The Consensus Forecast

Over the years I've spent countless hours with my head buried in old faded finance books. Many were published in past centuries. And I'd like to think it's been a valuable use of my time – after all it's brought me to a profound realisation. And here it is:

There is very little - a cynic would say "nothing" – that's written today in finance that's actually new. The fact is, if you dig deeply enough on any finance subject, then you'll usually find that someone has written about it before.

Take for example what drives share prices. My university lecturers used to bang on about "The Efficient Market Hypothesis".

It's a concept that's almost unfailingly credited to an American economist called Eugene Fama. Back in 1965 Fama proposed that a company's share price embodied all the information that, at that point in time, was known about it. And, as new information came to hand, the stock price rapidly adjusted to the fresh information. Which all meant, according to Fama, that the innocent were protected in their stock purchases by the informed and that no one could beat the market any way other than by luck.

Fama has been hailed a genius for coming up with this hypothesis. What's more, his concept delivered a goodly kick-start to the Index tracking funds that have proliferated since. After all – if you can't beat them why not simply join them?

Problem is (as I warned earlier) Fama wasn't the first person to come up with the idea. Back in 1889 a bloke called George Rutledge Gibson wrote:

[when] shares become publicly known in an open market, the value which they acquire may be regarded as the judgment of the best intelligence concerning them.

The *best intelligence* that Gibson was referring to isn't intelligence that's delivered by one or a few people. As Fama suggested it's more of a melting pot of broad-based investor and analyst opinion on how the future for a company looks at that point in time.

Central to shaping that opinion is what's called the *consensus forecast*. This article explores what consensus forecasts are, how they impact share price movements and whether you should pay any attention to them.

What is a Consensus Forecast?

Companies listed on the ASX (particularly the larger ones) have a goodly number of professional analysts (and plenty of amateur ones as well) following them. They study company operations and their future prospects in order to deliver "educated prophesies" (more politely referred to as forecasts) about future earnings which are then used as input into share valuations.

But since analysts are capable of holding different views on those future earnings which analyst should you believe? Enter the consensus forecast.

There are some subtle differences in how people choose to derive the consensus forecast.

Some define it as *the average forecast made by well-respected analysts on the future performance of a company*. In mathematical terminology this is referred to as the mean of the forecasts.

Others prefer to calculate the median rather than the mean forecast. The median forecast represents the middle forecast when all are arranged in ascending order. Doing this eliminates any significant outliers from the data thereby reducing any distortion of the *consensus* figure by some analyst who people reckon is a bit whacko.

Is it a Consensus of Forecasts or Forecast Consensus?

So, if it's individual analysts' forecasts that form the basis of consensus forecasts then the question needs to be asked: how do analysts come up with their earnings forecasts in the first place?

This is where things get a bit messy, so bear with me.

The fact is humans don't make judgments in a vacuum. They look to the ideas of others when forming their own. So, if other analysts are broadly agreeing that a company will deliver a certain profit next year, it takes a brave analyst to deliver a forecast that's a lot different.

As John Maynard Keynes stated in *The General Theory*:
Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally.

In other words, few analysts, even experienced ones, will choose to deviate far from consensus. If they do, and they're wrong, they'll look like a fool. But if they broadly agree with everyone else, and the majority turns out to be wrong, then they won't look like a complete idiot.

So this basically means that consensus forecasts are, to a degree, a product of forecast consensus.

An Idyllic World for Analysts……

Let's consider an idyllic world for analysts.

It's one where they'll never be accused of mimicking the forecasts of other analysts.

It's also one where they don't have to come up with their own forecasts.

It's one where the companies spoon feed the forecasts to the analysts.

That's absolutely wonderful for the analysts - a bit like "heads I win; tails you lose".

Here's why: if the forecast turns out to be right then each analyst can give themself a pat on the back. And if the forecast turns out to be wrong then the analysts can simply blame the company.

And believe me, this is what goes on all the time.

The company-delivered forecasts are referred to as forward guidance. Companies aren't required to deliver forward guidance but they often do. But CEOs need to be careful in delivering forward guidance. After all, Hell has no fury like an analyst's scorn. CEOs who repeatedly deliver optimistic profit projections, that overstate the final reality, can see their tenure as CEO threatened. Look no further than the recently announced departure of QBE's CEO, John Neal. Analysts and investors accused Neal of always delivering a glass half full message regarding QBE's future. Yet he repeatedly under-delivered when profit season rolled around.

Where can you Find Consensus Forecasts?

So where do you find these distillations of earnings forecasts?

Let's start with an obvious source. In this digital age you can simply Google "Consensus forecast (and then add your favourite company)". And if that's too difficult you could even ask Siri.

If that draws a blank then try one of the many earnings estimate aggregators like Vuma Consensus, Standard & Poor's Capital IQ, Zacks or Thomson Reuters IBES (Institutional Brokers Estimator Service). Yahoo Finance also covers consensus forecasts for many US companies.

You can also search your broker's website. For example Commsec clients can access some useful information on Aussie companies by clicking on the Company Research tag and then the Forecast tag.

And if you're still struggling to get a consensus earnings forecast then why not look to the company itself for guidance (it's likely to reflect consensus anyway!). To do that, access the ASX website and flick through recent company announcements for the company in question. Once there search recent ASX announcements with headings like investor presentation, AGM speech and performance or profit updates.

But, when it's all said and done, if you really want a chance of beating the market why not go out on a limb, defy consensus, and come up with your own forecast?

No one said that investing was easy.

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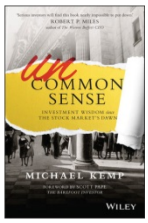

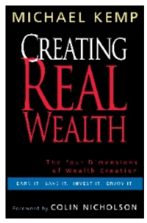

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Michael Kemp is the chief analyst for the Barefoot Blueprint and author of "Uncommon Sense". Published under the Wiley label "Uncommon Sense" delivers a deeply considered and logical approach to the otherwise complex world of investing.