

Chapter One



Forget About Conventional Analysis

SEEKING A PROFESSIONAL'S OPINION makes sense in lots of situations. Say you're about to agree to buy a house. If you don't happen to be an engineer who specializes in judging structural soundness and safety, it might be a good idea to hire someone with that expertise to look the place over. Or suppose you can afford a painting by a famous artist to hang on a wall in that house, but you don't know the art market

well. You'd be wise to pay a consultant who can tell you where comparable works sell at auction.

It might seem to follow that if you're trying to pick next year's #1 stock, you'd want to look for it in research produced by people who analyze stocks for a living. Equity analysts employed at Wall Street firms or independent research organizations know the companies they follow inside out, thanks to specializing by industry and concentrating on a small number of stocks. Over many years of studying their industries, they've developed valuable contacts at their companies' suppliers and customers.

As a result, analysts often know what's happening on the ground before it shows up in earnings reports or newspaper articles. What's more, these stock evaluators process vast amounts of data. That complements the judgment they've developed through lengthy experience. Most Wall Street equity analysts are also extremely bright. And you can learn exactly which of these brainy and highly motivated analysts are considered the best in their field, thanks to annual surveys and scorekeeping by various organizations, most famously by *Institutional Investor*.

Despite those assurances, do you want to run the top analysts' top picks through one more battery of tests? No problem. Their recommendations, which are based on "fundamental" factors such as companies' competitive strength and earnings prospects, are complemented by "technical"

analysis that's conducted by a separate group of highly intelligent professionals. Also known as "chartists," they make predictions about stocks' future movements based on statistical relationships between price trends from one period to the next.

No doubt about it, there's a lot of intellectual firepower for you to draw on as you attempt to identify the year's highest-return stock before it takes off for the moon. The question is whether any of it is useful in that quest. I'm not disputing the value of the skills that enable premier analysts to command big-time compensation packages. It's just that the system they're part of isn't geared toward the objective that's the focus of this book.

From Earnings Forecasts to Recommendations

A typical Wall Street equity research department includes specialized analysts covering a wide array of industries—high-tech, low-tech, financials, commodities producers, consumer goods, business-to-business, and more. The competitive dynamics of those industries vary tremendously, but the analysts boil their work down to a uniform, easy-to-understand set of acronyms.

Each analyst projects the company's earnings for the coming year and divides that amount by number of shares

outstanding to produce an earnings per share (EPS) estimate. Dividing the company's share price by its projected EPS produces the price-earnings (PE) multiple. PE multiples are also calculated with trailing-twelve-months EPS as the denominator.

PE multiples vary according to companies' perceived earnings quality and expected future EPS growth rate. The analyst assigned to a given company renders an opinion on what its PE ought to be, based on how it stacks up on those factors against other companies in its industry. Multiplying the company's "correct" PE multiple by its projected EPS produces a price target (PT).

Based on where the stock's current price stands relative to its PT, the analyst assigns a rating to the stock. The ratings terminology varies by firm, but the most straightforward set-up consists of a Buy, Hold, or Sell recommendation. Other firms' language emphasizes how a stock is likely to do relative to a market index, using designations such as "Outperform" and "Market Weight." But regardless of the terminology, the investor can examine a full list of a firm's recommendations and determine which stock has the biggest upside, based on where it stands in comparison to its PT. This is all founded, keep in mind, on the critical task of projecting the company's EPS.

There's just one small problem.

The Irrelevance of EPS

Almost half a century before this book's publication, the distinguished financial economist Joel Stern demonstrated that EPS has no bearing on stock prices. Stern's findings weren't by any means buried in obscurity and forgotten. His article "Earnings per Share Don't Count"¹ appeared in the widely read *Financial Analysts Journal* of July–August 1974, and it was actively discussed at Harvard Business School, which I entered the following month. (Warning: The next eight paragraphs are more technical than the rest of this book's content. You can skip lightly over the discussion if you're willing to accept Stern's findings on the grounds that they passed muster with the editors of a leading scholarly journal. The *Financial Analysts Journal* is now the flagship publication of the Chartered Financial Analysts' organization.)

The fallacy of regarding a company's share price as a function of its EPS can be seen by considering a fictitious PFDZ Corp., which is earning a solid 15% return on its fixed capital. (Fixed capital includes assets such as property, plant, and equipment.) Thanks to its strong profitability, the company has a high credit rating that enables it to borrow at a 4% interest rate. PFDZ can substantially increase its EPS by borrowing money to make a large investment

that will return anything in excess of 4%. I'll make it 5% for the sake of argument.

How will the market respond to learning that PFDZ, which previously earned 15% on fixed capital, expects to earn just 5% on its new investments? Let's just say the news won't be received warmly. And as Stern points out, the market will reduce the PE multiple on PFDZ's EPS to reflect the increase in its financial leverage, that is, its reliance on borrowed money. In short, EPS will increase, but XYZ's share price won't. It may even decline.

Here's another way to demonstrate the EPS fallacy suggested by Stern: Consider two companies, NWRQ and YMDO. Both earned \$1.00 a share in the latest 12 months and both are expected to grow their earnings at 10% a year. Neither company has any debt on its balance sheet and neither intends to use debt in the future. Based on what you know so far, you'd expect the two companies' shares to sell at the same PE multiple. Let's assume that's 20 $\times$, meaning that NWRQ and YMDO shares are both trading at \$20.

But now let's add one more piece of information. NWRQ can achieve its 10% earnings growth without needing to add to its present capital. It's an "asset-lite" company that generates sales primarily from the brainpower of software developers whose office space and computer terminals are already in place. YMDO, on the other hand, will need one additional dollar of capital for each additional dollar

of sales it must generate in order to increase its earnings. Where will YMDO get that additional capital? Having ruled out the use of debt, the company has just two possible sources.

One possibility for YMDO is to sell additional shares to fund the investments required to produce the projected 10% earnings increase over the next 12 months. In that case, YMDO's earnings will be spread out over a larger number of shares than formerly. Its EPS will go down, relative to the EPS of NWRQ, which won't need to issue any more shares. If EPS is truly the basis on which the market prices stocks, then on a forward-multiple basis, NWRQ's shares must carry a higher price today than YMDO's shares, yet in fact they're both currently at \$20.

The other way YMDO can raise the capital it requires to increase its earnings is by reinvesting some of its earnings in the business. NWRQ, on the other hand, can pay out all of its earnings to shareholders as a dividend. Reviewing the facts, would you really pay as much for YMDO's stock, with equivalent current-year EPS and projected earnings growth as NWRQ but with a smaller dividend?

Alternatively, NWRQ can return 100% of its earnings to shareholders by repurchasing stock. That will reduce its number of shares outstanding and increase its EPS over the next 12 months. If YMDO tries to follow the same strategy, it will have less money to spend on stock repurchases

because it needs to reinvest some of its earnings in its business. Compared to NWRQ, YMDO will have more shares outstanding a year from now and less projected EPS. Once again, the market will put a lower price on its shares than on NWRQ's today, even if it applies the same 20 times PE multiple to both companies' projected EPS. Yet that contradicts the original premise that both stocks are currently trading at \$20.

Clearly, it's impossible for NWRQ and YMDO to trade at both the same price and at different prices at the same time. Stern untangles this paradox with an inescapable conclusion: The market doesn't really value shares on the basis of EPS. What it really cares about is, in Stern's words, "earnings net of the amount of capital required to be invested in order to maintain an expected rate of growth in profits." He dubbed this metric *free cash flow*. The Corporate Finance Institute defines free cash flow as Operating Cash Flow – Capital Expenditures.

Stern laid out these irrefutable facts nearly 50 years before this book went to press. Yet to this day, as Hans Wagner lamented in a 2022 *Investopedia* article, "very few people look at how much free cash flow (FCF) is available vis-à-vis the value of the company."² But that's not surprising, given the massive volume of equity research that's pumped out every year with a single-minded focus on EPS. Investors who are trained to repeat the formula

“Price equals EPS times PE” aren’t especially inclined to muddy the waters with FCF.

EPS: Flawed but Dominant

As Stern commented in his 1974 article, “That EPS is easy to calculate is an insufficient excuse for employing it as an analytical device.”³ Certainly, simplicity is no justification for relying on a measure that doesn’t truly reflect how stocks are evaluated by the sophisticated investors (“lead steers”) who, according to Stern, ultimately determine prices. And it’s not unusual to see the market ignore the message supposedly delivered when a company reports an EPS number that beats analysts’ consensus forecast. Instead of rising, the stock sometimes falls because something else in the report represents a disappointment, such as revenue, gross margin, or the company’s earnings guidance for the next period.

EPS nevertheless remains entrenched in Wall Street equity research and understandably so. Imagine that you’re an industry-specialized equity analyst trying to make your mark by recommending a stock that you think will hugely outpace the index over the next year. It’s awfully hard to come up with that kind of a pick when your industry is massively out of favor and likely to remain so for the next several quarters. But in the meantime, you have a chance

to shine every three months. If you can precisely predict quarterly EPS for one of your companies, you'll have your moment of stardom. Never mind that the number may have a loose relationship with the underlying economic reality. EPS is routinely massaged by a variety of discretionary and arbitrary accounting decisions to achieve management's desired result. But only short-sellers care much about make-believe earnings numbers.

Aside from the gratification that comes from sometimes hitting the number on the nose, it makes sense for equity analysts to put lots of energy into predicting 90-day batches of EPS. Various organizations compile analysts' EPS estimates to generate the consensus forecasts that I mentioned a few paragraphs back. Being included in those compilations certifies a brokerage house or independent research firm as a thought leader. If that's how the game is played, it's in the analyst's interest to help the firm's research director fill in the EPS box for every company under coverage. To get along, go along, as the saying goes. (Not that providing an EPS forecast is optional.)

Simplicity helps to explain why EPS takes on such great importance in Wall Street's equity research machine. But EPS prediction has also intrigued finance professors, who are far from intimidated by complexity. They've done studies on such questions as why analysts' estimates are biased in the direction of excessive optimism⁴ and how analyst

incentives lead to forecast errors.⁵ Another study found that 40% of the time, an EPS forecast derived from a time series of past data was as accurate or more accurate than the analysts' consensus forecast.⁶

The question of what causes a particular S&P 500 stock to outperform all 499 of its peers isn't the sort of question that financial scholars tend to take up. Quite reasonably, they're more inclined to ask something like the following: "Within that group of 500 stocks, can I find some characteristic that enables me to select 100 that, on average, will beat the index?"

