

Earnings Forecasts: Easy, Fast and Accurate

The Investment Secrets of Warren Buffett: Part 2

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In part one of this series we explained how Warren Buffett selects great companies, using a rational common sense approach. He doesn't worry about the stock market or the economy, and neither should you!

In part two of this series, we take a look at the importance of earnings forecasts in determining the value of a company. The earnings of a company are the total revenues less all expenses including interest and taxes. When we are talking about earnings we usually mean earnings per share which is the total earnings divided by the number of shares outstanding.

The importance of accurate earnings forecasts

If you think of earnings as the profit the company makes on your behalf, it is clear that the ability to forecast earnings lies at the heart of finding great companies selling at low prices. No matter what the short term dips and peaks are, in the end we are investing in companies and the value of these companies depends upon their earnings.

To illustrate this, I looked at thousands of USA and Australian companies that had data for at least 10 years. Of these companies I compared the growth in earnings for the past 5 years with their average annual total return over this same period. This is the average annual percentage increase of an investment in the company assuming that dividends are reinvested. As we might expect, earnings growth over the 5 years was closely linked to investment performance.

In particular, strong growth in earnings led to strong share price performance.

As investors, to take advantage of this correlation, we need to be able to forecast the growth of earnings in the future. But this is where we run into a problem. For example, in 1997 Lawrence Brown published a landmark study in the *Financial Analysts Journal* looking at 130,000 forecasts by analysts from an 11 year period. He found that the average absolute error was a whopping 91.6 percent. Putting it another way, if the consensus estimate of earnings was \$1.00, on average the average actual earnings would be lower than \$0.04 or higher than \$1.96. That's not much better than tossing a coin.

Since Brown's original study, his results have been verified by many other researchers.

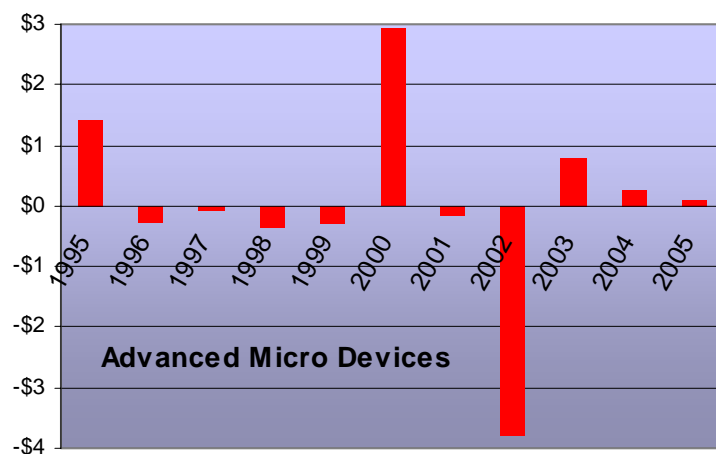
In contrast, using one of the tools in Conscious Investor®* any investor can forecast earnings with an average absolute error of just 18%. That means that we are able to forecast earnings with five-times the accuracy of analysts.

* Conscious Investor is a registered trademark

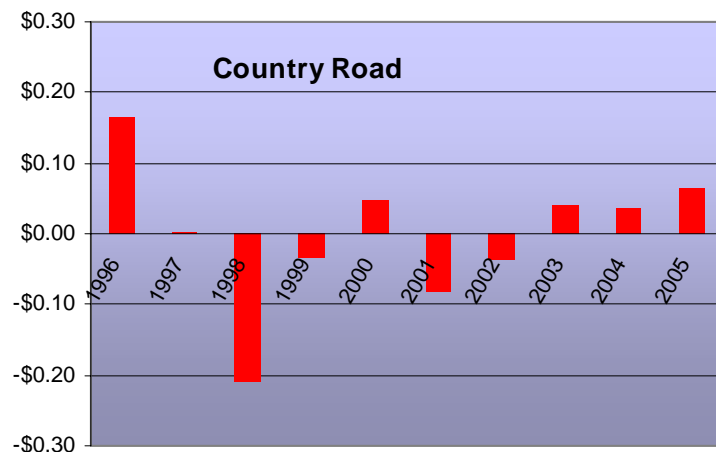
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In fairness to analysts, their terrible performance record is not all their fault. The difficulty is that they are starting behind the eight ball. They are assigned a group of companies in a particular industry and told to forecast their earnings. Unfortunately the earnings of many listed companies have more ups and downs and twists and turns than the Roller Coaster at Disney Land.

As an example, consider the graph of Advanced Micro Devices (AMD), a semiconductor company which designs, manufactures and markets a large range of computer chips. It is a huge company with annual sales of over \$5 billion. Unfortunately, very little of this revenue flows through to earnings as seen in the accompanying chart. Clearly it is almost impossible to be able to make any sensible forecasts of the earnings for the next earnings release, let alone over 5 or 10 years



Another example is Country Road, an Australian clothing manufacturer and retailer.



