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THE CONSENSUS TRAP

With fewer analysts covering ASX 300 forecasts, companies must be more proactive about managing earnings expectations.

Out-of-date sell-side analyst forecasts are causing serious and growing problems for listed entities and for investors who rely on consensus estimates when making important investment decisions. Commonly, this might be the consensus or average of the earnings forecasts of the analysts conducting research on a company among ASX 300 stocks.

A decline in the number of stockbroking analysts who publish earnings estimates is combining with an increase in the number of outdated or stale forecasts remaining in circulation to create an investing trap. In a nutshell, investors increasingly base their investment decisions on bad information, often without knowing it. This is because the consensus or average can be distorted by out-of-date forecasts from analysts.

Companies are frustrated. It is regarded as best practice for investor relations teams to keep a close eye on consensus numbers throughout the year, but especially as reporting seasons near. They don't want consensus to be out of whack with their own published earnings or other forms of guidance, if the company gives it, because that can leave investors uninformed and cause unwanted share price volatility, particularly on the day a company releases its results.

A survey undertaken last year by AIRA showed 61 per cent of respondents from leading ASX companies expressed concern about consensus estimates caused by out-of-date sell-side research. Representation has subsequently been made for a review of ASX's *Guidance Note 8*, which currently states listed entities have no obligation to correct individual analyst earnings forecasts or consensus estimates to bring them into line with an entity's internal projections. Some 71 per cent of survey respondents agreed *Guidance Note 8* should be amended to reflect the structural changes occurring globally in relation to sell-side research.

Since then, the problem has only worsened. We see the impact of that particularly during reporting seasons, when earnings results are laid on the table to compare with investors' own expectations. Sharp swings in price are being observed, rather than the measured responses companies and investors would prefer, which results from credible guidance. Such lurches in price were evident in some cases in the latest reporting season. This can occur for a number of reasons, but it shouldn't.

AIRA believes listed entities should be allowed to exclude stale analyst forecasts (those that are three months or longer out of date) from their internal version of the consensus of analyst forecasts. This should, in turn, give a listed entity sufficient comfort to publish its view of consensus on its website and inform investors. This would assist listed entities to track market expectations and comply with their continuous disclosure obligations.

Consensus forecasts published by third party service providers were until recently regarded as a valued input when investors considered whether a company was performing to expectations. When consensus numbers changed, they served as a measure of market sentiment. They were also useful to compare against a company's own guidance. But this insight has dimmed.

Many stockbroking firms and investment banks are employing fewer experienced investment analysts to cover major listed companies. The situation is even worse for small cap companies. Those analysts that remain often don't have the same depth of experience. Increasingly, they have to cover more companies across a greater number of industry sectors. That has led to updates to analyst forecasts becoming less frequent and the number of individual forecasts for any given stock also declining. Put simply, the so called consensus of analyst forecasts is far less reliable.

When grouped together in a consensus, individual earnings estimates for any given company used to provide a valuable marker to future performance. Investors saw a broad range of credible expectations, compared with the mere few that are now commonplace.

Large funds management companies are overcoming the problem by increasingly using in-house analysts to provide their own estimates. Of course, they also contract the services of experienced, private researchers. In some instances, fund managers even prepare consensus numbers for their own use.

Increasingly, listed companies are being challenged by this squeeze. If their own earnings expectations move materially away from consensus, then that can be a material event which diligent investor relations professionals and other senior management would often believe needs to be corrected via an ASX release. This is particularly important the closer it comes to the end of the June and December reporting periods, when any differences should be the narrowest.

AIRA believes companies need to actively manage earnings expectations. They need to monitor consensus numbers throughout the year, particularly as reporting seasons draw near when discrepancies emerge, as analysts may not have incorporated the latest publicly available information from companies into their thinking. In some circumstances, it may be necessary for them to contact individual analysts who have published outlying forecasts to understand better how they were derived. And they may need to explain their company's own publicly available guidance and correct any factual errors in analyst assumptions.

Market integrity is a very important issue. As it stands, it is being eroded by the increasing unreliability of consensus forecasts. Sadly, it is retail investors who often bear the brunt of the impact, because they don't have access to reliable consensus estimates.