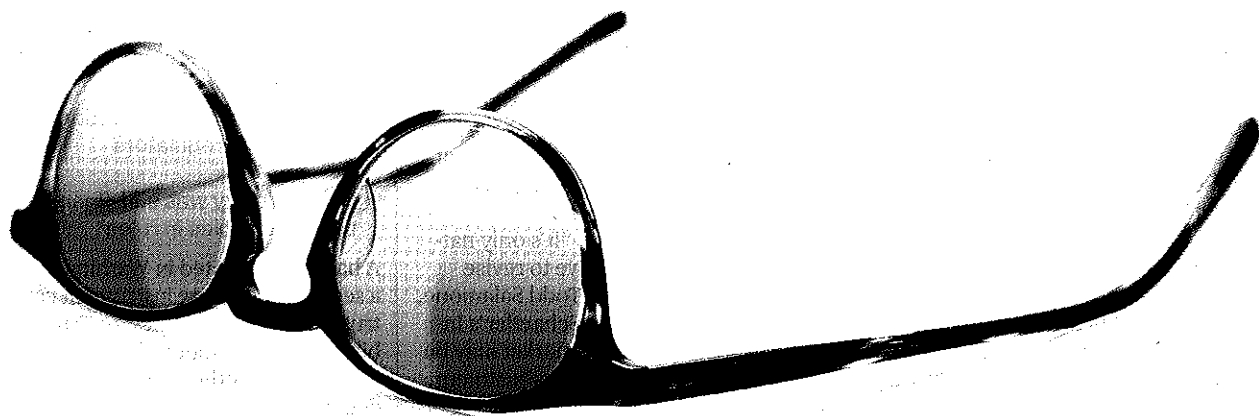


# Markets & Finance

## For Analysts, Things Are Always Looking Up



39

▶ They're raising earnings estimates for U.S. companies at a record pace

▶ As a group, McKinsey says, they have been "persistently over-optimistic for 25 years"

For years, the rap on Wall Street securities analysts was that they were shills, reflexively producing upbeat research on companies they cover to help their employers win investment banking business. The dynamic was well understood: Let my bank take your company public, or advise it on this acquisition, and—wink, wink—I will recommend your stock through thick or thin. After the Internet bubble burst, that was supposed to change. In April 2003 the Securities & Exchange Commission reached a settlement with 10 Wall Street firms in which they agreed, among other things, to separate research from investment banking.

Seven years on, Wall Street analysts remain a decidedly optimistic lot. Some economists look at the global economy and see troubles—the European debt crisis, persistently high unemployment worldwide, and hous-

ing woes in the U.S. Stock analysts as a group seem unfazed. Projected 2010 profit growth for companies in the Standard & Poor's 500-stock index has climbed seven percentage points this quarter, to 34 percent, data compiled by Bloomberg show. According to Sanford C. Bernstein, that's the fastest pace since 1980, when the Dow Jones industrial average was quoted in the hundreds and Nancy Reagan was getting ready to order new window treatments for the Oval Office.

Among the companies analysts expect to excel: Intel is projected to post an increase in net income of

**Despite the European debt crisis and high U.S. unemployment, the call is for profits to climb 34 percent**

142 percent this year. Caterpillar, a multinational that gets much of its revenue abroad, is expected to boost its net income by 47 percent this year. Analysts have also hiked their S&P 500 profit estimate for 2011 to \$95.53 a share, up from \$92.45 at the beginning of January, according to Bloomberg data. That would be a record, surpassing the previous high reached in 2007.

With such prospects, it's not surprising that more than half of S&P 500-listed stocks boast overall buy ratings. It is telling that the proportion has essentially held constant at both the market's October 2007 high and March 2009 low, bookends of a period that saw stocks fall by more than half. If the analysts are correct, the market would appear to be attractively priced right now. Using the \$95.53 per share figure, the price-to-earnings ratio of the S&P 500 is a modest 11 as of June 9. If, howev-

Learning from  
Wall Street's  
angriest bears  
page 48 ▶



## Markets & Finance

er, analysts end up being too high by, say, 20 percent, the P/E would jump to almost 14.

If history is any guide, chances are good that the analysts are wrong. According to a recent McKinsey report by Marc Goedhart, Rishi Raj, and Abhishek Saxena, "Analysts have been persistently over-optimistic for 25 years," a stretch that saw them peg earnings growth at 10 percent to 12 percent a year when the actual number was ultimately 6 percent. "On average," the researchers note, "analysts' forecasts have been almost 100 percent too high," even after regulations were enacted to weed out conflicts and improve the rigor of their calculations. As the chart below shows, in most years analysts have been forced to lower their estimates after it became apparent they had set them too high.

