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ABSTRACT

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Abstract

Investment decisions are often based on short-term earnings forecasts, which are provided by security analysts from brokerage firms. The objective of this study was to investigate the uses of analyst's earnings forecasts in equity valuation in the Finnish and Swedish stock markets in 2000-2003. The analysis contains studies on the accuracy of earnings forecasts filed in the IBES archives, and comparisons of different valuation models using those forecasts as inputs in valuation calculations.

Analysts' forecast accuracy was examined by calculating a forecast error, which is the difference between the forecasted EPS and actual EPS deflated with stock price. The forecast error in the whole sample was on average 3.4 % of firms' market value, which is in level with results from the US. This suggests that although the forecasts have been optimistic in the Nordic stock market, they can be seen reliable enough for equity valuation purposes during the period. The firms' R&D to sales ratio was not found to have a significant affect on forecast accuracy, while examination on the M/B ratio revealed that there was significant difference in accuracy; forecast errors with low M/B firms were higher on average.

Second part of empirical analysis concentrated on the value estimates produced by dividend model, residual income model, and price-earnings-to growth model. The objective was to replicate a situation an investor faces attempting to calculate the intrinsic value of stock. Valuation models were evaluated with a prediction error measure, which was calculated by the difference of value estimate and actual stock price divided by the actual stock price. Out of the three valuation models the PEG proved out to be the best with the smallest mean prediction error. However, there was variation in results across firms from different industries. Firms with the highest spending on R&D or high M/B ratio were systematically undervalued by valuation model estimates. Regression analysis supported the view that all studied models were good at explaing cross-sectional variation in stock prices.

Key words	Analysts, Earnings forecasts, Equity valuation, Investments, Stock markets
Further information	