ANALYSTS' FORECASTS IN "GOOD-NEWS" AND "BAD-NEWS" ENVIRONMENTS: EVIDENCE OF ECONOMIC SIGNIFICANCE OF THE DIFFERENTIAL VARIANCE

Davit Adut, College of Business Administration, University of Cincinnati, Cincinnati, OH 45255-0211, (513) 556-1872 davit.adut@uc.edu
Pradyot K. Sen, College of Business Administration, University of Cincinnati, Cincinnati, OH 45255-0211, (513) 556-7033, pk.sen@uc.edu
Praveen Sinha, The George L. Argyros School of Business & Economics, Chapman University, One University Drive, Orange, CA 92866, (714) 744-7986, sinha@chapman.edu

ABSTRACT

There is compelling empirical evidence to suggest that good news about corporate performance comes out early but bad news comes out late. Regardless of the underlying reason for such differential timing, existence of such systematic behavior leads to three related questions that we seek to answer in this paper. First, would the existence of this differential timing fundamentally alter the information environment surrounding the main event (earnings announcement) in a way that the forecasts of earnings under a good-news and a bad-news environment would be associated with different levels of uncertainty exhibited by different forecast variances? Second, if earnings forecasts do have different variances under good-news and bad news environment, can these variances be exploited to construct an improved consensus earnings forecast? Finally, can we make ex-ante arbitrage profit based on portfolios constructed on variance of analysts' forecasts?

In this paper we examine the above questions by analyzing the properties of the analysts' forecast variances under alternative definitions of good-news and bad-news environments. Specifically, we examine (a) if the variance of analysts' forecasts of earnings in the good-news environments are significantly lower than those in the bad-news environments, (b) if the reduction of variance over time occurs more quickly under a good-news environment, perhaps indicating a early consensus building and, (c) if the variance (of forecasts) can be used to predict the good-news or the bad-news about earnings *ex-ante* with a better accuracy than mean alone, and (d) if we can earn abnormal returns based on portfolios constructed in the beginning of the year as well as in the beginning of the quarter (PEAP).

Our empirical results show that the variance of analysts' forecasts is smaller when the expected or the actual news about earnings is good (relative to when it is bad). There is also some evidence on an earlier consensus building, measured by reduction in variance over time, amongst the analysts in the good-news environment. We also find some evidence that prediction of earnings can be improved by incorporating variance of analysts forecast along with the mean forecasts, especially in the bad news environment. Our analysis indicates that the variance of analysts' forecasts can be used in predicting earnings more accurately. Finally, we show that a trading strategy based on the variance of the analysts' forecasts provide positive abnormal returns.

The finding that variance helps improve the market expectation of earnings above and beyond what is conveyed in the mean is an important finding. It has significant implications for market-based accounting research that requires a proxy for market expectation of earnings because most of the studies have simply used mean of all analysts' forecasts in their research. Additional research is needed to understand the implications of our findings.