The wrong focus? How the race to meet targets can throw corporate America off course

While earnings predictions can give valuable insights into company performance, pressure to ‘make the numbers’ may conflict with the wider interests of shareholders, writes Francesco Guerrera.

It is one of the rituals of American capitalism. Every three months, companies, investors and analysts eagerly await the word from the corporate version of the ancient oracles: the chief executive.

Like their Greek and Roman predecessors, these corporate titans are charged with predicting the future: no number is more eagerly awaited by Wall Street than “earnings guidance” — companies’ own performance forecasts. Setting a recurring target for profit growth was intended to make companies more accountable to the market and focus management minds on achieving tangible results for shareholders. But more than five years, that part of the ritual appears to be losing its appeal.

Long-standing critics such as the veteran investor Warren Buffett have been joined by academics, politicians, regulators and, increasingly, chief executives and analysts in attacking the premise that forces companies to focus on narrow, short-term results.

Some companies have already acted. Pfizer, Motorola, Intel, Ford, General Motors, McDonald’s, Coca-Cola and The Washington Post — the last two part of Mr. Buffett’s portfolio — have stopped feeding analysts quarterly forecasts. Google, a high-profile newcomer, has dared to incur the wrath of Wall Street by refraining from any guidance at all.

According to the National Investor Relations Institute, just over half of all publicly listed companies offer earnings guidance every quarter, down from 75 percent three years ago.

The question facing corporate America and its various stakeholders is whether the market has moved on from the idea that quarterly earnings, or “guidance,” is the key to shareholder value.

No company is going to grow at exactly x per cent quarter after quarter. Life just isn’t like that — STEVE OLLAND

Despite that, chief executives argue that guidance can help reduce share price volatility and boost valuations. There is a perception that public companies need quarterly earnings guidance as part of their marketing process, says Kurt Schacht, managing director of the CFA Centre for Equity Market Integration.

Indeed, companies such as General Electric have built a reputation on quarterly guidance, which has been a key driver of share price performance. In fact, many hedge funds have no concern over the fact that they make large profits by “shorting” companies whose announced earnings fall short of their guidance.

“Earnings guidance causes more problems than it solves,” says Rob Markay, a partner at the management consultants Bain & Company. “By giving guidance, the management team increase the level of disappointments and anxiety when unexpected events invariably occur.”

Although corporate America’s disenchantment with earnings guidance is undeniable, there are obstacles to change. For a start, the salaries, and even the jobs, of both analysts and fund managers are heavily dependent on quarterly performance. And with trading volumes rising sharply in recent years, the average time investors hold a stock is down to a mere nine and half months, heightening the market’s need for rapidly delivered information on their long-term plans.

“The dilemma is that we are asking management to provide a short-term horizon,” says John Castellani, president of the Business Roundtable.

The same is true for America’s business leaders. With the typical chief executive of a large US company expected to last no more than five years, few can be expected to set their sights on the long term. Some politicians and activists believe attitudes could be changed by tax laws that penalise investors who trade in and out of stocks. But given regulators’ limited set of options such as earnings guidance and investment decisions, legislation would be unlikely to curb the focus on the short term.

In the words of Louis Thompson, chief executive of the National Investor Relations Institute: “If you want to get away from the short-termism chains you have to break all the links.”