If those stocks collectively return 1% more than the index, with some doing better and some doing worse, and this is shown to be a statistically valid result rather than a chance outcome, then the study has a good chance of getting published in a prestigious journal. That may help the author become a tenured professor or, in the case of someone who's already attained that status, to attract an offer to move to a rival university at a higher salary. The methodology described in the study may even get adopted as one of the strategies employed by an institutional investment manager with the necessary resources to select and monitor hundreds of stocks at a time.

The point is that the finance departments of the world's business schools produce a large volume of genuinely useful research every year. But it's not directed at the investor

who's attempting to do something financial theorists don't believe a rational individual would try to do. That is, trying to find the needle in the haystack that may double your money or more within the next 12 months.

The theoreticians might be less astounded if you explain that you're allocating just a minor portion of your portfolio to trying to hit the jackpot. And in the meantime, you're investing most of your self-managed 401(k) in the more prudent, well-diversified manner they approve of as a rational approach. But even if the finance professors are okay with that, they probably won't make your hunt for #1 the subject of their next research study. Their chances of getting published in a prestigious journal are higher if they stick to the topics that the journals have focused on in the past.

EPS versus Underlying Reality

The equity research establishment's overreliance on EPS might be more excusable if earnings invariably represented a genuine creation of economic value on behalf of shareholders. In practice, the gap between reported earnings and bona fide profits can be vast. Sometimes the mismatch reflects outright accounting fraud. But investors shouldn't be lulled into believing that they're getting the straight dope on a company's earnings merely because none of its executives are under indictment. Reported EPS can diverge

from the underlying reality because of perfectly lawful accounting practices or because the numbers dispensed in quarterly financial statements are later said to have been mistakes.

Before we examine how companies present a distorted picture without violating any securities laws, let's get clear on why they routinely do it. The reason is that those who operate within the $PE \times EPS = \text{Stock Price}$ framework assume that obtaining a high multiple depends not only on achieving high growth, but also on achieving steady growth. All else being equal, they reckon, investors prefer EPS that climbs year by year at a steady clip to one that moves up in fits and starts. So between two otherwise similar stocks, the one with less volatile EPS should receive a higher PE multiple and deliver a higher return.

That, at least, is what corporate managers believe. But that's not what a 2013 study by Tim Koller, Bin Jiang, and Rishi Raj⁷ concluded. Those researchers at the management consulting firm McKinsey found no statistically valid evidence that lower earnings volatility produces higher returns for shareholders.

But even if low-volatility earnings don't ultimately translate into superior investor returns, institutional investment managers may tell corporate managers that they prefer smooth over erratic earnings. Imagine a portfolio manager meeting with a client, a pension plan sponsor, for instance.

In a review of the portfolio's current holdings the client asks about a company that recently reported a big, unexpected drop in EPS from the year-earlier quarter. The resulting price drop has made the stock a conspicuous underperformer within a portfolio that wasn't doing especially well before this nasty surprise. Why, the client wants to know, didn't the portfolio manager foresee the trouble and reduce exposure to the stock?

This isn't a comfortable conversation for the portfolio manager. Striving to own companies that never rock the boat with negative earnings surprises may help to avoid such unpleasant interactions in the future. The message this portfolio manager is likely to convey in meetings with corporate managements and their investment bankers is, "We like companies that show nice, steady EPS progression."

Eager to get its stock into the portfolios of all the managers who deliver a similar message, the company can, if it chooses, try to accommodate their desire in perfectly legitimate ways that truly affect its economic performance. Suppose, for example, that a manufacturer uses as raw materials certain commodities that gyrate wildly in price from one quarter to the next. By hedging its raw materials costs in the futures market, the company can prevent those cost swings from making its earnings bounce around like a jumping bean.

Smoothing out input costs isn't the only way to produce smooth EPS growth. Broader corporate strategies can also take some of the volatility out of earnings. For example, companies in industries where revenues are closely tied to the business cycle might diversify into others that hold up better in recessions.

Working at various investment banks over the years, I saw senior management deal with the boom-and-bust nature of the commission business. A hot market stoked the public's interest in the stock market, with the result that trading volume and commissions went up. But boom turned to bust when the market slumped. To even out those swings, the investment banks sought to concentrate more of their revenues in steadier, fee-based activities. Asset management was one such activity. Instead of depending on customers to make trades and pay commissions, the firms managed the customers' portfolios for a fee calculated as a percentage of aggregate portfolio value.

Portfolio values were subject to ups and downs, but management fees were still a stabler source of revenue than commissions. The attractiveness of that proposition helped investment banks overcome their hesitancy about doing something they had to think long and hard about. Entering the fee-based management business meant going into competition with the asset managers who were their customers on the institutional side.

It's important to note that the McKinsey authors mentioned earlier don't recommend realigning corporate revenues in pursuit of steadier EPS progression. But that's exactly what some companies do. They attempt to reduce their earnings volatility through diversifying acquisitions. The idea is that industries have different business cycles, so one business line's peak earnings will offset the trough at another's.

It sounds good in theory, but it doesn't work out so well in practice. Koller, Jiang, and Raj found that of the 50 S&P 500 companies with the lowest earnings volatility over a 10-year period, fewer than 10 were diversified, as defined by owning businesses in more than two distinct businesses. Furthermore, the McKinsey experts uncovered no evidence that low-earning-volatility companies commanded premium prices. They reported that in their experience, the sum of the values of diversified companies' businesses almost never differed materially from the market values of their stocks.

The McKinsey researchers conducted their study in a period long after the breakup of most of the famous conglomerates that were created in the 1960s partly on the premise of reducing earnings volatility through diversification. Those companies' experience supports the view that in terms of market value, the whole was less than the sum of the parts. Their stocks traded with a "conglomerate discount."

The discount was so substantial that corporate raiders were able to pay a premium to a conglomerate's prevailing stock price, gain control, and then sell or spin off the distinct operations and come away with a handsome profit. In these cases, the original conglomerate builders' plan to obtain high PE multiples by minimizing EPS volatility achieved the opposite effect. They set out to make $2 + 2$ equal 5 but instead created a total of 3.

So much for the available methods of reducing volatility in quarterly earnings reports by actually addressing the underlying reality. When those methods don't accomplish everything management had hoped for—probably because no business actually grows by the same percentage year in and year out, much less quarter to quarter—there are ways to create the *appearance* of earnings stability without breaking any laws.

Imagine that a company's sales get a sudden boost in its second quarter thanks to a temporary surge in demand or a few unusually large orders. This might sound like good news, but in a world of EPS-obsessed traders, analysts, and portfolio managers it can present a problem. Suppose there's little chance that the company's windfall will be repeated in next year's second quarter. What's likely to happen if, as a result of the short-term factors, the company reports second-quarter earnings that are substantially above trendline? Twelve months from now management could find

itself in the unenviable position of having to report a subnormal year-over-year second-quarter earnings increase, even though business is going fine. If that happens, those stability-conscious portfolio managers may become disenchanted and reduce their positions in the stock. Their liquidations could depress the share price, a bad outcome for the CEO, whose bonus is tied to it.

Luckily for the CEO, there's a solution. Just accelerate some of the regular maintenance work scheduled for the third quarter to the second quarter. With an extra quarter's worth of that expense booked in the second quarter, second-quarter earnings won't be far above trendline. So it will be possible to report the desired year-over-year percentage gain in next year's second quarter.

The benefits of the short-run demand boom won't be lost. They'll just be more conveniently timed. Result: No stock hiccup next year and no damage to the CEO's bonus from too much of a good thing. Too bad for serious investors who are just trying to get an accurate picture of the company's performance.

Naturally, problems in producing the steady growth of EPS that helps everyone except the investors can arise from events that cause quarterly earnings to be too low rather than too high. When that happens, "channel-stuffing" can come to the rescue for companies that sell products through distributors or wholesalers. These companies ring up sales

when the middlemen buy their products, not when a sale is made to the ultimate consumer. So if sales look like they're going to fall a little short in the current quarter, it's just a matter of getting the distributors or wholesalers to buy a little earlier than they had planned. That way, the company can count some sales in this quarter rather than the next. It's a practice otherwise known as borrowing sales from a future period.

There's a potential snag in this remedy, however. The distributors that accept delivery earlier than usual have to hold above-normal amounts of goods in inventory until the sell-through to their customers brings those inventory levels back down. That increases the cost of financing their inventories. While they might be glad to lend a hand in the manufacturer's effort to present a misleadingly smooth earnings progression, they're not necessarily willing to reduce their own profits in the process. Consequently, the manufacturer may have to persuade them to play ball by offering them a discount in exchange for taking delivery ahead of the usual schedule.

The revenue that the manufacturer sacrifices in this arrangement isn't revenue that it will make up later. It's lost forever. And it's not the result of a discount offered for a legitimate business purpose, such as clearing out stale merchandise. Instead, the discount's purpose is purely cosmetic, namely, creating the illusion of a rock-steady rate of increase

in EPS. Creating genuine economic value has taken a back seat to manufacturing numbers that just make it *look like* the company is creating economic value.

A further step into the realm of financial reporting fantasy involves *arbitrary timing of discretionary accounting decisions*. That phrase may sound like gobbledygook, but what it represents is easy to understand. Suppose, for example, that a company does have some stale merchandise in its inventory. At some point, it will have to write down that value of those goods to a level that represents prices it can now realistically expect to obtain. But there's some judgment involved in determining exactly when the merchandise's current carrying stops being a realistic number.

Management's professional judgment is that the current quarter isn't the best time to come to that conclusion. By an incredibly amazing coincidence, earnings are threatening to come in a bit below trendline this quarter. Taking a write-down at this particular time would worsen that problem.

Everything points to a profit rebound a couple to quarters from now. In fact, at that point EPS will be in danger of going too far *above* trendline. Upon very careful consideration, management concludes that the loss of value on that stale merchandise will become indisputable just about six months from. So that's when the company will take the write-down.

Another type of loss that companies can book when it's most convenient is a write-off of bad receivables. These are amounts owed by customers who bought on credit but, as it turns out, won't be able to pay what they owe. Also, management can exercise judgment in deciding when to write off goodwill.

By way of explanation, goodwill is a balance sheet item that arises when a company makes an acquisition for more than the accounting-based fair value of the acquired company's net assets. Suppose the acquisition doesn't work out as hoped. In that case, the acquiring company must eventually acknowledge that the value it expected to create by combining the acquired company's operations with its own never materialized.

A different way for a manipulative management to exploit acquisitions is to make a subjective judgment that some of the receivables of the company being acquired will never be collected. Writing them off at the outset, before they can affect the acquirer's earnings, sounds like management is acting responsibly. But the acquirer may go even further and write off some receivables that actually aren't so bad. Later on, the company can collect those good receivables and record a gain, producing earnings as if out of thin air.

