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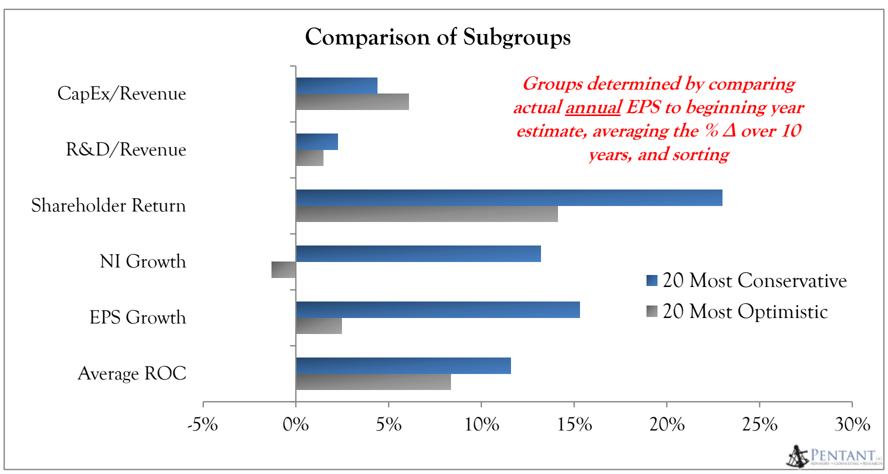
Is Your Optimism Killing Your Performance?

Executive Summary

Our prior work has highlighted the widespread underperformance of companies that habitually adopt or are infected with an overly optimistic outlook – these companies continually set themselves up for negative surprises/revisions and stock price underperformance. This embedded optimism reflects itself more broadly in poor capital allocation decisions that erode return on capital. See Exhibit below. Managements that are continually optimistic about their business and earnings outlook have higher aggregate capital spending levels with lower and generally declining returns on capital. This result holds nearly any way we slice the data and on a number of metrics, for the broad Industrials & Materials space, on a sector neutral basis, and within the large cap universe. The underperformance holds when we analyze 10 year averages, discrete years and quarterly trends.

We quantify optimism on an annual basis by comparing a company's full year EPS estimate on January 1 to the actual reported result. The chart below represents 10 year average metrics for the 20 most optimistic companies in the Industrials & Materials universe (excluding the Metals space) and the 20 most conservative. The outcome remains consistent from the original work – **optimists underperform.** The universe is approximately 110 companies and in the chart below we are choosing the companies with the most consistent 10 year optimism and conservatism record.



There is strong and compelling evidence to suggest the cycle of optimism is repeating again in 2015. On average the historical optimist group has already seen year-to-date negative EPS revisions five times in excess of what the conservative group has seen. Estimates call for a modest 2% EPS growth for the conservative group versus 26% EPS growth for the optimists in 2015, a reversal of what the groups have delivered historically. The optimists remain optimistic and the conservative group remains conservative and sell side analysts repeat what they hear!

Investors should think twice about owning companies that are serial optimists for more than a trade.

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Pentant Disclaimer and Sources

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Sources:

All of the data shown in the charts in this report and mentioned through the text were obtained from publicly available sources and corporate reports, much of it aggregated through Capital IQ. We also use Bloomberg, IHS and government data bases.

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