Discussion of ‘How Do Analysts Interpret Management Range Forecasts?’

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High Level Overview

• Paper holds potential interest and is written very thoughtfully and clearly (albeit too repetitively)

• Quick Summary:
  - Management forecasts have become predominantly range forecasts, with widths increased since the crisis
  - Analysts react to management forecasts; researchers have generally (implicitly) assumed they react to the mid-point of range forecasts (i.e., place equal weights on upper and lower bounds)
  - This paper relaxes that assumption and empirically assesses how analysts weight upper & lower bounds on average, and some factors that may explain variation in this average weighting
  - Main findings are that analysts place more weight, on average, on lower bound and that this is true to larger extent when more ambiguity/uncertainty present (extending “max-min” axiom)
Background

• Range forecasts a minority until Reg FD, but become strong majority thereafter, with post-crisis width increase (Table 1)

• MF range heavily influences AF revisions (Table 2)
  o MF range roughly symmetric around prevailing consensus
  o Analysts’ revisions move consensus forecast to be more often within MF range than the pre-MF consensus was
  o Analysts more often revise above the MF midpoint

• Given dominance of ranges for MFs, and evidence that analyst revisions aren’t based just on midpoint, this paper examines weights placed by analysts on upper vs. lower bounds of range forecasts by management
Hypothesis development – average effect

• H1 – analysts put more weight on lower bound of MF range when revising their forecasts in response

• Reasoning given – People more likely to assign high probability to worst scenario when facing ambiguity and they make choices that “maximize their expected utility under the least favorable scenario”, called “max-min” axiom

• Paper cites evidence analysts are ambiguity averse – FINE

• Paper argues MF range is an ambiguous signal – FINE

• Paper assumes low realized earnings is a “least favorable” outcome for the sell-side analyst following the firm – WHY? (e.g., true if analyst has “sell” recommendation?)
Economic agents respond to incentives

• Groysberg et al. (2011) demonstrate that changes in performance on *Institutional Investor* survey cause changes in compensation

• Groysberg et al. also find that changes in forecast accuracy are not associated with changes in compensation

• Bagnoli et al. (2008) find forecast accuracy is of relatively low priority in determining *Institutional Investor* All-Stars

'I have never tracked [analyst forecast error] and nowhere that I have been did before I arrived. I don't think it is any kind of acid test for whether an analyst has keen insight. If the clients pay attention to and pay for the services of an analyst, then that is a good analyst, whether or not they get the earnings, or for that matter, stock prices, right.‘

-- Research director of large brokerage firm
Hypothesis development – XS & TS variation

• H2 – Analysts overweighting of MF lower bound of range greater when there’s more ambiguity, as proxied by
  • MF earlier in period,
  • Wider range of MF,
  • More preexisting analyst forecast dispersion, and
  • More stock return volatility

• Basic hypothesis of H2 makes sense IF H1 CAN BE BETTER JUSTIFIED

• Proxies seem reasonable for capturing uncertainty, but is uncertainty = ambiguity in the theories that motivate H1?
Descriptive Statistics (Table 3)

• Repeating old finding, authors find the revision by analysts following a MF is too small compared to the optimal revision

• Should we worry that this well known under-reaction by analysts affects relative weights analysts place on the upper and lower bounds of the MF range?

• Authors (in f.n. 9) say no, because “over- or under-reaction should apply equally to the upper bound and lower bound of range forecasts”

• Doesn’t it potentially depend on why the over- or under-reaction occurs? E.g., if analysts were under-reacting to bad news and over-reacting to good news with the goal of maintaining an optimistically biased forecast, would f.n. 9 statement hold?
“Distance” vs. “Weights” in analyst reaction to MF range

Distance:
- Which point within the MF range is “closest” to analysts’ revised forecast?
- Table 2 (and Ciconte et al. [RAST]) find analysts’ revised forecasts are “closer” to upper bound of MF range

Weights:
- Sensitivity of analyst revision to forecast news conveyed from MF range endpoints
- This paper finds more weight on the lower bound

How to reconcile Distance vs. Weight results?
- Positive intercept – “analysts respond positively to act of MF being provided” – I don’t think this is consistent with most disclosure theory (2nd moment vs. 1st moment)
Do “weights” matter for analyst research?

• P. 19 – “future studies should at least include Width in the analyst revision model to allow analysts to place unequal weights on the endpoints of management range forecasts”

• Why? What inferences will be changed/improved?

• If there generally isn’t an intercept analogous to the one from this paper in other analyst research (due to frequent use of fixed effects) can we expect to see any change in inferences when an analyst researcher follows the prescription stated above?

• Might be nice to replicate some prior influential result from literature on analyst reaction to MF range and then show how it is altered by following prescription above
Concluding remarks (dark side)

• Analysts don’t adjust forecasts as quickly as a Bayesian forecaster would

• I question the paper’s assertion that such under-reaction by analysts to MF range will apply equally to the upper and lower bounds of the range (and that it can thus be ignored in the paper’s research design)

• Hypothesis development unsatisfying about ambiguity’s impact because no specifics about analyst forecast context (e.g., buy vs. sell recommendation linked to forecast) or analyst incentives

• Importance of “weights” vs. “distance” not completely clear (what findings would change by allowing for empirically determined weights?)

• More weight on lower bound even though distance is closer to upper bound reconciled via an interpretation of the positive intercept seemingly inconsistent with disclosure theory
Concluding remarks (bright side 😊)

• Tests are thoughtful and quite strongly consistent with both overweighting of the lower bound on average and greater overweighting of the lower bound when there is likely more uncertainty (which may not = more ambiguity)

• MF range is clearly important and the general notions that analysts may focus on more than the midpoint and weight the endpoints differentially are intuitive and appealing

• MF range moves the revised analyst consensus toward being more often within the MF range – I think this is a key motive for use of the MF range worth thinking about in more depth – in other words, consideration/investigation of management incentives could enhance the paper