These examples don't by any means exhaust the range of non-illegal gimmicks that companies have devised over

the years for manipulating their earnings. In his heyday in the 1980s and 1990s, General Electric's legendary Jack Welch was determined to make EPS rise at a steady rate every quarter, come rain or come shine. Every division of the company was expected to do its part.

An executive in GE's financial services business recounted that if quarter-end was approaching and divisional earnings were in danger of falling short of their target, he and his colleagues would scramble to find an acquisition. The acquired company's earnings could be counted for the full quarter, enabling the division to meet its quota. It's not unreasonable to suppose that GE's selection of acquisition targets would have been different if it had been based strictly on maximizing the company's long-run economic value, instead of satisfying Wall Street's demands for an ultra-smooth earnings progression.

Hooray! There's Less Accounting Fraud Than There Used to Be

Up to this point, I've described only techniques for artificially reporting steady EPS growth that don't violate the accounting rules and land senior management in the slammer. There's some good news on this front for investors who want to know what's actually going on at companies. I mean the ones who aren't interested in playing the game

of seeing whether the company beat analysts' forecasts of a manipulated number that has no real bearing on the stock price. The good news is that outright financial fraud has become less frequent in the United States over the past several years.

Is it necessary to add that this wasn't the result of CEOs suddenly deciding that collecting big bonuses based on their stocks' performance was less important than providing a true and transparent picture of their companies' performance? No, the real reason that making stuff up became a less favored tactic is that the Sarbanes-Oxley Act of 2002 made it harder for the CEO to shift the blame for fraud to subordinates.

That law required CEOs to sign the financial statements that their companies submitted to the Securities and Exchange Commission. Previously, a CEO could get away with implausibly claiming that the fraud was entirely the Chief Financial Officer's doing, even if that executive's bonus plan wasn't tied in any way to the company's stock performance. In that case, the CFO had no obvious motive for falsifying the financial results.

By the way, Congress's largely successful effort to suppress financial reporting fraud was a response to several high-profile cases, most famously the collapse of Enron. That epidemic of accounting crimes, in turn, resulted from an earlier shift in executive compensation practices. In the

old days, boards of directors evaluated CEOs' performance on the basis of EPS, rather than stock performance. This enabled CEOs to game the system with accounting changes that did nothing to increase shareholder value.

For example, suppose a manufacturer had some equipment for which it had determined the useful life to be seven years. Each year, one-seventh of the machine's purchase price would be deducted from the company's reported earnings, until it was regarded as having no remaining value due to wear-and-tear or obsolescence. (This treatment for reporting to shareholders is known as "straight-line depreciation.") In the separate and different set of financial statements submitted to the Internal Revenue Service, the company would write off more than one-seventh per year in the early years, in order to obtain bigger tax deductions.

The CEO would get the engineers and accountants together and ask whether eight years wouldn't be a more realistic estimate of the machine's useful life. Surely some justification for the change could be found. Especially given that the CEO had a big say in the engineers' and accountants' compensation and promotion. The revised accounting treatment would produce a smaller annual depreciation charge, meaning earnings would go up. Serendipitously, so would the CEO's performance-based bonus.

Research studies found that the market saw through this charade. The resulting increase in EPS wasn't mirrored by any increase in free cash flow, the metric that Joel Stern had

found was the true driver of stock valuations. Consequently, the CEO-instigated rejiggering of the numbers didn't push the stock price higher. It merely fattened the CEO's bonus, which was based on a severely flawed, highly manipulable measure of corporate financial performance.

Boards of directors, to their credit, began to recognize the flaw in their previous approach. They saw that CEOs were taking advantage of the EPS-based compensation plans. Instead of increasing shareholders' wealth with actions that would boost the stock price, CEOs were extracting money from shareholders in the form of inflated bonuses.

In the name of "aligning shareholder and management interests," corporations shifted to bonus plans geared to stock price performance. Going forward, bonuses would be paid in stock options that would gain in value if the share price rose, making the company's owners better off. No more would the CEO benefit from accounting ploys that added nothing to FCF.

One might have thought, amid this awakening to contrived EPS increases that had no effect on share prices, equity analysts would have revised their methods as well. Some research organizations did in fact incorporate more sophisticated analysis into their reports. But a noteworthy counterexample stands out in my memory.

The incident resulted from the Financial Accounting Standards Board (FASB, pronounced "fazz-bee") announcing a rule change that was to take effect the following year.

Unlike the changes in accounting practices that individual CEOs brought about at their respective companies, the new standard applied to all companies. But it, too, had no effect on companies' cash flows, instead changing only how quickly certain expenses hit their income statements.

Because I was known to have an interest in the topic, I was pulled into a discussion of the revised accounting standard. One equity analyst expressed enthusiasm for the new rule. "Earnings will rise by 10% at all of my companies," he exulted. "I'm raising my valuations across the board."

I pointed out that FASB's rule revision's impact was purely cosmetic, as it left companies' cash flows untouched. The analyst clearly had no idea what I was talking about. Having previously worked in the industry that he now covered, he understood his companies' operations inside out. But his grasp of accounting went only as far as being able to calculate EPS. His mastery of equity valuation began and ended at $PE \times EPS = PT$.

In contrast, the CEOs quickly grasped the implications for their compensation of boards' new emphasis on stock price performance over pliable EPS numbers. The response of the more unscrupulous among them was to resort to outright fraud. Instead of monkeying around with depreciation schedules, they manipulated EPS in a way the market couldn't see through, namely, creating totally fictitious earnings. This had the intended effect of raising their

companies' stock prices, at least until the schemes collapsed and criminal charges were filed. So many scandals erupted that, for a time, stock prices in general were depressed as investors wondered whether any company's stated earnings were reliable.

The 2002 "Sarbox" law cut down significantly on outright accounting fraud at U.S. companies. But even today, investors aren't completely out of danger in the form of PE multiples getting applied to largely imaginary EPS numbers. Clever CEOs have managed to dodge the prospect of 10-year prison terms (20 years if the misconduct is found to be willful) through a gimmick known as "subcertification." The CEOs require lower-level employees to affirm the accuracy of the financial statements. Then, the CEOs merely certify that if those affirmations are correct, the reported numbers are accurate. As a result, there haven't been many Sarbox-based prosecutions or convictions of CEOs for faking the earnings.

Even the reduction, as opposed to elimination, of sensational financial reporting frauds in the United States has significantly cut down the number of attractive targets for short sellers who specialize in scrutinizing companies' accounting practices. Fortunately, other countries have continued to provide them plenty of lucrative opportunities. And it's not as if the EPS figures reported by American companies always turn out to be correct.

Let's imagine a company reports quarterly EPS far in excess of analysts' consensus forecast. You quickly enter a Buy order for the stock, expecting that the market will now begin pricing it on the basis of higher expected earnings than formerly. And the stock does in fact rally, giving you a healthy profit. But several months later, the company says (I loosely paraphrase), "Oops! Those EPS numbers we gave you were too high, due to a mistake in our accounting department. Sorry about that." The share price plunges on the news, erasing your earlier gain.

You may have a suspicion that the initial, incorrect report wasn't genuinely the result of an error. A study by Joshua Livnat and Christine E.L. Tan of New York University's Stern School of Business Administration examined thousands of earnings restatements.⁸ The authors found evidence that, as they diplomatically put it, "the originally reported earnings may have been strategically managed." *Investopedia* defines *earnings management* as "the use of accounting techniques to produce financial statements that present an overly positive view of a company's business activities and financial position."

Livnat and Tan reported that restatements occurred in only 3.4% of the 220,000 quarterly financial reports in their database. But that isn't necessarily a good enough reason to be complacent about the reliability of the EPS figures that Corporate America pumps out. Midway through 2021

the *Wall Street Journal* reported that more than 540 companies had restated earnings in the previous three months, an amount higher than in any full year since 2013.

The upsurge resulted from an SEC determination that many special-purpose acquisition companies (SPACs) were improperly accounting for warrants they'd issued in the course of raising capital. According to analysts, this development took the market by surprise. On top of that, some SPACs and companies acquired by them disclosed more serious accounting problems in their restatements. For example, Lordstown Motors Corp. said it had "substantial doubt" about its ability to finish the year as a going concern. The company's top two executives subsequently resigned over inaccurate recording of preorders for its electric trucks.

Aside from the specific case of SPACs, it's important to realize that restatements sometimes go beyond "correcting an error" in a recent quarter. In some cases, the company is forced to change reported earnings for every quarter in the last few years. The stock price can get hammered in the process.

Earnings versus Value Creation

Many investment pundits are so wedded to the fallacy that wealth is created when a company borrows two cents a share from next quarter's earnings to beat the analysts'

consensus forecast that they deny the reality of billions of dollars of legitimate wealth creation in some of the world's most dynamic growth industries. They deride companies that have never reported a profit according to Generally Accepted Accounting Principles (GAAP, pronounced "gap"), yet are awarded with *market capitalizations* in the billions by allegedly deluded investors. ("Market cap" = Share Price $\times$ Total Number of Shares Outstanding.) These companies trade on multiples of sales rather than PE multiples, like normal ones. "It's the Dutch tulip craze all over again!" shout the naysayers.

Have there been examples of companies that went public with no bottom line, obtaining astronomical market valuations, only to crash and burn a few years later? Certainly. Did some of them have business models that didn't make a lot of sense, but rode the wave of a prevailing investment fad? Yes. Reasonable people can conclude that certain failed ventures fit the narrative. This is true despite the conviction of hardcore believers in *efficient markets*. (That's the notion that it's impossible to beat the stock averages on a risk-adjusted basis because stocks are always priced correctly.) But did every company that amassed a gigantic market capitalization without producing positive GAAP earnings prove to be a speculative bubble that burst, leaving its credulous investors in tears? Absolutely not.

Amazon (AMZN) can be considered the poster child for bona fide value that's unrelated to EPS. In its first several years after going public in 1997, the online retailer unfailingly reported losses. The first year in which it showed a GAAP profit was 2003. But before that "breakthrough" year began, Amazon had attained a \$7.3 billion market capitalization. The graph shown in Figure 1.1 illustrates just how long it took for GAAP to catch up with the reality that Amazon was generating a substantial *economic profit*.

How were the allegedly gullible investors who bought AMZN punished for their supposed folly? By the end of 2021, the company's market capitalization had risen by more than 20,000% to \$1.7 trillion. From the end of 2002 to the end of 2021, Amazon shareholders realized a 31.27% total return versus 11.49% for the S&P 500. If that's what a fool and his money soon being parted looks like, bring it on!