While a few analysts, like Meredith Whitney (pages 43 and 48), have made their names on bearish calls, most are chronically bullish. Part of the problem is that despite all the reforms they remain too aligned with the companies they cover. "Analysts still need to get the bulk of their information from companies, which have an incentive to be over-optimistic," says Stephen Bainbridge, a professor at UCLA Law School who specializes in the securities industry. "Meanwhile, analysts don't want to threaten that ongoing access by being

too negative." Bainbridge says that with the era of the overpaid, superstar analyst long over, today's job description calls for resisting the urge to be an iconoclast. "It's a matter of herd behavior," he says.

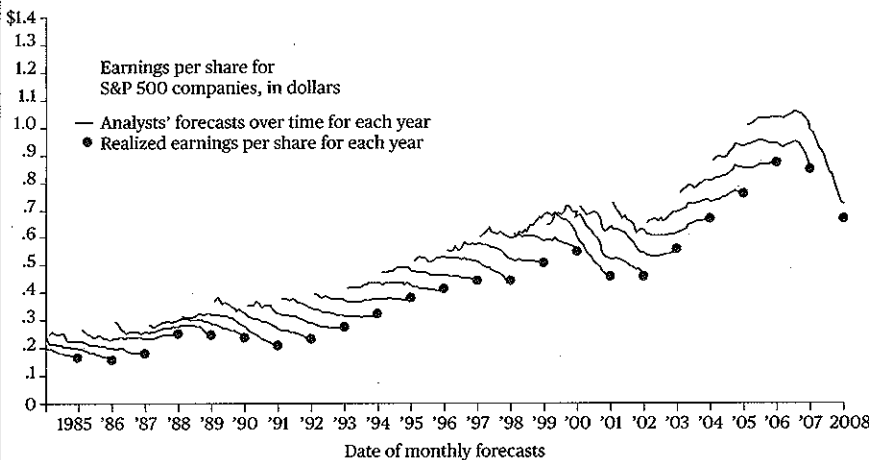
So what's a more plausible estimate of companies' earning power? Looking at factors including the strengthening dollar, which hurts exports, and higher corporate borrowing costs, David Rosenberg, chief economist at Toronto-based investment shop Gluskin Sheff + Associates, says "disappointment looms." Bernstein's Adam Parker says every 10 percent drop in the value of the euro knocks U.S. corporate earnings down by 2.5 percent to 3 percent. He sees the S&P 500 earning \$86 a share next year.

As realities hit home, "It's only natural that analysts will have to revise down their views," says Todd Salamone, senior vice-president at Schaeffer's Investment Research. The market may be making its own downward adjustment, as the S&P 500 has already fallen 14 percent from its high in April. If precedent holds, analysts are bound to curb their enthusiasm belatedly, telling us next year what we really needed to know this year. —*Roben Farzad*

**The bottom line** Despite reforms intended to improve Wall Street research, stock analysts seem to be promoting an overly rosy view of profit prospects.

### The Earnings Roller Coaster

Analysts have a long history of overestimating future profits. As this chart from McKinsey shows, analysts on average tend to start high and ratchet their numbers down as the companies get closer to releasing their results. Initial estimates proved to be too low in only a few cases.



DATA: THOMSON REUTERS I/B/E/S GLOBAL AGGREGATES; MCKINSEY ANALYSIS

### Financial Regulation

## How Banks Got Tripped Up By TruPS



▶ Another financial innovation that got past the regulators

▶ "The industry was self-financing, using loopholes in rules"

A battle has erupted in Washington over a seemingly obscure instrument called trust-preferred securities, or TruPS. This bit of financial exotica didn't get as much attention as synthetic collateralized debt obligations or credit default swaps during the global credit crisis. Yet TruPS definitely did some damage. Now Senator Susan Collins (R-Me., above) has proposed restricting them, and the banks are fighting back.

To understand what's at stake, consider the story of **Riverside National Bank of Florida**. Back when the industry was booming, Riverside sold at least \$99 million of TruPS. The appeal for banks was that regulators counted the TruPS they issued as part of their capital—the buffer they are required to hold against potential losses. Riverside, based in Fort Pierce, Fla., was one of almost 1,400 U.S. lenders that had issued \$149 billion of TruPS by the end of 2008, according to the Federal Reserve Bank of Philadelphia.

That by itself might not have become a problem. Securitization helped compound the dangers of these securities. Much as they did with mortgages, investment bankers pooled TruPS into CDOs, some pieces of which were sold to banks—including Riverside, which bought \$211 million of them. When the real estate market soured and lenders racked up losses, Riverside and more than 400 of its peers suspended interest payments on their TruPS. That caused the CDOs holding TruPS to default or lose value,