

An examination of Value Line's long-term projections

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Abstract

Unlike previous papers, which have focused on the timeliness ranks, we examine Value Line's 3–5 year projections for stock returns, earnings, sales and related measures. We find that Value Line's stock return and earnings forecasts exhibit large positive bias, although their sales predictions do not. For stock returns, Value Line's projections lack predictive power; for other variables predictive power may exist to some degree. Our findings suggest the spectacular past performance of the timeliness indicator reflects either close alignment with other known anomalies or data mining, and that investors and researchers should use Value Line's long-term projections with caution. © 2007 Elsevier B.V. All rights reserved.

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1. Introduction

The Value Line Investment Survey follows approximately 1600 stocks. It has been continuously published for many decades and is widely used by investors. Value Line publishes a timeliness rank that forecasts stock price performance over the following 6–12 months. The performance of this indicator has been the focus of dozens of published articles beginning with Shelton (1967). Other notable studies include Kaplan and Weil (1973), Holloway (1981), Stickel (1985), Huberman and Kandel (1987, 1990), Affleck-Graves and Mendenhall (1992) and Choi (2000). The consensus of these and other studies is that after controlling for systematic risk factors, Value Line timeliness ranks have substantial predictive power for future short-term stock returns. Although it is true that much of the abnormal returns occur shortly after *changes* in the timeliness ranking, and it is not clear that one can “beat the market” once transactions costs are taken into account, Value Line's record is impressive. As Choi (2000) notes, it has captured the imagination of the finance community like few others.

In addition to its timeliness rank, Value Line publishes a large amount of information in its quarterly stock reports that may be useful to investors. In particular, once every quarter, for each stock, Value Line reports 3–5 year projections for annual total return, sales per share, earnings per share, dividends per share and historical data for these measures.¹ Unlike virtually all previous studies, which focus on the timeliness ranks, our study concentrates on Value Line's long-term projections. In the spirit of past studies using timeliness ranks, we examine whether Value Line's 3–5 year projections for common stock returns, earnings, sales, profit margins or earnings yields have *predictive power* with regard to realized values over that horizon, e.g. whether purchasing stocks with higher predicted returns would really enable investors to earn higher realized returns, or if firms with higher predicted growth in earnings per share actually do exhibit higher earnings growth ex-post than firms with lower predicted growth.

¹ Current Value Line reports for each of the 30 stocks comprising the Dow Jones Industrial Average can be freely accessed even by non-subscribers at <http://www.valueline.com>. A brief perusal reveals the enormous range of information these reports contain beyond the timeliness rank that has been the focus of most prior studies.

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Furthermore, because many previous studies of analyst forecasts have focused on forecast bias, we also examine whether Value Line's 3–5 year projections exhibit significant bias, i.e. whether mean predicted values for stock returns, earnings, etc. differ from mean realized values.

Beyond the fact that Value Line's long-term projections have received little past scrutiny, our study is motivated by three broader considerations. First, while at least dozens of studies have examined various aspects of analysts' short-term (under one year horizon) earnings and stock price forecasts, surprisingly little research has been conducted concerning longer horizon projections. La Porta (1996) sorts stocks into portfolios based on analysts' five-year earnings projections. He finds that stocks with low expected earnings growth earn considerably higher returns, ex-post, than those with high expected growth, partly because analysts subsequently revise earnings forecasts upward for stocks with low expected earnings growth (and vice-versa). Dechow and Sloan (1997) find that analysts' five-year earnings projections are biased upward in general, and that stock prices appear to naively reflect these biased forecasts.² Our study, which uses a long sample period and examines the record of an independent advisory service, may shed further light on whether (and if so, why) analyst forecasts are biased.

