, the range of earnings projections widened and errors in forecasts worsened. That generated more uncertainty among investors, more risk and lower share valuations.

One reason companies give for halting guidance is that they want to focus on long-term, rather than quarterly, results. But Lev and his collaborators found no evidence that companies that halted guidance had increased their capital investments or R&D, or even were offering more information on their long-term strategy.

Ultimately, 30% of the companies in their sample resumed quarterly guidance, putting them back in sync with many of their peers. Over 2006's first three quarters, more than 600 companies provided quarterly guidance, a figure down from the peak above 700 hit in 2001.

Of course, eschewing guidance doesn't necessarily mean a company is a loser. Berkshire Hathaway (ticker: BRK.A), which has fared very well over the years, steadfastly refuses to offer hints about coming earnings. And no less an investor than its leader, Warren Buffett, has inveighed against the practice, noting the "many instances in which CEOs engaged in uneconomic operating maneuvers so

that they can meet earnings targets," sometimes even playing "accounting games to make the numbers."

Lev, who specializes in accounting, also condemns such maneuvers as a fool's game that can lead only to trouble. To discourage excessive focus on the short term, Kekst & Co.'s Lawrence Rand would have companies consider offering guidance on an annual basis, but with quarterly updates. (Dow Jones & Co. (DJ), Barron's publisher, recently switched to annual guidance.)

A July 2006 paper released jointly by the CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics includes several sensible proposals for "Breaking the Short-Term Cycle." But one includes abandoning guidance by all but small-cap firms. Ironically, one of the reasons given -- that providing guidance drains company resources -- applies especially to small companies. For larger outfits, however, the financial benefits of achieving a better share price would more than justify the commitment of resources.

Critics are right to object to the evils of "short-termism," but they're misguided in calling for an end to guidance. Investors will inevitably speculate about earnings. So, if you can't beat 'em, lead 'em. It's the only practical alternative in an often impractical world.

---

For Barron's subscription information call 1-888-BARRONS ext. 685 or inquire online at <http://www.barronsmag.com/subscription/subscription.html> .

# THE WALL STREET JOURNAL.

The Buzz

## **MarketWatch Weekend Investor: If Earnings Guidance Lacks Clear Direction, Why Bother?**

By Herb Greenberg

749 words

3 February 2007

[The Wall Street Journal](#)

B3

English

(Copyright (c) 2007, Dow Jones & Company, Inc.)

For the life of me I don't know why companies give earnings guidance. Nobody can see the future; yet every quarter it's the same old song and dance: Will they or won't they? (Beat the estimates, that is.)

Estimates by analysts, of course, aren't necessarily the same as guidance provided by a company. But guidance creates a target analysts can work from. Sometimes companies beat the consensus estimate by low-balling guidance. Other times they beat numbers that everybody conveniently forgets had been revised downward. And sometimes, as if miraculously clairvoyant, they hit the number they forecast quarters or even years earlier on the nose.

Part of running a business includes making internal forecasts. But I've never quite figured out how companies can claim to see the future so clearly down to the penny. Berkshire Hathaway Chairman Warren Buffett is equally dubious. Writing in his company's 2000 annual report, he said he and his vice chairman, Charlie Munger, "think it is both deceptive and dangerous for CEOs to predict growth rates for their companies. They are, of course, frequently egged on to do so by both analysts and their own investor-relations departments. They should resist, however, because too often these predictions lead to trouble."

Mr. Buffett added: "The problem arising from lofty predictions is not just that they spread unwarranted optimism. Even more troublesome is the fact that they corrode CEO behavior. Over the years, Charlie and I have observed many instances in which CEOs engaged in uneconomic operating maneuvers so that they could meet earnings targets they had announced. Worse still, after exhausting all that operating acrobatics would do, they sometimes played a wide variety of accounting games to 'make the numbers.'"

Mr. Buffett's comments caused a number of companies, including Coca-Cola, McDonald's and Mattel, to do away with guidance. (At the time, Mr. Buffett was a director of Coke; he no longer is.) A survey by the national Investor Relations Institute shows that as of last March, the number of companies providing any type of earnings guidance slipped to 66% from 71% a year earlier. At the same time, in an effort to stop playing into the hands of short-term traders, companies that provide only annual guidance rose to 43% from 23%. Among those recently making the shift to annual guidance is Dow Jones & Co., publisher of The Wall Street Journal.

Some companies are even modifying their annual guidance by adopting rolling guidance, which involves setting an annual target that's reaffirmed or revised quarterly. Still, there's the question: Why do it at all? Lawrence Rand, a founding partner of Kekst & Co., a New York investor-relations firm, says anecdotal evidence suggests companies get higher valuations when their actual results are closer to expectations compared to companies whose results differ materially from analyst estimates. "Perhaps analysts just want to punish those companies that surprise," he says.

Furthermore, a new academic paper on the subject, aptly titled, "To Guide or Not to Guide," says that contrary to frequent arguments, there's no evidence that companies that stop guidance tend to increase long-term investments. Instead, the study says, they tend to stop providing guidance (sometimes quietly) after one too many quarters of missing analyst forecasts.

"I don't deny there's a game going on with analyst forecasts and with guidance," says one of the study's authors, Baruch Lev of New York University's Stern School of Business. But he adds he believes that guidance is important. Without it, he says, analysts will continue to forecast. "All you'll have is forecasts," he says, "some of them completely wide. Guidance is a way for managers to induce some reason into them." That's assuming management has a better handle on the numbers than the analysts. Given the amount of guidance that is often revised downward -- three for every two revised upward in the past four weeks alone, according to Zack's Investment Research -- it's not altogether clear they do. Case closed.

---

Herb Greenberg is senior columnist for MarketWatch. He doesn't own stocks except those of his employer -- and doesn't sell individual stocks short or invest in hedge funds. MarketWatch is a unit of Dow Jones, which publishes The Wall Street Journal. Email: [hgreenberg@marketwatch.com](mailto:hgreenberg@marketwatch.com)