Here's what the Amazon bashers missed and what their present-day kindred spirits continue to miss: GAAP is an accounting system that's very well designed . . . for nineteenth-century manufacturing companies. Through most of the twentieth century, GAAP served investors in most industries reasonably well. But GAAP hasn't adapted well to the transformation of America's industrial base beginning in the 1990s. The problem arises from failing to acknowledge what constitutes an asset in this day and age.

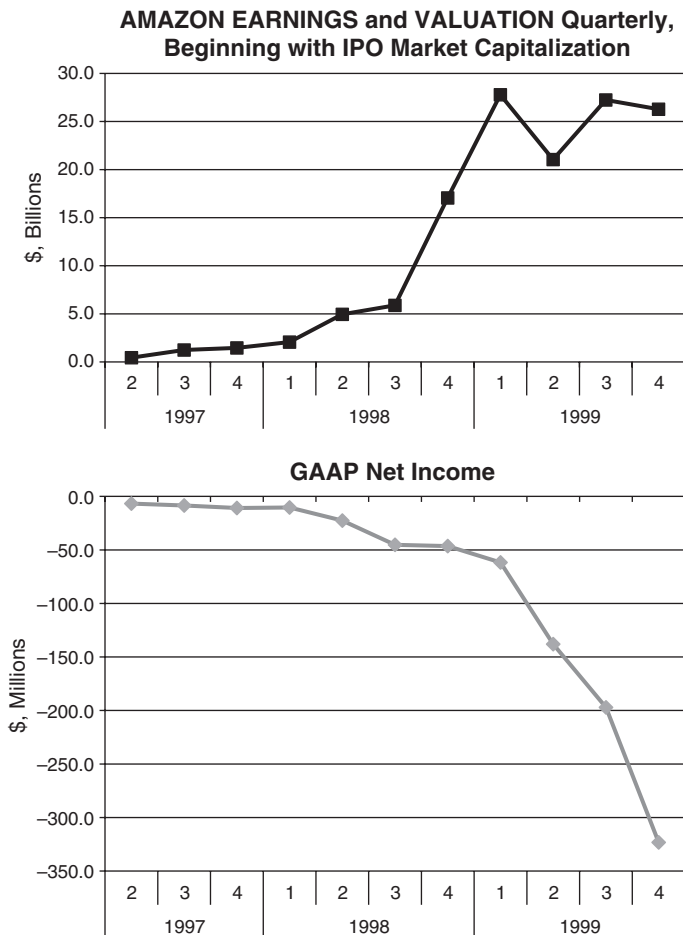


Figure 1.1 Amazon Historical Market Cap and Net Income

Source: Bloomberg L.P.

In a correct, non-jargony way, Oracle Netsuite defines an asset as: “anything that has current or future economic value to a business.” Here’s what that means in practical terms: Suppose a textile mill circa 1850 buys a loom for \$100. That \$100 doesn’t get counted as an expense. Instead, it goes into the asset column on the company’s balance sheet. On the other hand, if the textile mill pays \$100 in wages over a given period, that amount does get recorded as an expense, thereby reducing net income by \$100.

According to GAAP, wages paid last month don’t provide any ongoing economic value to the company. The mill has sold the cloth that the workers produced, so it will provide ongoing economic value to the mill’s customers, not to the mill. The company will have to pay its workers again this month to produce more cloth. But the loom is still in service and providing value beyond the period in which the company shelled out the money for it.

Now let’s consider an infotech company that spends \$10 million in 2023 on designing a software package for small businesses. The project proves successful, the company copyrights the new software, and customers love it. In the first year, sales of the new product total \$4 million, exceeding management’s most optimistic expectations. Note that the company hasn’t sold its ownership of the software package, only licenses to use it. Cash is flowing in, the owners are

high-fiving each other, but the picture presented by the company's income statement is much less rosy.

Under the rules laid down by GAAP, the \$10 million research expenditure was classified as an expense. That's despite the fact that the outlay produced something that definitely delivers current and future value to the business—a proprietary software package that will generate revenue for years to come. But according to GAAP, the company lost \$6 million on the new software in 2023, before even taking into account the selling costs and corporate overhead.

Even more weirdly, if the product generates \$6 million of sales in 2024, the company will report a substantial profit on the software package. Of course, that profit may get wiped out by the planned \$12 million of research and development (R&D) expenditures on its next product, to be introduced in 2025. Still, the company is generating cash and all indications are that it will continue creating cash-generating products for the foreseeable future. If the founders decide to sell the company, the response they'll receive certainly won't be, "Your GAAP earnings are negative. *You'll* have to pay *me* to take this loser off your hands."

The distorted picture produced by GAAP-defined earnings wasn't an entirely new problem in 1995 or so. I first heard about it in business school in the mid-1970s, long before dotcoms and other asset-lite tech companies arrived on the scene. Then as now, pharmaceutical producers were

creating enduring value for their businesses in the form of patented drugs. The huge numbers of R&D dollars expended on inventing those drugs were booked as expenses, rather than on the asset side of the companies' balance sheets. Sparse asset amounts relative to their liabilities meant that the pharmaceutical makers had less shareholders' equity than other industrial companies with comparable revenues.

Because of the modest amount of GAAP equity on their balance sheets, drug makers had exceptionally high ratios of net income to equity (return on equity, or ROE). Due to this mathematical quirk, pharmaceutical companies' ROE was conspicuously high among industrial companies. The industry's critics cited the numbers as purported evidence that drug companies were reaping unconscionably high profits by charging excessive prices on their desperately needed products. If GAAP had permitted them to treat patented drugs with ongoing benefits to their businesses as assets, politicians and the public would have gotten a very different—and more accurate—picture. But as you can imagine, explaining this arcane accounting issue was no simple task for the pharmaceutical industry's government affairs and public relations staffs.

For the drug industry, it was a problem that GAAP was wiping out sources of ongoing value that were assets in all but name. But this wasn't a concern for most other companies. Shortly before the dawn of the present millennium,

however, the problem began to become more widespread. Certainly, the S&P 500 still included lots of companies that depended on physical capital to bend metal or sell merchandise off store shelves. But over the next several years Corporate America's ranks were increasingly populated by companies that relied primarily on brain power to produce digital entertainment or to recruit social network users.

One likely response to the idea of treating a *New Economy* company's intellectual property as an asset is, "That's not something I can touch and feel, like an oil refinery or a truck fleet." But it's eminently feasible, outside of the GAAP world, to assign values to these non-physical assets. For example, cable or satellite television subscribers pay a known subscription fee and on average continue as subscribers for a determinable number of years. Those predictable future revenues can be converted into an asset value by well-established financial methodology.

In fact, it's common nowadays for companies to supplement the GAAP numbers that they're required to report with adjusted numbers. These are meant to help investors understand businesses that don't quite fit the mold of conventional securities analysis. The alternative measures include adjusted versions of EPS. In many cases, analysts place primary emphasis on the adjusted EPS, rather than the GAAP version.

Unfortunately, companies can craft their own versions of adjusted financial ratios. Without the standardization that's one virtue of GAAP, comparing companies becomes difficult. And comparing companies' financial results and valuations is an essential component of securities analysis. But if companies with a vested interest in putting the best possible face on their financial performance start tinkering with a measure as deeply flawed as GAAP EPS, would you really expect them to wind up producing something better?

All is not bleak, however. Let's pick up the stories of Joel Stern, who documented the disconnect between EPS and valuation way back in 1974, and Amazon, the poster child for value creation without benefit of EPS. Stern went into the consulting business with another outstanding innovator in financial analysis. Bennett Stewart created an improved profit measure called economic value added (EVA).

One feature of Stewart's alternative approach was to put R&D and advertising expenditures on the company's balance sheet, rather than treating them as expenses that reduce income. Amazon measured up more favorably with EVA than in conventional securities analysis. That was because its comparatively narrow profit margins were offset by high turnover of its merchandise. In his 2013 book, *Best Practice EVA*,⁹ Stewart wrote about what happened in the period after Amazon first reported positive annual earnings, according to GAAP.

Over a five-year span, Amazon's EPS plunged from a peak of \$2.50 a share to -\$0.33. During that time, the online retailer's margins collapsed, deeply negative cash flow from operations forced it to raise tons of new capital, and the company missed consensus EPS estimates for 11 consecutive quarters. The share price did exactly what you'd expect, given those facts. Well, no, actually. The price more than quadrupled, making AMZN one of the period's best-performing large-cap U.S. stocks.

Stewart recounted how the pundits offered a totally wrong explanation for this price response, which defied everything they'd previously said about how the equity market works. It wasn't that AMZN was a unique "story stock" driven by its visionary CEO Jeff Bezos, exempt from the forces that governed all other stocks' valuations. Instead, said Stewart, the investors who really matter looked through Amazon's GAAP earnings and focused instead on genuine economic profits.

Even as the company's EPS was spiraling downward, its EVA profits nearly tripled in the five years ending in mid-2013. AMZN's price went up and up as this happened, rather than down and down, as the doctrines tirelessly promoted by equity analysts and their enablers in the media said it had to. There could hardly be a more forceful demonstration that Joel Stern was correct way back in 1974, when he wrote that earnings per share don't matter for stock valuations.

Incidentally, those wiser-than-thou critics of Amazon in its pre-positive-EPS days were also wrong about the historical episode that's usually cited in connection with supposedly irrational overvaluations. "Tulip mania" refers to a seventeenth-century episode of speculation in the Netherlands. It's commonly stated, erroneously, that the prices of tulips rose to absurdly high levels. In fact, the activity involved certain rare varieties of tulip *bulbs*. Those, in fact, had great value for their ability to propagate, much as prize bulls are valued for their ability to sire many other prize bulls.

The economist Peter Garber long ago found that prices never got out of line for the rare bulbs capable of producing exceptionally beautiful flowers. Those specimens were traded by professionals in a well-organized exchange. The excesses occurred only in informal markets set up in taverns, where non-experts could take fliers on ordinary bulbs without having to back their speculations with significant amounts of cash.¹⁰

Garber's conclusions have been challenged by subsequent researchers. But what seems clear is that the history of the tulip mania isn't as clear-cut as maintained by the detractors of stock that pulls way, way out of the pack. So next time you hear a self-appointed guardian of market propriety invoke tulip mania to trash a high valuation on a zero-EPS stock, as if it proves that investors have taken

leave of their senses, keep in mind that the celebrated pundit probably doesn't have a thorough understanding of the event.

Bottom Line on the Supposed Bottom Line

Let me summarize this exploration of the equity research community's favorite yardstick. EPS can't logically be the basis of how stocks get priced in the market. This isn't altered by the fact that it's arithmetically possible to divide a stock's price by its EPS to calculate a PE multiple, which can be compared with other companies' PE multiples. (I'll leave aside the conundrum of how to calculate a PE on a company that has negative EPS for the year.)

