Why investors misprice cyclical stocks

FINANCE

Why is it so difficult for investors to beat the market? The Nobel Prize–winning analysis by Chicago Booth's Eugene F. Fama argues that stock-price movements are essentially a random walk, making future prices nearly impossible to predict. However, research suggests that in some cases, performance does follow predictable patterns.

In retail, for example, Christmas sales consistently drive stronger fourth-quarter results. At Borders, the now-liquidated bookstore chain, the top 14 quarters of 63 total, from 1995 to 2010, all occurred in the fourth quarter. But how well do investors make use of this information? Two insights on earnings seasonality come from research by Tom Y. Chang and David H. Solomon of the University of Southern California, Samuel M. Hartzmark of Chicago Booth, and Eugene F. Soltes of Harvard Business School.

First, even though seasonal performance patterns should be predictable and easy to interpret, the median analyst forecast for quarterly earnings per share, as recorded by the Institutional Brokers' Estimate System, often seemed not to account for this information. Although investors did adjust expectations upward for seasonality, they did not adjust enough, consistently underreacting to positive seasonal-earnings announcements.

People not only make this error, but do so repeatedly. The researchers argue that this might be explained by a behavioral constraint involving attention. Investors tend to focus more on recent data. Low-performing recent quarters shape expectations, while higher performance from the same quarter the previous year gets ignored. As a result, investors miss a golden opportunity by being overly pessimistic when a seasonal peak comes around again.

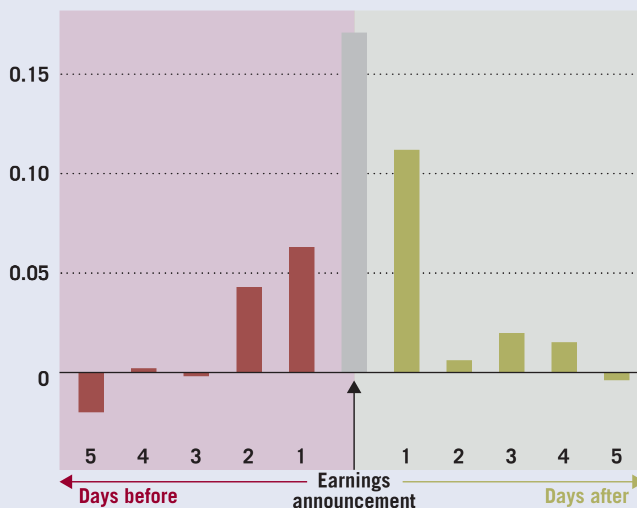
This explanation is consistent with the availability heuristic from behavioral economics—a mental shortcut that investors take by relying on the most recent examples—and a similar idea from cognitive psychology, the recency effect, which is a tendency for people to best remember the last items in a list. Overall, the researchers find that this recency effect was strongest when the gap in performance between the peak and other quarters was largest. "The errors mean that prices are predictably wrong every seasonal quarter, so there's a large, profitable opportunity for investors not subject to the bias," Hartzmark explains.

The researchers suggest investors can avoid these problems by taking a longer view when analyzing earnings data. When predicting stock prices, although they make adjustments in the right direction, investors would benefit from taking seasonal expectations more seriously.—*Luke Wilmshurst*

To everything, there is a season

Investors often seem to be surprised when companies with seasonally strong quarters announce earnings—these companies tended to have high stock returns on the day earnings were announced.

Excess returns on stocks of companies with seasonally high quarterly earnings* (%)



*Relative to companies with seasonally weak earnings in the same quarter

Source: Chang et al., 2015

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Tom Y. Chang, Samuel M. Hartzmark, David H. Solomon, and Eugene F. Soltes, "Being Surprised at the Unsurprising: Earnings Seasonality and Stock Returns," Working paper, April 2015.

Eugene F. Fama, "The Behavior of Stock-Market Prices," *Journal of Business,* January 1965.