The second motivation for our study arises from the extensive debate about *why* Value Line's record has been so impressive when compared with those of other security analysts. Several recent studies, notably Desai and Jain (1995), Barber et al. (2001, 2003) have examined security analyst recommendations, and report some evidence that purchasing stocks with the most favorable consensus recommendations (and/or selling short stocks with the least favorable ratings) yield abnormal returns. However, these returns are generally not as large as has been documented for portfolios constructed from Value Line rankings, and the performance of the analysts varies greatly over time (for example, relative to the market as a whole, their buy recommendations performed extremely poorly in 2000 and 2001, while their sell recommendations handily outperformed the market). One possible reason Value Line's record stands out is that Value Line, being an independent subscription service, is not beholden to the firms whose

stocks it covers. In contrast, most analysts are employed by investment banks that are dependent on client firms for business. These analysts are notoriously reluctant to issue sell recommendations, and their buy recommendations may depend more on self-interest than on objective analysis of a firm's prospects. Moreover, as Bradshaw et al. (2006) show, analysts' overoptimism is systematically related to corporate financing activities: overoptimism is greatest for firms issuing securities and smallest for firms repurchasing securities. However, an alternative possible reason for Value Line's superior record that has been suggested by many (see for example, Gregory, 1983) is that this record is a product of luck. If a large number of independent advisory services exist and Value Line is the only one that has managed to outperform the market substantially ex-post, then this finding is unsurprising in a statistical sense and does not necessarily imply that markets are inefficient. Finally, some studies suggest that Value Line's timeliness rankings are highly correlated with other known anomalies such as post-earnings announcement drift (Affleck-Graves and Mendenhall, 1992) and that Value Line's record is an artifact of this alignment.³ By examining Value Line's long-term return predictions, we believe we can contribute towards a resolution of this debate. If it turns out that Value Line's long-term predictions perform as well as their short-term predictions, this would support the argument that Value Line's forecasts are inherently of high quality. Conversely, finding that Value Line's long-term prediction record is not good would suggest that the performance of its timeliness ranks might be a product of data mining or alignment with other anomalies.

The third important motivation for our study is that Value Line's 3–5 year return projections have been extensively used to estimate the cost of equity capital, and to test asset pricing models in ex-ante (rather than the traditional ex-post) form. The performance of these projections is therefore an important issue in its own right. Botosan (1997), Botosan and Plumlee (2002, 2005) and Francis et al. (2004) have all used Value Line 3–5 year projected stock returns as proxies for the cost of equity capital. Ang and Peterson (1985) use ex-ante data from Value Line to investigate the relation between expected stock returns and dividend yield. Similarly, in an interesting recent paper, Brav et al. (2005) use Value Line 3–5 year predicted returns as a proxy for consensus expected returns. Unlike prior studies (e.g. Fama and French, 1992) using realized returns, Brav, Lehavy and Michaely find a robust positive relation between Value Line's expected returns and market

² Among studies investigating short-term analyst forecasts, results regarding bias vary depending on the time period and variable examined; for example, Brown et al. (1985), along with O'Brien (1988) find no compelling evidence of bias in security analyst earnings forecasts over their 1976–1980 and 1975–1981 (respectively) sample periods, while Butler and Lang (1991) show analysts were sharply overoptimistic in predicting earnings between 1983 and 1986, and Easterwood and Nutt (1999) report similar evidence for the period 1982–1995. More recently, Agrawal and Chen (2005) find little evidence of systematic bias in earnings forecasts between 1994 and 2003, but Bradshaw and Brown (2005) document substantial overoptimism in 12-month horizon target stock price predictions over their 1997–2002 sample period, and Asquith et al. (2005) find that the probability of achieving a 12-month price target is inversely related to the favorability of an analyst's recommendation.

³ Some studies have claimed, however, that information contained in Value Line reports can move the market in ways that cannot be completely explained by post-earnings announcement drift. For example, Peterson (1987) documents that initial reviews of stocks in Value Line generate abnormal returns around a three-day window surrounding publication; Peterson (1995) shows that post-earnings announcement drift does not fully explain abnormal returns around publication of stock highlights in Value Line.

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