Even if EPS, rather than free cash flow, were the true source of a stock's value, using EPS to calculate the stock's proper price would be prone to error, due to accounting tricks that commonly render EPS misleading, if not fraudulent. Or if the reported numbers aren't fraudulent, they may be distorted by "accounting mistakes." And the erroneous EPS data may later be subject to a do-over. This is all in addition to EPS being based on accounting standards that don't apply very well to a large percentage of today's companies.

Wall Street research ignores these difficulties, blithely continuing to place EPS front and center. There's occasional talk of quality of earnings as a consideration in assigning PE multiples. Some research shops go as far as bringing more

sophisticated financial theory into their reports. But the competition among analysts to be the best at what they do largely boils down to providing the most accurate forecast of a number that's frequently a work of fiction.

I recall once seeing a stock analyst at a leading Wall Street firm receive the news that his quarterly EPS estimate for one of his companies had matched the actual figure to the penny. He was punching the air and beaming like a baby boy with another brand-new choo-choo toy, to quote an antediluvian song lyric. This was a well-established expert in his field who seemingly had nothing left to prove. But I guess the thrill of nailing an artificially contrived number, long since shown to be irrelevant to stock valuation, never gets old.

The Guidance Game

Bennett Stewart's development of a superior profitability measure hasn't been just an academic exercise. Through his consulting work he has persuaded many corporations to adopt EVA as a management tool. For corporate executives using this tool, the objective is to maximize the wealth of the shareholders. That's certainly an improvement over managers maximizing their own wealth at the expense of shareholders.

In a perfect world, every corporation would shift its focus from EPS to a superior measure that truly advanced

the objective of building shareholder wealth, be it EVA or another well-conceived yardstick. Stock analysts would then be compelled to redirect their efforts as well. Investors, in turn, would start to receive research reports that supplemented the analysts' valuable intelligence on companies' operations and prospects with genuinely helpful advice on valuation.

That would indeed be a perfect world. Here on earth, inertia controls much of what goes on in the business world. An immense infrastructure has been built up over many years on the foundation of predicting EPS, translating the predictions into price targets, debating the price targets in the media, and grading analysts and their firms on the accuracy of their predictions. Converting all the participants in this to a different, more complex metric wouldn't just be tantamount to moving a mountain. It would be more like moving a mountain range.

Refusing to conform to the established system could penalize a company in terms of the number of analysts following it. Wide analyst coverage is regarded as essential to obtaining a high stock valuation, and not necessarily without reason.

Omaima A.G. Hassan and Frank S. Skinner stated in a 2016 article that "it is well documented that analyst coverage affects firm value."¹¹ According to the previous research they cited, wide coverage makes it less costly for investors

to monitor companies' activities. So owning the shares of widely covered companies is more profitable than owning stocks followed by only a few analysts.

One study concluded that analyst coverage makes companies' stocks more valuable by increasing the demand for their shares. This is true even when the analysts merely recycle existing facts instead of ferreting out new information. The SEC requires companies to report EPS anyway, so why not play along with the system, even if EPS has nothing to do with how management runs the business?

An essential part of playing along with the system is providing earnings guidance to analysts. This consists of management telling investors the level of EPS it expects to report for the current quarter and beyond. Guidance is carefully couched in language that allows the company to escape legal liability if the actual numbers turn out to be different.

A constructive view of earnings guidance is that it helps investors price stocks properly. After all, the share price is supposed to reflect a company's future performance, rather than earnings from past quarters that have already been reported in its financial statements. Who's in a better position to know how things are shaping up for the next few months than the company's own managers?

If investors were to rely solely on companies' guidance, analysts' EPS forecasts would become irrelevant. Fortunately

for the analysts, investors continue to express interest in analysts' tweaks. For one thing, self-predictions by companies with earnings that are sensitive to the business cycle will depend on their internal outlooks on the economy. Analysts may get a better handle on key economic indicators with the help of their firms' economic teams.

Also, a corporation's managers spend a lot of effort building enthusiasm among the troops: "Rah! Rah! We're going to make that sales target. Yes!" They might find it difficult to switch hats in an instant to, "Here's a dispassionate view of what we're realistically likely to achieve." The managers' guidance might be biased to the optimistic side as a result.

Analysts who also cover the company's competitors will recognize the possibility that the companies' own earnings estimates may add up to more than the industry as a whole is likely to earn. It's mathematically impossible for every competitor to gain market share in the same period. So investors aren't crazy to suppose that analysts can be useful in tamping down excessive expectations built into guidance.

But any presumption that companies will invariably guide too much toward the upside doesn't fully account for how the guidance game is played. That's because there's a negative repercussion for a company that grossly overstates its expected EPS. Let me explain.

From the investors' perspective, the game's point is to determine whether the company is exceeding, meeting,

or falling short of expectations. That's supposed to become clear when the company reports its actual EPS. Under the rules of the guidance game, a *beat*—exceeding the analysts' consensus by even one penny—means the company is outperforming expectations. When that happens, the stock is supposed to go up. A *miss*, on the other hand, indicates that previous expectations were too high. The stock has to follow the script and fall.

As I previously discussed, a company can employ various gimmicks to boost or restrain its reported EPS in any given quarter, so as to maintain a smooth upward path. Now imagine that all through the quarter, analysts are formulating a pretty accurate picture of how things are going at the company. They know what's happening on the ground through intelligence they've gathered from the company's suppliers, customers, and competitors.

The analysts' earnings estimates reflect all that information. But what the analysts don't know is that management is worried about reporting EPS that will be too high to exceed in next year's corresponding quarter. So management is planning to trim the quarterly number with some adroitly timed accounting adjustments.

When the company releases its artificially constructed EPS number, the analysts who've based their forecasts on the reality underlying the reported number wind up being much too high. Getting blindsided in this way makes the

analysts look bad. Seeing that the company isn't playing by the rules, they may decide to stop following it in favor of another company that won't embarrass them. That's a bad outcome for the management that sprang the smoothing plans on the analysts at the last minute, since wider coverage is associated with better stock performance.

A better strategy is to guide analysts to a number close to the largely predetermined EPS figure. Not exactly to the number, mind you. The ideal outcome is for the analyst consensus to be at least \$0.01 below the number that eventually gets reported. As *Barron's* put it in 2021, "Most companies tend to set expectations conservatively so that they can then exceed a low bar."¹²

This way, if everything goes as planned, the stock will rally on the EPS beat. By the rules of the game, nobody will fault analysts for being off by a penny or two. The analysts get credit for being able to forecast earnings with a high degree of accuracy. And even if the price spurt lasts for only a day, the stock builds a reputation as the kind you want to own. The message is, "The company's outstanding management team consistently exceeds expectations."

To paraphrase an old Wall Street joke, this cozy little system works out well for the companies, it works out well for the analysts, and two out of three ain't bad. The investors can't be said to benefit from an arrangement that

discourages the sort of independent thinking that might just lead them to a hidden gem within the universe of stocks. But they're not the ones running this game.

Analysts operating within the established structure understand all too well the risks of ignoring company guidance. They can end up being right, according to the company's actual sales volumes and cost factors, but wrong, according to the EPS number concocted by management to avoid dreaded earnings volatility. From a career standpoint, the key thing is to avoid standing out with a way-off-the-mark forecast.

The safest strategy for analysts playing the guidance game is to stick close to the number being put out by management. After all, one of these quarters, business conditions may spoil the party. Actual revenues and costs might careen outside the range that management can control with channel-stuffing and discretionary accounting decisions. If that happens, analysts won't look any worse than their peers at other firms as long as they're close to the guidance-influenced consensus.

But what if an analyst thinks the price target implied by the prevailing group-think—otherwise known as the consensus—is unrealistically high? No problem. Just lower the stock's assumed PE multiple and presto, the price target is back to a realistic level.

In an extreme case, the incentives built into the Great Guidance Game could drive analysts all the way to perfect uniformity in their EPS forecasts. Once again, a bad outcome for investors. To the extent that analysts are focused on not looking bad in the guidance game, they're depriving investors of the benefit of their independent judgment.

Fortunately, the game doesn't normally work out that way. You can readily observe that analysts' estimates don't invariably converge exactly at the guidance number. But a 2020 incident provided evidence that analysts tend to avoid deviating too far from where the companies wish them to be.

At that time, the COVID-19 pandemic was creating major uncertainty about the economic outlook. In response, the *Wall Street Journal* reported, 180 of the companies in the S&P 500 stopped issuing guidance. With those helpful hints removed, the dispersion among analysts' earnings estimates became the widest since at least 2007.

Maybe dispersion would have increased in any event, given that the U.S. economy was in a recession in March–April 2020. But that recession was much milder than the Great Recession of 2008–2009. So if the divergence of estimates resulted primarily from economic contraction, it should have been greater in 2008–2009 than in 2020. We can conclude that to the extent that analysts' estimates bunch together, guidance does appear to play a role in it.

Making Nice to Management

One more reason for analysts to defer to companies' guidance is to preserve access to management. This includes obtaining face time for clients with companies' senior executives. Entrée at the corner office pays off.

A 2016 study by Ling Cen, Jing Chen, Sudipto Dasgupta, and Vanitha Ragunathan indicated that analysts who get invited to ask questions early during earnings calls have superior career trajectories.¹³ And that sort of treatment by management isn't a random thing. According to a 2014 study by Lauren Cohen, Dong Lou, and Christopher J. Malloy, 59% of surveyed investor relations officers said that they actively manage the order in which analysts are called on to ask questions.¹⁴

A standing joke on Wall Street is about the frequency with which analysts suck up to corporate bigwigs with the phrase "Great quarter, guys!" The research firm Sentieo reported that in August 2021 mentions of those words and their synonyms set an all-time record of 327. "Congratulations" also made a strong showing, according to the financial website's analysis of earnings call transcripts.

In 2017 the *Wall Street Journal's* Jason Zweig reported¹⁵ on research by Jonathan Milian and Antoinette Smith.¹⁶ They analyzed 16,000 earnings calls of 500 companies. Analysts on those calls described the quarterly results

with the adjectives “good,” “great,” or “strong” more than 215,000 times.

Companies had good reason to encourage such obeisance. Milian and Smith calculated that the more lavishly analysts praised management’s performance, the more the stock shot up after the earnings announcement. Zweig’s description of analysts’ behavior on earnings calls included the phrases “craven flattery,” “lapdog,” “snivel,” and “boot-licking sycophants.” Newsletter writer Marc Rubinstein’s account¹⁷ invoked “cozy up to management” and “public debasement in exchange for private access.”

