

(WallStraits.com, [www.wallstraits.com](http://www.wallstraits.com), May 2002)

**Investor Psychology Series**  
***Why Analysts are commonly overoptimistic***

Today's quiz...

1. *Imagine that you face the following choice: You can accept a guaranteed \$1,500 or play a lucky-draw. The lucky-draw is determined by a coin toss. If heads comes up, you win \$1,950. If tails, you win just \$1,050. Would you choose to participate in the lucky-draw game, or go home with your \$1,500?*

2. *Imagine that you face the following choice: You can accept a guaranteed loss of \$750 or play a lucky-draw game determined by a coin toss. If heads comes up, you lose just \$525, but if tails you lose \$975. Would you accept the guaranteed loss? Would you pay the \$750, or take your chances with the coin toss?*

Most people would take the guaranteed \$1,500 in the first situation, and not gamble that they could take less money home. However, in the second situation, most people choose the lottery over the guaranteed loss. The first choice is decidedly risk-averse, while the second is decidedly risk-seeking. What's up?

The lesson is this: People are not uniform in their tolerance for risk. Here's a second example...

1. *Imagine you just accepted \$1,500 in the game above and have the cash securely in your pocket. Now you are offered a chance to play coin-toss again, heads you win another \$450, and tails you lose \$450. Would you play the game?*

2. *Imagine you have just accepted the guaranteed \$750 loss in the second game above. The pain of the empty wallet still fresh in your mind. You are now offered a chance to recoup some of your losses. You can coin-toss, and heads you win back \$225, but tails you lose another \$225. Would you play the game?*

Most people will play the first game but not the second, even though statistically they are the same game with similar outcomes and risks. People tend to feel that if

they are \$1,500 ahead are willing to accept the chance for another \$450, because if they lost they still consider themselves as winning \$1050. However, if someone has just lost \$750, they are very unlikely to accept another challenge where they could lose another \$225, viewing each loss as an independent and painful event. People are loss-averse!

### **Buy Losers**

One of the strongest data that refute the efficient market hypothesis is the fact that low PE stocks consistently outperform high PE stocks. High PEs (stock price very high versus historical earnings) are nearly always attributed to optimism by analysts and investors that past track records of high growth will continue into the future uninterrupted. Low PE stocks are likewise shunned by analysts and investors who have low expectations for these out-of-favor businesses which often underperformed the market in the recent past.

De Bondt and Thaler (1989) presented evidence to support that buying losers is more profitable than buying winners. If all companies are categorized based on their past 3-year performance track records, and one group of investors buy the top 10% of these performers (extreme winners), and another group invests in the bottom 10% (extreme losers), the winner portfolio will be expected to return -10% over the next year, while the loser portfolio returns +30%.

Academic finance typically explains risk in terms of expected reward. Thus, they would have to conclude that the extreme out-of-favor losers were riskier than the highly respected winner businesses. Does that make sense? It doesn't to Warren Buffett, and he has become the richest investor on the planet by exploiting this academic point of view. Buffett jokes that as long as Harvard MBAs think the stock of a sound business is more risky when it has fallen to low valuations, he can continue to make lots of money in the market.

### **Buy Upgrades**

Further data mining has shown that analysts are too conservative in their reactions to a business turning around. Thus, when there is one upgrade by analysts, it is commonly followed by one or more subsequent upgrade as analysts come to grip

with reality. Likewise, one downgrade is usually followed by several subsequent downgrades. For example, in the 60-days following an earnings announcement, the stocks with the highest earnings surprises outperformed the overall market by about 2%.

### **Beware Buys From Underwriters**

Analysts who work for underwriting firms follow stocks that their firms do not bring to market as well as those they do. After an initial quiet period, analysts are allowed to issue recommendations on their own firm's sponsored and underwritten IPOs, such as the current Buy recommendation by UOBkayhian on United Food Holdings Limited (underwritten by now acquired OUB). If analysts are divided stocks with Buy recommendations into two groups: (1) companies brought to market by their firm, and (2) all others, data shows that the buy calls on all others perform much better, suggesting analysts overpromote their own IPOs.

Underwriter analysts have been found to issue 50% more Buy calls than nonaffiliated analysts for a given stock. Moreover, 2 years later, the Buy recommendations from nonaffiliated analysts performed 50% better than those from underwriters promoting their own IPOs. Since it is fair to assume underwriter firms have superior information about their client's business, this should not happen in an unbiased environment. Investors find themselves torn between trusting the underwriter analyst's superior information, and being suspicious about his biased motivations.

### **Beware Optimistic Earnings Forecasts**

In general, analysts forecasts are notoriously inaccurate, with some academic studies showing average error of 44% even after final revisions. The distribution of error is even more interesting. It turns out analyst error, in one study by Hansel and Sarin (1998) is biased to the down side for low PE stocks and the upside for high PE stocks. They found analysts, on average underestimated the earnings of low PE stocks by 3.6%, and overestimate the earnings of high PE stocks by 17%.

The lesson for investors is to take analyst predictions of future earnings with a grain of salt, and be especially wary of predictions about IPO the analyst firm has underwritten, and forecasts of continued strong growth by high PE companies.

Tomorrow we'll explore the IPO phenomenon.

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*The author, Curtis J Montgomery, is no psychologist, and thus has committed most of the illogical mistakes we will discuss this week. These ideas are gleaned from a book by Hersh Shefrin, Beyond Greed and Fear, published in 2000 by Harvard Business Press.*