Does Earnings Guidance Affect Market Returns? The Nature and Information Content of Aggregate Earnings Guidance

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March 2005, Chiba Marine Stadium, giving advice to Bobby V.

"Having Mo'" Ahead of the Tape, *WSJ*, C1, January 6, 2004

"The earnings preannouncement season starts kicking into gear this week. Fortunately for investors, they have little to worry about when it comes to fourth-quarter earnings or warnings…

Preannouncements so far have been mild, with a low ratio of negative to positive earnings previews. According to Thomson First Call, the ratio stands at 1.3, a low rate because negative warnings almost always outpace positive preannouncements..."

Two key points. Guidance is assumed to:

1. Be informative about earnings in general, and
2. Preempt much of the earnings news.

Research Question

- Does aggregate earnings guidance provide information to the market as a whole?
  - We know from much prior research that earnings guidance, especially downward guidance about quarterly earnings, is informative at the firm level.
  - It also seems that earnings guidance has become increasingly common, and is no longer something that companies do only on occasion.
  - If guidance is now pervasive, can we aggregate in any meaningful way?

Why might guidance affect market-level returns?

Stock returns are affected by (e.g., see Fama, 1990):

1. Shocks to expected cash flows,
2. Predictable variation in expected returns,
3. Shocks to expected returns.

Whether guidance conveys information about aggregate cash flow shocks depends on:

- Whether it's pervasive.
- Whether it's representative.
- Whether it's timely.

Does guidance convey information about economy-wide cash flow shocks?

- Pervasiveness: The larger the number of firms that issue guidance, the more likely it is that aggregate guidance captures market-wide cash flow news.
  - It may not take many firms if these firms are very large (GE, Microsoft) given an increasingly skewed size distribution.
- Representativeness:
  - It may not take many firms if these firms are "bellwethers" (are there firms whose earnings are sufficient statistics for the economy?).
  - On the other hand, previous research shows that guidance tends to be issued by firms with unusual or surprising earnings performance (e.g., Lev and Penman, 1990; Skinner, 1994).

Does guidance convey information about economy-wide cash flow shocks?

- Recent evidence in finance suggests that firm-level earnings news is largely idiosyncratic, and diversifies away upon aggregation.
- It is not settled whether firm-level earnings news is largely idiosyncratic or contains systematic components.

- Timeliness: Earnings guidance will not be informative if it's fully anticipated. By definition though, earnings guidance is more timely than normal quarterly earnings releases.
  - Does the nature of the guidance affect when it's released? Previous research suggests that managers tend to release more "bad news" forecasts than "good news" forecasts, especially for the quarterly horizon (Skinner, 1994). Does the market "build this in" (that is, look at the relative extent of bad news)?

Will guidance affect market-level expected returns?

1. It is well known that macroeconomic news is positively related to current earnings news (e.g., Lucas, 1977) and negatively related to current expected returns (e.g., Fama and French, 1989; Cochrane, 1991).

   This implies that good earnings news signals an improvement in economic conditions, which lowers required returns on stocks and causes stock prices to increase.

   Alternatively, good earnings news could signal an improvement in aggregate demand, increasing inflationary expectations which increases (nominal) required returns on stocks. Kothari, Lewellen and Warner (2005) find that aggregate quarterly earnings news is *negatively* related to quarterly returns.

   Note: Researchers in finance (e.g., Chen, Roll, and Ross, 1986) have had a surprisingly difficult time establishing a relation between macroeconomic variables and stock returns.

Will guidance affect market-level expected returns?

2. Earnings guidance may affect levels of market uncertainty. If, for instance, guidance increases market uncertainty, this will increase the volatility of market returns. Since volatility shocks are persistent, this will increase expected returns and push stock prices down.

   Anecdotally, a spate of earnings warnings from technology companies in the summer of 2004 increased market uncertainty and caused stock prices to decline; see "Investor Jitters Greet Earnings Season," *Financial Times*, July 12, 2004.

   "Volatility feedback" – if earnings news increases uncertainty and so required returns on stocks, it will tend to reduce the positive response to good earnings news and exaggerate the negative response to bad news, causing asymmetries in the market's response to good and bad news (e.g., Skinner and Sloan, 2002).

We know relatively little about the effects of earnings news at the aggregate level

- Penman (1987). Documents seasonal patterns in aggregate earnings news (firms tend to announce good earnings news in the first two weeks of calendar quarters 2, 3, and 4) and that there are corresponding patterns in market returns.
- Kothari, Lewellen, and Warner (2005). Find that quarterly market returns are *negatively* related to measures of aggregate quarterly earnings news. The authors argue that this result suggests that aggregate earnings news is positively related to expected returns, so that good earnings news pushes stock prices down.

What we find: On guidance

- Guidance is increasingly pervasive and representative.
  - The extent of earnings guidance increases substantially over the sample period (1994-2003).
  - Firms issuing guidance now represent over one-half of total market cap and nearly one-half of total assets, up from levels of 10%-20% in the mid-1990s.
  - Guidance is now driven more by firm characteristics such as size and growth, and is less attributable to period-specific earnings performance. Prior forecasting is increasingly important.
- Similar to previous research, the distribution of earnings guidance is tilted toward shorter-term forecasts of adverse earnings news, which is also the most informative.
- An increasing tendency for guidance to be issued at earnings announcement dates.

What we find: On guidance

- There are clear patterns in the timing of guidance:
  - Managers tend to issue neutral guidance early in the quarter, negative guidance late in the quarter, and positive guidance only after the end of the quarter.
  - The information content of earnings guidance increases steadily during the quarter.
- There is a good deal of quarter-to-quarter variation in the relative extent of downward quarterly guidance (ratio of the amount of downward to upward guidance), reinforcing the idea that this ratio may capture variation in overall earnings news. There is much less variation using annual guidance numbers.

What we find: On the informativeness of guidance

- Quarterly guidance measures, esp. the relative extent of quarterly negative guidance, are strongly associated with measures of aggregate earnings news such as analyst forecast- and time series-based measures.
- There is no evidence that these quarterly guidance measures are correlated with market returns.
- Some evidence that guidance is related to market returns when we use monthly data. But direction of causality harder to establish – does macro news cause changes in guidance and returns, or does guidance lead returns?
- There are clear differences in the pattern of market returns during good and bad news quarters – market returns increase smoothly during good news quarters but decline in bad news quarters only during the last month of the fiscal period. Market volatility is noticeably higher in bad news quarters.

What we find: On the informativeness of guidance

- Guidance issued by very large firms is associated with market returns in narrow windows around its release, further supporting the idea that guidance is informative at the market level.

Summary of Findings

- Over the past decade, earnings guidance for US firms has become increasingly pervasive – now provided by around 30% of Compustat firms by number and over 50% by value. Moreover, firms are now providing guidance on a more routine basis (often at earnings announcements), so that guidance has become more representative.
- Find strong evidence that negative guidance is more informative than other guidance at the firm level, and that the relative amount of quarterly downward guidance available does a good job of capturing the quarter's overall earnings news.
- However, the evidence that aggregate guidance measures drive market returns is not as strong. Hard to be sure that it is not macroeconomic news that drives both guidance and returns. Still, we find some evidence that certain types of guidance, especially negative guidance issued near the end of the quarter, is informative for overall returns, but only in bad news quarters.