Perhaps these findings don’t completely justify calling “Beat-the-Consensus” a rigged game. But consider the following statistics, reported in early 2022 by Reuters. Out of 180 companies that had reported 4Q 2021 earnings by that time “just” 78.8% had beaten analysts’ consensus estimates, according to Refinitiv. According to the Reuters headline, Wall Street was underwhelmed by the latest results. Over the previous four quarters, by contrast, an average of 84% of earnings reports were beats.

Any odds maker whose lines on sporting events resulted in an 80% ratio of winning bets would go bust. The handicapper’s goal is to set the line so that half the bettors win and half lose. If that happens the bookie—or legal gaming site, as the case may be—profits by raking in the vigorish, a fixed percentage of the amount wagered.

EPS forecasting isn't organized on the same business model. But a naïve investor who's familiar with the concept of an unbiased prediction probably assumes that when a company beats the consensus forecast, it genuinely represents a surpassing of previous expectations. That's simply not a valid conclusion when the vast majority of outcomes are beats.

Deviating from the Script

If you're feeling outrage at this point, let me add something to the story that may calm you down a bit. A system that involves management control over setting expectations, with full cooperation from the analysts, is a dandy arrangement from the companies' standpoint. But that's not how things always play out in practice. Analysts' EPS forecasts don't actually congregate right at the guidance number. Sometimes several analysts are well outside the pack, both above and below the consensus. What's "going wrong" in those instances?

The fact is that some companies simply don't fit very well into the EPS/PE/PT/Guidance ecosystem. Their revenues and, consequently, their profits are extremely hard to predict with any accuracy, even over a period as short as the next three months. These aren't companies that rely almost entirely on recurring revenue sources. They don't compete

in industries in which market shares change only glacially from year to year. The ups and downs of their sales don't correlate with familiar economic indicators.

These companies' financial success depends on continuously coming up with new products that may or may not catch on in intensely competitive markets. They may operate in technologically dynamic industries, where the interval between revolutionary innovation and obsolescence is brief. Or the company's revenues may depend on generating entertainment content that has massive popular appeal. There's no way of knowing for certain what moviegoers or music fans will go for. And if a company with highly uncertain prospects manages to catch lightning in a bottle, there's no guarantee that it can do it again next year.

As we'll see when we study the #1 stocks in detail, this sort of unpredictability can be a virtue. Suppose a company has a valuation that reflects the consensus expectation, but it winds up exceeding the most optimistic, far-outside-the-pack analyst's assessment of its prospects. The company's stock will probably go up way more than the average stock. Its price may even double in the space of a year.

But there's another side to that coin. Precisely because the range of plausible outcomes is so wide for a company of this type, there's a substantial risk that its EPS will turn out to be worse than the most pessimistic analyst expects.

If that happens, the stock will probably finish closer to #500 than #1 in the S&P index.

Investors who get pulled into the EPS guidance game can receive a nasty surprise even with a company that has none of the characteristics I've just described. Note the phrase a few paragraphs back: "If everything goes as planned." An unplanned-for event such as a natural disaster, a strike, a calamitous industrial accident, or loss of a major customer can upset the otherwise steady revenue stream of a mature company in a low-tech, non-cyclical industry.

It won't matter that up until the moment the bad news crossed the screen, the analysts' EPS estimates were all bunched around the company's guidance. Through no fault of the analysts, none of their earnings models included the one factor that really mattered for the quarter. Theorists might be curious whether the PE multiples that the analysts applied to their EPS forecasts somehow incorporated the small risk of an event like the one that occurred. But as a practical matter, it's an all-around disaster, for the company, the analysts who follow it, and—no surprise here—the shareholders.

Potholes in the Road Paved with EPS

Here's another way you can get tripped up by linking your trades to the guidance game: Suppose you identify an

analyst with a knack for anticipating a company's short-run zigs and zags. Over a period of several years, the company has beaten the consensus when this analyst's forecast has been above the consensus and missed when it's been below consensus. This time the ace's forecast is above consensus. The forecast is well supported by a current research report that meticulously analyzes all the important drivers of the company's earnings. You buy call options on the stock, expecting to make a quick profit and then wait to see how the analyst sizes up the next quarter.

Earnings come out and just as your hot-handed analyst predicted, the company beats by a few cents. But to your dismay, the stock goes down instead of up and your trade is a loser. As it turns out, EPS exceeded the consensus, but the company's gross margin fell short of expectations. In this particular quarter, the market cared more about the company's gross margin than about the usual center of attention, EPS.

In some other quarter, the stock may fall despite a beat on EPS because the company's updated guidance for the next quarter is lower than the market was looking for. Key takeaway: It's hazardous to participate in a game where the rules can change without warning.

An additional hazard can arise from following an analyst who isn't genuinely producing independent analysis. Let me hasten to say that I don't think that sort of slackness is typical. Most analysts, I believe, work extremely hard

to give their stock-picking customers an edge. They do this even though they know that companies can pull the rug out from under them at any time with an arbitrary accounting adjustment. Although I think most stock analysts are on the up and up, an experience I once had on Wall Street taught me the importance of probing what's underlying an analyst's EPS forecast.

My firm's compliance department asked me to resolve a divergence in opinions about a particular company by the equity analyst and the corporate bond analyst assigned to it. To understand the problem, you have to be aware that, contrary to what some investors may suppose, bond analysts don't simply examine a company's balance sheet and calculate a credit-risk score based on measures such as the debt-to-equity ratio. Like their counterparts in stock research, they strive to be forward-looking.

One of the key future numbers that bond analysts try to get a handle on goes by the acronym EBITDA, which stands for earnings before interest, taxes, depreciation, and amortization. Earnings are generally the swing factor in projecting future EBITDA. That's because most of the other components are largely locked in from the outset of the year. In the case of taxes, the number is a highly predictable percentage of pretax earnings.

In the situation I was involved in, the bond analyst's projection of the coming year's earnings was considerably

more pessimistic than his equity research counterpart's. The compliance department worried, not unreasonably, that if the stock wound up performing poorly, customers who lost money would sue. Their lawyers would argue that our firm knew the equity analyst's EPS forecast was unrealistic, as evidenced by our bond analyst's more conservative projection.

Incidentally, this scenario is less farfetched than it sounds to readers who aren't familiar with securities litigation. I once met a fellow alumnus of my college who had a dozen separate lawsuits going against brokerage firms with which he traded. Initially, I suspected—somewhat cynically, I admit—that his trading strategy was, “If the stock goes up, I win. If it goes down, I sue.” But the guy seemed totally sincere in the belief that he'd been cheated in every single instance where his infallible judgment failed to produce a profit.

Getting back to the main story, we had to get the two analysts' earnings predictions better in sync to avoid potential legal liability. I figured this would be easy to accomplish. I obtained the bond analyst's spreadsheet for his earnings projection. It included estimates for each line of the company's income statement for the coming year—cost of goods sold; selling, general, and administrative expenses; and so forth. Then I phoned the stock analyst and asked him to provide his corresponding spreadsheet so that we could

compare the two. We could then determine the source of the disagreement about the bottom line, that is, earnings.

After realizing that a couple of days had passed and I hadn't heard back from the stock analyst, I called again and he assured me he'd send his spreadsheet right over. Several days later, when it still hadn't arrived, it dawned on me that there wasn't any such document. The stock analyst's published report showed just a revenue forecast and an EPS forecast. He hadn't worked his way down from the top to the bottom of the company's income statement. Instead, he simply plugged in the company's revenue and earnings guidance, perhaps modifying it slightly to avoid being too obvious. It was certainly a more efficient, streamlined procedure than the hardworking bond analyst followed.

Rest assured, I don't believe this shortcut method is representative of most stock analysts' practices. But neither should you assume that analysts who grind away for countless hours are guaranteed to generate output that will help you create an index-beating portfolio. Even less assured is their ability to steer you toward the very best performing stock in the S&P 500.

No one expects perfect foresight from stock analysts. But at the very least, you might hope for a clear signal when things are starting to change direction. Your hopes for that modest benefit may remain unfulfilled. In July 2022, long-time market strategist Richard Bernstein commented¹⁸ that

Wall Street analysts' outlooks are invariably positioned in the middle of a market cycle. "When you start getting 'negative surprises' in corporate earnings—when a lot of companies aren't meeting expectations—analysts will say at first that it's an aberration."

Later, according to the head of Richard Bernstein Advisors, the analysts will gang together and cut their forecasts sharply. Then, when things finally start to turn around, analysts will be slow to recognize it. "Nobody will want to be the first to say that, either," said Bernstein.

There's also a risk that an analyst's conclusions will be influenced, even if only subconsciously, by considerations that have nothing to do with recommending the best possible stocks. Sometimes an analyst's assigned industry falls out of favor. That situation may persist for years, unfortunately for the analyst's career ambitions or yearning for the limelight. It would be only human in the face of such a roadblock to convince oneself that the great mass of decision makers have it all wrong.

The resulting narrative is familiar: "These stocks are unjustly disfavored. The way to make money in the market is to buy what everybody hates." If it's too much of a stretch to make a case for the group, there's another route available. The analyst may try to convince investors that one stock within the group differs in some essential way from its competitors but "has been tarred with the same brush."

Or, “They’ve thrown out the baby with the bathwater.” An even more colorful cliché goes, “When the police raid the brothel, they even arrest the piano player.”

Could people with the grave responsibility of dispensing investment advice truly allow their judgment to be compromised by self-interest? I hope it won’t shock you that the answer is yes. Let me share another anecdote.

I was once invited to be a panelist in a wide-ranging conference session. My assigned topic was speculative-grade debt, a category derogatorily referred to as “junk bonds.” I assumed that what the program’s sponsor wanted from me was to present a cogent analysis of the asset class’s prevailing downside risks and upside potential, documented with concrete facts and figures. To the best of my ability, that’s what I did in my allotted time. My 12-month outlook was for so-so returns on high-yield bonds—to call them by the purely descriptive name employed as far back as 1919.

Also on the panel were two equity portfolio managers. They interpreted the honor of being awarded a slot on the program quite differently. Both devoted their time exclusively to berating the audience for not being fully invested in stocks. Brushing aside signals suggesting that caution was warranted at that time, they cherry-picked some favorable indicators and delivered sermons on the virtues of equity investment. Never mind that the attendees had come to the conference to be enlightened rather than harangued.

The mission, as these panelists saw it, was to attract more capital to their asset class and, if possible, to their own organizations' billions of assets under management (AUM).

More AUM means more management fees, potentially leading to higher compensation for the portfolio managers. Do you suppose that motivation influenced their highly favorable assessment of the prospects for equities? And is it conceivable that the stocks on an analyst's coverage list, seen by most others as dead-in-the-water for the next couple of years, might appear attractive from the analyst's vantage point?

