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Discussion: “Long-term Earnings Forecasts, Managerial Distortion, and Stock Returns”

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Caveats

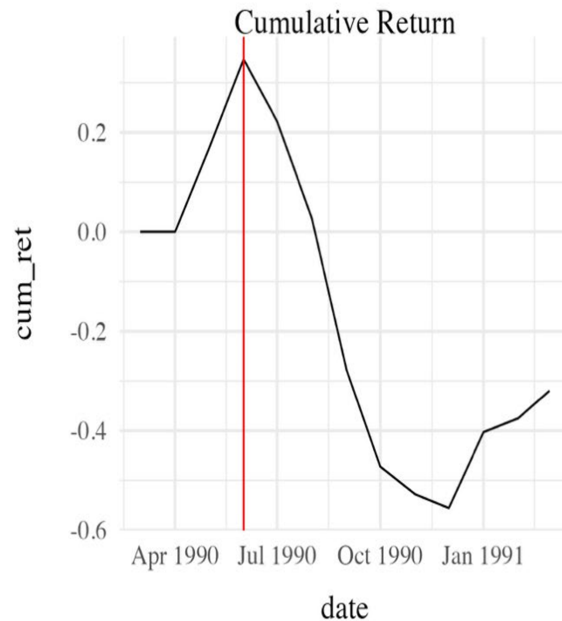
- This is a very polished paper
  - 73 pages with 27 tables
  - Presented at ~ 10 conferences and university seminars
  - My colleague John Loudis gave a comprehensive discussion very recently at MFA

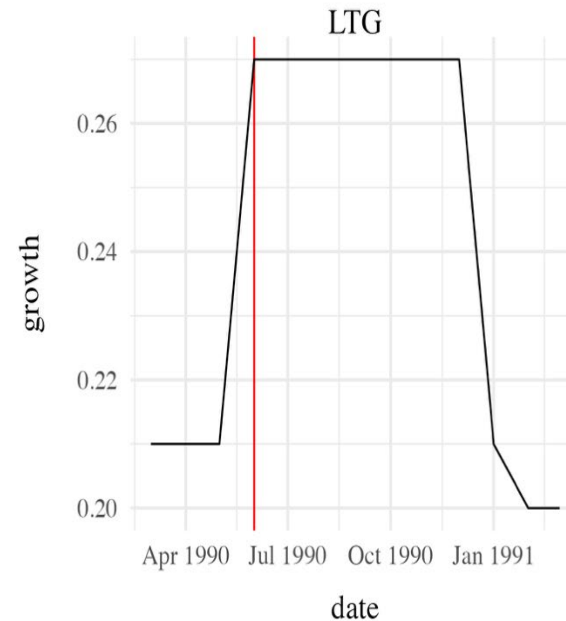
- My Comments are mostly about how to better interpret and organize the results

Main Finding

- Managerial manipulation among high-LTG conglomerates causes overvaluation today and lower subsequent stock returns

Example: Allwaste Inc. manipulated earnings in 1989





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This paper speaks to two important literature

- High-LTG stocks have low returns
  - La Porta (1996), Da and Warachka (2011), Bordalo, Gennaioli, La Porta and Shleifer (2019), …
  - Explanation: biased expectation, limited attention, diagnostic expectations…
  - This paper: high-LTG conglomerates with managerial manipulation are driving the result!

- Conglomerate discount
  - Lang and Stulz (1994), Berger and Ofek (1995), …
  - Explanation: managerial mistake & wasteful spending; endogenous selection; offsetting disagreement / lottery…
  - This paper: high-LTG conglomerates with managerial manipulation are actually overpriced!

Biased expectation vs. Managerial manipulation

- Ruling out biased expectation is hard
  - Presumably, managers manipulate accounting numbers to mislead investors
- The paper finds that analysts are not fooled by managerial manipulation but market is
  - The existing literature generally finds the opposite: market can largely undo analyst biases
  - If LTG is unbiased, why sorting on it identifies mispricing?
- Managerial manipulation makes a directional prediction: optimistic forecast
  - Focus on forecast bias rather than absolute forecast error
  - Focus on LTG rather than short-term earnings forecasts
- My view
  - It is easier to focus on "ruling-in" managerial manipulation

Conglomerate valuation is extremely challenging!

FB How does an investor value a conglomerate?

Valuing a conglomerate involves a comprehensive analysis of its financial performance, growth prospects, competitive position, and other relevant factors. While there is no one-size-fits-all approach, here are some key steps an investor may take to value a conglomerate:

1. Gather Financial Information: Obtain the conglomerate's financial statements, including income statements, balance sheets, and cash flow statements. Review the historical financial performance, revenue growth, profitability, and cash flow generation of the conglomerate. Look for trends and assess the quality of earnings.
2. Analyze Business Segments: Understand the conglomerate's different business units or segments. Evaluate the financials, market positions, growth rates, and competitive advantages of each segment. Identify any segments that are contributing significantly to the overall value or are potential sources of future growth.
3. Assess Growth Prospects: Evaluate the conglomerate's growth potential. Analyze the industry trends, market opportunities, and competitive landscape in which the conglomerate operates. Consider factors such as product innovations, expansion plans, and potential acquisitions or partnerships that could drive future growth.
4. Evaluate Synergies: Determine the synergistic benefits derived from operating diverse businesses under the conglomerate structure. Assess how the conglomerate leverages synergies between its business units to achieve cost savings, operational efficiencies, and cross-selling opportunities. Quantify the potential financial impact of these synergies.
5. Conduct Comparable Company Analysis: Identify comparable companies in the same industries or sectors as the conglomerate. Analyze their financial metrics, valuation multiples, and market performance. Compare these metrics to the conglomerate's financials to assess its relative valuation and identify any potential discrepancies.
6. Apply Valuation Methodologies: Utilize various valuation methodologies, such as the discounted cash flow (DCF) analysis, price-to-earnings (P/E) ratio, price-to-sales (P/S) ratio, and other relevant approaches. These methods can provide different perspectives on the conglomerate's value and help validate the valuation range.
7. Consider Risk Factors: Evaluate the conglomerate's risk profile, including industry risks, macroeconomic factors, regulatory challenges, and operational risks. Assess how these risks may impact the conglomerate's future performance and valuation.
8. Factor in Management and Corporate Governance: Assess the conglomerate's management team's capabilities, track record, and strategic decision-making. Consider the effectiveness of the conglomerate's corporate governance practices, transparency, and alignment with shareholder interests. A competent and shareholder-friendly management team can positively impact the conglomerate's value.
9. Monitor Market Sentiment: Stay informed about market trends, investor sentiment, and broader economic conditions that may impact the valuation of conglomerates or specific sectors. Market dynamics can influence investor perceptions and the pricing of conglomerate stocks.

It's worth noting that valuing conglomerates can be complex due to their diversified nature and varying business units. Investors should exercise judgment and employ a combination of quantitative and qualitative analysis to arrive at a reasonable valuation range. It is also advisable to consult with financial professionals or conduct further research to make informed investment decisions.

Task is more manageable in this paper

- A relatively small set of conglomerates is driving the result in this paper
  - Total # of conglomerates each year: 468
  - Those in the high-LTG decile : 46.8
  - Those with managerial manipulation: 23.4
  - Those with high shorting fee: 11.7

- I would have RAs do case studies of these interesting firm-year observations

Case study: Allwaste Inc. in 1990

- 1977-86: private company
  - Founded in 1977 by Raymond Nelson, focusing on industrial waste removal, based in Houston
  - Listed on NYSE on Dec 1986

- 1986-90: growth by acquision
  - Acquired 37 companies
  - Got into new lines of business & locations, and became a conglomerate
  - Revenue soared from $13.1 million in 1986 to $152.7 million in 1990
  - Income grew from $0.6 million to $15.4 million

- 1991-93: Trimming the sails
  - Divestments
  - Growth slowed

Case study: Allwaste Inc. in 1990

- Company president Clayton K. Trier, a former accountant, was largely credited by Forbes for Allwaste's outstanding record of growth by acquisition

- The company's methods were challenged, however, in *Barron's* by a professor of accounting who concluded the company was "paying at least as much attention to collecting other waste-collection companies as to actually collecting or cleaning up waste" and "indulging in hazardous accounting practices that tend to inflate corporate profits.

- According to the author, Abraham J. Briloff, under legitimate but misleading accounting rules Allwaste had recorded only a tiny fraction of its costs for acquisitions in fiscal 1989 on its balance sheet. Trier resigned shortly after this article was published and was succeeded by Nelson, who was also chairman.

Acquisition-driven growth

- Managerial manipulation
  - Hidden acquisition cost → consistent inflated earnings across segments → distortion according to the measure of Harbaugh, Maxwell and Shue (2017)
  - Acquisitions focus on favorable industries → distortion according to the measure in Chen, Cohen and Lou (2016)
  - The CEO may receive more stock / option based compensation during the growth → high delta and vega

- Acquisition-driven growth could be the cause while managerial manipulation is the symptom

- Differentiate organic vs acquisition-drive growth

- How many CEOs are accountants?
  - Why don't all high-LTG conglomerate firms manipulate earnings?

Minor suggestions / questions

- What are correlations among the four measures related to managerial manipulation?
- Having consistent earnings across segments → less offsetting of disagreement at the conglomerate level → more overpricing under short sale constraints (Huang, Hwang, Lou and Yin, 2020)
- If most of the overpricing is concentrated among high shorting fee stocks, is it tradable?
- How do you deal with negative EPS when computing realized LTG?
- How about running the Coibion-Gorodnichenko regression at the level of individual analyst?
- For mutual fund trading regressions, examine changes in # of (split-adj) shares held rather than changes in portfolio weights (which are affected by prices)

Summary

- Striking empirical results
- Clear contributions to two important literature
- My suggestions:
  - Focus on “ruling-in” the managerial manipulation channel instead of “ruling-out” biased expectations
  - Zoom into high-LTG conglomerates with manipulation and examine other possible reasons for their overpricing