Chapter 18

Forecast Scenarios for the Most Important Critical Factors

Introduction

There are many different ways to be successful in almost every profession, but there's usually one factor that sets apart the good from the great. For financial analysts, *discovering alpha-generating ideas* is arguably the most important skill to master, but it's followed closely by *accurately forecasting future earnings*, especially for sell-side analysts. Research shows that abnormal stock returns are earned when following the recommendations of sell-side analysts who are among the top quintile of *accuracy in forecasting earnings*. If you're on the buy-side, the recommendation here is to find the sell-side analysts who have the most accurate forecasts and if you're on the sell-side, do your best at forecasting earnings. Based on my experience, I suspect the connection between earnings forecast accuracy and generating alpha is not the result of more complex financial models (although it can help at times), but rather an analyst's ability to *find insights surrounding critical factors*, which is important to both activities.

When I started in the business in the early 1990s, sell-side analysts provided earnings estimates, but it was rare to see price targets in writing or in client discussions. As the Internet age emerged, allowing buy-side clients to more quickly and easily access all of the underlying fundamentals of a sell-side analyst's work, they began requesting price targets, which eventually became commonplace by the time the Internet bubble started expanding. But after the bubble burst, analysts and PMs began questioning if single-point price targets were the best way to do business. After all, stocks don't trade at one point over an extended period of time.

In 2006, Juan Luis Perez, Morgan Stanley's global director of research, was at the forefront of the effort to move analysts toward thinking about modeling scenarios in order to provide a range of earnings estimates *and* price targets. The concept became unofficially dubbed *open platform* within the firm, because it was intended to get analysts to open up their thought process, thus allowing buy-side clients to use these scenarios for *their* investment process. The initiative was intended to get the firm's analysts to explore factors that wouldn't normally be considered, by stretching their thought process to consider more extreme possibilities. He would tell analysts to "think big both ways, potential upside and downside." After all, *it's what you don't know you don't know that usually creates the biggest surprises.* (The things you know you don't know can be investigated through research, but if it's not anywhere in your gray matter, it can't be something to look out for.) It's also important to appreciate that all analysts have biases in their models, thus causing them to confirm their view (confirmation bias is discussed in Chapter 21). Some of the confirmation bias can be eliminated (or at least recognized) by forecasting scenarios. This concern is held by the director of research of a large hedge fund who said, "Too often new analysts think they know the answer because they are overly confident in their models. Their mind can't comprehend where they could be wrong."

It would be impractical to change every model assumption for each scenario, because it would take an inordinate amount of time and make a relatively small difference compared with simply modifying the two to four most important factors. After all, if your base-case scenario is, Read the rest of this chapter in the full version available at [Amazon.com](https://www.amazon.com)

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