It Doesn't All Even Out in the End

Self-serving bias toward optimism isn't a potential problem only in out-of-favor industries. And it isn't just a potential problem, judging by data compiled by FactSet. In April 2022, John Butters from that company reported the following breakdown of thousands of analyst ratings on S&P 500 stocks, based on monthly averages over the preceding five years:

Buy	52.9%
Hold	41.1%
Sell	6.0%

This breakdown doesn't directly tell us how many of the S&P 500 companies are rated Buy, Hold, or Sell by a majority of the analysts following them. But it's mathematically impossible for every research organization represented in the survey to have an equal balance between Buy and Sell recommendations, yet produce so lopsided a mix of Buys and Sells in aggregate. We can therefore infer that the split between Buys and Sells within many research organizations tends to be closer to the nearly 9 to 1 ratio (52.9%/6.0%) shown above than to a 50/50 split.

That inference is supported by an analysis of recommendations issued by leading brokerage houses during August 2022. According to the MarketBeat data, the median ratio of Buys to Sells among the 18 firms was 7.1 times. The least unbalanced output among the 18 research departments was "only" 2.0 times as many Buys as Sells. At the opposite extreme, one brokerage house's mix included 60% Buys and 0% Sells, resulting in a ratio of infinity. The next-most-lopsided distribution was a 33 to 1 Buys-to-Sells ratio.

An overwhelming preponderance of Buys might seem to signal some sort of malfunction. Certainly, a dairy that set out to make equivalent amounts of chocolate and vanilla ice cream but instead produced 2 to 30 times as much chocolate as vanilla would reckon that something went wrong in the production process.

But consider the matter from the standpoint of an equity salesperson, whose compensation depends on generating lots of transactions. A Sell recommendation is useful only to customers who already own the stock. A Buy recommendation, on the other hand, is relevant to everybody on the salesperson's coverage list.

This includes customers who already own the stock. They might be talked into buying more when the analyst electrifies the market with the words "I'm reiterating my Buy." (That action might not satisfy finance professors' definition of "new information entering the market." But financial news editors are okay with reporters crediting a reiterated Buy for an otherwise unexplained price jump.) As far as the salesperson's bottom line is concerned, if analysts are working on reports that will culminate in Sell recommendations, they're not making the most productive use of their time.

Even if you aren't in the business of selling stocks, which makes a Buy report more useful to you than a Sell report, you too might see no problem with a 9 to 1 ratio between the two. After all, if the market as a whole rises by a significant amount, it's likely that many more stocks will go up than down. That will confirm that they were all good stocks to own at the time that the analysts made the recommendations. And the fact that the stock market dependably

risers over the long run means that those trades will probably pay off sooner or later

The flaw in that reasoning is that equity analysts aren't paid to identify stocks that will go up at some point in the next several years, in line with a rise in the market as a whole. Investors who want to invest on that kind of premise buy index funds. There's nothing wrong with that, but equity research departments exist for the benefit of the other class of investors, the active managers who focus on security selection. They prefer the challenge of attempting to do better than the market average by picking stocks that will outperform.

Among the stock pickers are investment managers who are engaged in fierce competition for institutional assets. They face annual reviews by the pension plans and university endowments whose money they manage. Their performance is measured over quarterly, and even shorter, periods. One year of underperforming their benchmark (an index matched to the type of portfolio they run) probably won't cause clients to yank their money. But it steps up the pressure to outperform next time. Mutual fund managers' short-run results are out there for the world to see. If they want to run bigger funds and increase their personal compensation, they have to put up good numbers with a high level of consistency.

Since these managers' success is tied to market indexes, owning stocks that go up in a bull market isn't good enough. They need analysts to recommend stocks that will go up by more than the index when the market rises. Under this arrangement, a stock that goes down by less than the index in a bear market is actually a better recommendation than a stock that goes up by less than the index in a bull market. Recognizing that their professional customers' objective is to beat their benchmark, some research organizations use terminology along the lines of Outperform/Market Perform/Underperform, rather than Buy/Hold/Sell.

Now imagine you're a portfolio manager who's trying to excel within this set-up. The one indisputable fact you know is that by definition, half of the stocks in the index will do better than the median and half will do worse. Yet here you are, with your firm's most trusted research provider claiming that nine times as many stocks are going to beat the median as are going to return less than the median. Oh yes, that's in addition to assigning Hold ratings to about 40% of the stocks they cover. That rating implies that all those stock will match the index. That's one more thing that ain't gonna happen.

How can this research be useful to you when you know that its predicted outcomes are impossible?

Some market pros reading this will say that I don't understand how things actually work. Those Holds, they'll

explain, are really Sells. If you count that way, the wildly skewed 52.9%/6.0% Buy/Sell ratio cited above magically turns into a 52.9%/47.1% Buy/Sell ratio. Not a perfect 50/50 split, but then again, neither is the proverbial coin flip. (Rigorous testing by Persi Diaconis, Susan Holmes, and Richard Montgomery found that 51% of the time, a coin will land on the side that was facing up when it was flipped.)¹⁹

“You see,” the pros will continue informing me, “by taking the irresponsibly radical step of putting a Sell on a stock, an analyst would instantly become *persona non grata* with the company’s management.” No more front of the line to get picked to ask questions on earnings calls. No more open door at corporate headquarters for the analyst’s VIP buy-side customers. A total freeze-out. Think Michael Corleone: “Fredo, you’re nothing to me now. You’re not a brother, you’re not a friend. I don’t want to know you or what you do.”²⁰

Fortunately, there’s a way to avoid that terrible fate without losing all credibility by continuing to recommend an obviously overpriced stock. If the company’s outlook is undeniably horrible, the analyst can lower the boom on it by downgrading it . . . all the way to Hold. This is done with a wink to those in the know. (“You understand, without my saying so, that this means ‘Get out immediately,’ right?”) It’s not exactly in line with the biblical injunction, make your

yea a yea and your nay a nay. But it does get the point across and everybody saves face. What's the harm?

I get all that, but putting myself in the portfolio manager's shoes, I have some gnawing questions about this cozy arrangement. First of all, what's the difference between an actual Sell and a wink-wink Sell (otherwise known as a Hold)? Maybe Sell means, "Really, truly. I'm serious. Dump it right away!" Or maybe it just means, "Don't add to position." Am I supposed to exit the Holds but sell the Sells short, or what?

Also, you and I both know that nothing like 40% of the stocks in the index are going to perform close to the median. Within the S&P 500, the middle 40% by total return are those ranked 151 to 350. In 2021, the returns on those stocks ranged from 15.33% to 42.45%. That compared with a median (halfway between #250 and #251) of 28.17%. So some of those Holds validated their classifications as Sells in all but name, but others were stocks that would have helped me a lot in my quest to beat my benchmark. Does that mean, in reality, that some of those 200 stocks were "strong Holds" and some were "weak Holds"? Maybe in the future you could let me know which are which?

Based on the fact that some Holds massively outperform the averages, while others massively underperform, I'm inclined to agree with veteran traders who told me early in my career that there's no such thing as a Hold.

That designation is just a way for analysts to avoid taking a stance. Traders can't waffle; they have to hit the bid or lift the offer.

Finally, stepping back from all this, is the analyst's purpose to recommend good stocks to me? Or is it to avoid hurting the feelings of CEOs, whose multimillion-dollar compensation packages ought to constitute adequate cushions for such blows?

These objections, I hasten to say, haven't a prayer of changing the status quo. The established charade, in which "Hold" is code for "Sell," is too entrenched. On September 4, 2018, *Bloomberg News* reported that the mix of Wall Street analyst recommendations on Advanced Micro Devices was "balanced" at 14 Buys and 4 Sells. That 77.8%/22.2% ratio shifts to something in the vicinity of balanced, at 45.2%/54.8%, only if you count the 13 Holds as Sells.

It's reminiscent of a riddle, a version of which was reportedly used by Abraham Lincoln although he didn't originate it: How many legs does a dog have if you call his tail a leg? Answer: Four. Saying that a tail is a leg doesn't make it a leg.

Breaking Out of EPS/Guidance Prison

It's easy to get locked into an excessively narrow, EPS-obsessed view of the stock market. Quarterly earnings

reports provide ready-made news events for the media. The quarterly ritual also gives analysts recurring opportunities to demonstrate their prowess as prognosticators. The hoopla surrounding these numbers fosters the illusion that equity returns are all about 90-day slices of a statistic that's been shown to play no part in how the market's real price-setters evaluate stocks.

Compounding the absurdity, the companies that are supposed to be measured by the master metric EPS have perfectly legal ways of altering it to their advantage. They also have some ability to constrain independent forecasts of the quarterly numbers by analysts, who risk looking bad if they stray too far from the companies' guidance. And by the way, some corporate players in the EPS game don't even focus on it for the internal process of running their businesses. But confronted with an elaborate structure erected on the foundation of EPS, investors fall into the trap. They conclude that their task is to anticipate beats and misses that will produce one-day price spurts or stumbles.

To the extent that investors look for a story to supplement this simplistic numerical analysis, the commentary they obtain from the media consists largely of uninformative sound bites. In many of those superficial discussions, the supposed rationale for buying this particular stock at this particular time involves something that was equally true last year and the year before that. ("Great company. Strong

balance sheet. Seasoned management.”) This unhelpful commentary typically comes from permabulls who act as advocates rather than analysts.

The saving grace is that confinement in EPS prison isn’t a mandatory life sentence. It’s eminently feasible to break out with the help of equity researchers who’ve caught up with Joel Stern’s 1974 revelation that earnings per share don’t count. Some have gone further, developing genuinely useful analysis for those willing to put in the effort to benefit from it.

To provide just a taste of what’s out there, I looked over Bloomberg-compiled research reports of 2021 on Meta Platforms (FB), which was still known as Facebook at the time. I won’t detail the methodology of every organization represented in that list. But I’m glad to say that there’s legitimately useful information available for EPS escapees, even though in the end, some of the research departments still reduce their findings to $\text{EPS} \times \text{PE} = \text{PT}$.

As I mentioned earlier, Stern highlighted free cash flow (FCF) as a more important determinant of stock prices than EPS. On a per share basis, FCF shows up as the numerator in a metric reported by Barclays, FCF yield. JPMorgan provides prospective FB buyers a variant it calls “FCFF yield.”

Needham included in its summary a metric that labeled OIBDA (operating income before depreciation & amortization and stock compensation). PhillipCapital related

its price target to its projection for discounted cash flow. That research provider stated that its price target also took into account qualitative factors such as the stock's risk-reward profile, market sentiment, the recent rate of share price appreciation, the presence or absence of stock price catalysts, speculative undertones surrounding the stock, and other factors. Note particularly the emphasis on catalysts. It contrasts with the less thoughtful form of value investing, which asks us to believe that one day the market will spontaneously recognize that the stock has been trading below its intrinsic worth for months or years.