Restricting the companies that we look at

Fortunately as investors we do not have this problem of being told which companies to examine. We are free to examine, and invest in, any companies that we choose. We have thousands of companies to choose from. So why not turn the problem around and

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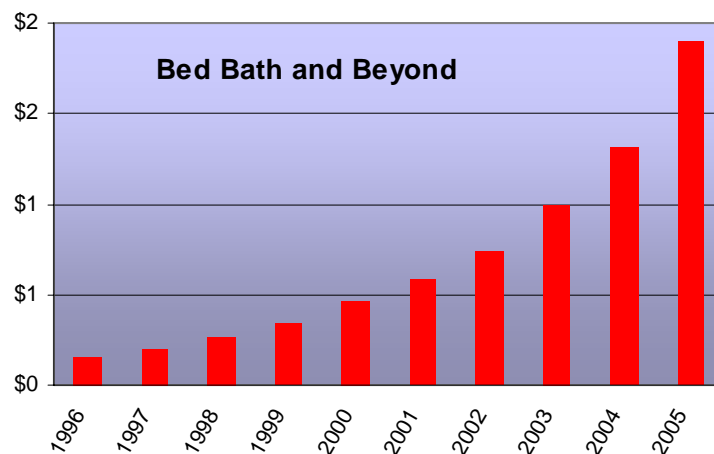
focus on those companies about which we can have confidence? By confidence, we're talking about companies that have demonstrated an ability to grow their earnings smoothly in the past.

Large-scale research that I conducted in Australia and the USA shows that the more stable a company's earnings and sales have grown in the past, the greater confidence we have in predicting earnings and sales into the future. So by avoiding stocks with unpredictable earnings growth, we substantially reduce our risk of eroding our investment capital.

When considering a company for my bottom drawer, the first thing I look at is how smoothly the earnings and sales grew in the past. If they grew in a stable way in the past, then I am more confident that the same will be true in the future. Conversely, if past earnings were haphazard and chaotic, then I just skip over the company as a long-term investment.

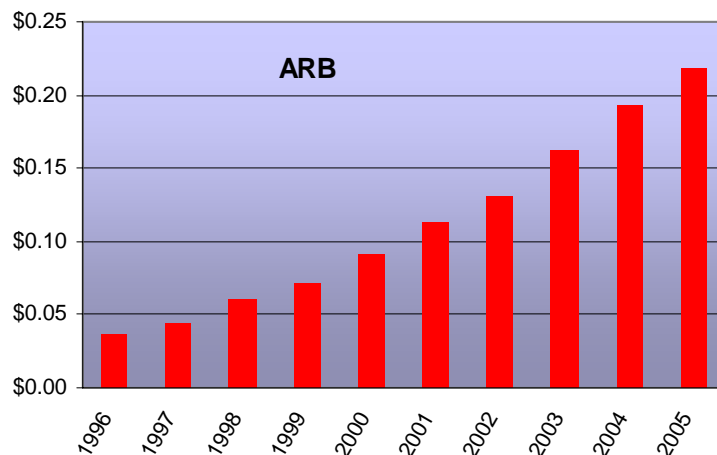
Of course, consistency in the past does not guarantee consistency in the future. But if earnings growth has been stable over five, even ten, years, then this is a telltale sign that there is a good mix of management and products.

Consider, for example, the earnings of Bed, Bath and Beyond, a U.S. domestic retailer. As shown in the next chart, each year earnings have been growing at approximately the same rate.



A similar pattern appears with ARB Corporation, an Australian company that manufactures and retails equipment for four-wheel drive and off-road vehicles around the world.

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These are the type of companies we aim for. Companies with earnings growth that is both consistent and strong.

Instead of just drawing graphs of past earnings, I have developed a measure called STAEGR®* (pronounced stay-ger) which stands for Stability of Earnings Growth. Applied to the earnings numbers, it scores how stable these have been on a year to year basis. The maximum figure of 100 per cent represents earnings that go up (or down) by the same percentage each year. A low figure means that there has been more variation over the years.

Another benefit of focussing on high STAEGR companies

At the start of the article I talked about the correlation between earnings growth and total return. When you look at companies with a high STAEGR you even get a benefit here. As we just saw, you can forecast earnings with more confidence when you focus on high STAEGR companies. The extra benefit with the high STAEGR companies is that the correlation between earnings growth and total return jumps from 29.0% to 77.8%.

To a very high level of accuracy, if the earnings went up by, say, 15% per year, then the total value of your investment went up by the same amount each year.

If you're feeling a bit confused, the good news is that Conscious Investor does all the number crunching for you! STAEGR is a proprietary function contained within Conscious Investor that can be applied to both earnings and sales. Conscious Investor provides access to 10 years of fundamental data on all companies listed on the Australian Stock Exchange (ASX) for Australia, the American Stock Exchange (AMEX) the New York Stock Exchange (NYSE), and NASDAQ for the USA and the Toronto Stock Exchange (TSX) and Toronto Venture Exchange in Canada. STAEGR is another of the investment tools contained in Conscious Investor that will ensure that you focus your attention only on outstanding companies.

* STAEGR® is a registered trademark authorized to be used by Conscious Investing.

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The benefit of using STAEGR in Conscious Investor is that it is all set up to scan through thousands of companies. Instantly it picks out those stocks with stable and high growth rates in both earnings and sales.

To see examples of how easy it is to use Conscious Investor, please view the demo videos at: www.consciousinvestor.com/software/demo/demous.asp. There are also links on the page to demo videos for Australian and Canadian markets.

However, being a great company with stable earnings and sales growth is still not enough to justify your investment. You also need to ensure that you're not paying too much!

Conscious Investor can assist you there as well. Our software is designed to help you know exactly what price to pay for great companies, ensuring you make money year after year.

In our final article in this series, we explain the single question that you need to be able to answer as an investor!