The most thoroughgoing exit from the $\text{EPS} \times \text{PE} = \text{PT}$ paradigm among the FB reports is Valens Research's analysis. Valens stresses that its reports don't constitute Buy, Hold, or Sell recommendations on particular securities. The authors urge readers to consider other information in making their investment decisions. But Valens employs metrics of its own that probe more deeply than those found in most other research.

Providing detailed descriptions of all the Valens-devised valuation tools would make for extremely dense prose. But you can get the idea from one such tool. It consists of net working capital plus long-term non-depreciating operating assets. The latter component, in turn, includes land and non-depreciation operating intangible assets, excluding goodwill and other acquisition-related intangible assets.

As for the earnings calls that trigger-happy traders listen to for beats and misses, Valens applies a propriety process it calls “Earnings Call Forensics.” This methodology examines and evaluates management’s representations during the quarterly calls, as well as at other public events. Valens contends that broker-dealers are either unable or unwilling to use the techniques it employs, often out of fear of endangering their relationships with companies’ management teams.

There’s further good news for investors who harbor a suspicion that it’s not in their financial interest to allow corporations, research departments, and the media to maneuver them into playing the guidance game. Some companies have opted out of providing guidance. Most conspicuously, perhaps, Berkshire Hathaway CEO Warren Buffett has said, “I think it’s a very bad practice to be in the game of earnings guidance, and it is a game.”²¹ The Oracle of Omaha says he has seen guidance lead to a lot of bad things.

Hearteningly too, Berkshire forswears smoothing of its quarterly and annual results. In its “owner’s manual,” written by Buffett, the company colorfully vows that it will always tell shareholders how many strokes it took on each hole and will never play around with the scorecard. Reinforcing a key point of this chapter, Buffett points out that consolidated reported earnings may reveal relatively little about Berkshire’s true economic performance, due to the limitations of conventional accounting.

In this context, Buffett sounds a lot like Joel Stern saying that the sophisticated investors who actually determine stock prices don't rely on accounting-based reported earnings. He expresses confidence that shareholders will fully realize the benefits of earnings that are unreportable under GAAP. The benefit will come through capital gains.

Finally, Berkshire rejects the "big bath" tactic employed by companies that suffer too big a loss to paper over with accounting sleight-of-hand. It's widely believed that while a big loss is bad for a stock, a bigger loss isn't worse for the stock. So if a quarterly loss from legitimate business setbacks is inevitable, that's a convenient time to take a whole bunch of write-offs. Management often has a backlog of write-offs that it had planned to postpone until they could be used to offset an unusual gain that it wouldn't be able to replicate in the corresponding quarter a year later.

Since management doesn't think another hundred million dollars of losses will do any more damage to the share price, why not take even bigger write-offs than necessary? This can be an opportune time to deal with a variety of items that management has purposely overlooked until now in order to avoid reporting anything but a steady climb in reported earnings. The balance sheet still assigns full value to some shaky debts, tired inventory, and goodwill arising from acquisitions that didn't pan out as hoped.

By being extra aggressive about writing down those assets, management can create a “cookie jar” of written-off assets. It can write them back up when—surprise!—the previous accounting treatment turned out to be too conservative. And wouldn’t it be a stroke of good luck if that revelation just happened to occur during a quarter in which weak earnings were otherwise threatening to spoil the company’s smooth upward progression?

Final Thoughts on Fundamental Analysis

The ultimate point of this extended tour of equity analysts’ methods is not to dispute that they sometimes generate extremely profitable stock recommendations. One extraordinary example occurred in August 2022. A London-based Jefferies analyst, Charles Brennan, predicted in a note to investors that a wave of takeovers in the European tech sector would continue. He helpfully included a diagram of acquirers’ possible targets.

The very next evening, the Canadian software company Open Text Corp. announced that it would acquire Micro Focus International. Brennan had identified the UK enterprise software developer as the second-most-likely takeover target on his list. Open Text’s bid represented a 99% premium over the previous close. When Micro Focus International reopened for trading, the price zoomed almost

to that level. Holders nearly doubled their money in the space of about 24 hours.

If this kind of thing happened every day, an investor really could start with a small grubstake and make enough money in the space of a year to retire for life. But as I stress throughout this book, that isn't a realistic or appropriate aspiration. Patience is an indispensable component of a successful investor's psyche.

There are two valid reasons to try to pick next year's #1 stock, if that excites you. The first is that it can provide an outlet for the speculative urge that won't harm you financially if you allocate just a percent or two of your portfolio to your annual pick. The second is that conducting the research needed to make your selection can teach you valuable things about the dynamics of stock prices. Those lessons will help you assemble a well-chosen, responsible equity portfolio.

What you should take away from the preceding overview of fundamental equity research is that the analysis published by brokerage houses and independent research firms, useful though it may be in other respects, isn't geared to the specific objective of identifying in advance the single best-performing stock in the S&P 500. Those organizations are rewarded if they enable managers of diversified portfolios to beat their investment benchmarks by modest margins and avoid large losses. Looking for #1 requires an entirely different focus.

As for Technical Analysis . . .

The opening section of this chapter mentioned that equity analysts' study of a company's fundamentals—competitiveness, financial strength, earnings, and so on—is supplemented by the work of technical analysts who focus instead on a stock's price behavior. They construct charts of the stock's past price movements, believing that certain observable patterns provide useful indications of its future price. Many stock pickers take both fundamental and technical conclusions into account.

A comprehensive assessment of technical analysis is a great topic for another author, time, and place. The purpose of this book is to assist in the effort to identify in advance the year's best-performing stock. Toward that end, I'll just provide some reasons to doubt that technical analysis provides a quick, easy solution to that puzzle.

In my role as book review editor of the *Financial Analysts Journal* I reviewed a 2009 book by Andrew W. Lo and Jasmina Hasanhodzic titled *The Heretics of Finance: Conversations with Leading Practitioners of Technical Analysis*.²² It's a serious, methodologically rigorous book that's by no means unsympathetic to the chartists' efforts to generate useful investment advice by studying price histories.

In fact, the authors summarize a study that found 10 price patterns favored by technical analysts to be statistically valid. They stop short of inferring from these findings

that technical analysis can lead to profitable trading strategies. Still, they urge finance professors, who are generally skeptical about technical analysis, to open a dialogue with its practitioners.

Lo and Hasanhodzic's open-mindedness on the subject contrasts with the conviction of hardcore believers in efficient markets that a stock's past price movements have no bearing whatsoever on its future price movements. According to that view, a stock's price changes because new information arrives that alters the stock's intrinsic value. End of story. To efficient market hardliners, the countless hours that technical analysts spend on predicting future stock prices is at best a total waste of time.

The technical analysts interviewed in *The Heretics of Finance* don't exactly counter this criticism with concrete evidence that their labors meet high scientific standards. Here's a sample of their responses to the suggestion that their work ought to pass the test of empirical verification:

- "I doubt that many of the theories have been—or can be—back-tested."
- "Few things in life are perfectly black or white."
- "Technical analysis is an art."

If those comments don't inspire confidence, consider how Lo and Hasanhodzic's interviewees answered the

question “Do you think that the inclusion of astrology in technical analysis undermines the credibility of the craft?” Their replies include the following:

- “Could astrology in some offhand way be beneficial or instructive? I’m going to say yes.”
- “It depends on the type of astrology you’re talking about.”
- “I’ve seen some people make some very good calls using astrology.”
- “Astrology is bad for technical analysis only in the eyes of closed minds.”

Skepticism about the usefulness of technical analysis isn’t restricted to academics. The renowned market analyst Laszlo Birinyi tells Lo and Hasanhodzic that the discipline is problematic due to an absence of hard and fast rules and proven theories. “It allows you to pick a stand and then find things that support your stand,” he says. Birinyi has debunked some venerable technical rules and flatly declares, “The truth is technical analysis doesn’t work in the market.” He notes that anybody who relied on the chartists’ cherished advance/decline ratio would have stayed out of stocks all the way from 1957 to 2002.

Unfazed by outright dismissals of their work, the technicians insist that theirs is the true path to stock market

enlightenment. Robert Prechter scoffs at the notion of deepening the insights of technical analysis by combining it with fundamental analysis. In his opinion, that's like asking, "Is food more effective when used on its own or when combined with arsenic?" Confronted with the criticism that charting is inherently backward-looking, Alan Shaw counters that fundamental analysts are also backward-looking in their reliance on income statements and balance sheets. This skips over the fact, emphasized throughout the preceding critique of the fundamental approach, that analysts' price targets are based on *projected* EPS.

Technical analysis has legions of fans, but its detractors seem to be more outspoken than critics of fundamental analysis. Without specifying "technical" or "fundamental," I searched Google for the phrase "Is stock analysis bogus?" The first batch of headlines included the following:

- "Why Technical Analysis Is Useless"—Seeking Alpha
- "Is it proven that technical analysis of stocks is a fraud?"—Quora
- "Why Technical Analysis is Nonsense"—Seeking Alpha
- "Technical Analysis Is Fundamentally Flawed"—forbes.com
- "Is Technical Analysis Bogus?"—Mitchell Rosenthal, medium.com

That last headline is for an article that's actually constructive on technical analysis. But it's revealing that the author sees a need to answer the question he poses. There were no comparably deprecating comments or pointed questions about fundamental analysis among the top hits generated by asking if that approach is bogus. As extensively documented in this chapter, fundamental securities analysis isn't immune from criticism. But only technical analysis, whether fairly or otherwise, generates the intense skepticism that a quick search of the Internet produces.

It's faint consolation for technicians that their image has improved from "low-level criminals." That's how they were perceived in the 1920s, according to technical analyst Anthony Tabell. In those days, *point-and-figure charts* were used in apparent attempts to benefit from pools. Those were collusive efforts to manipulate stocks, which were disreputable although not yet illegal at the time. Tabell said that cloud continued to hang over technical analysts' reputation as late as the 1950s.

The purpose here, however, is neither to bury technical analysis nor to praise it. What matters to this book's theme is what can help investors who want to take a shot at picking the #1 stock. That's not the specific focus of technical analysts. Neither is that the goal of their fundamental counterparts who make EPS forecasts, apply PE ratios, and generate price targets. Whatever the merits of their respective

disciplines may be, stock pickers who are trying to zero in on the coming year's biggest gainer must look beyond their input. One logical place to look is in the stories of the stocks that have captured that crown in the past. Let's now turn to that topic.