
STREET RESEARCH

CORPORATE EARNINGS AND CREDIT DEBACLES

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“Street Research” intends to highlight the recent trend of important research topics pursued by the practitioner community. These topics cover strategic issues, portfolio management, and valuation. It will not deal with street research on individual securities, a well-publicized topic with regard to conflicts of interest. In fact, “Street Research” goes beyond what happens in the Wall Street broker/dealer community and looks at research conducted and implemented by corporations, buy side firms, institutional investors, independent research boutiques, and consultants.

Street research forms the basis for unifying ideas and practices. While the research may not be as comprehensive as that demanded by academic standards,¹ the ideas are nevertheless sought after by practitioners. These ideas represent the important issues that practitioners face daily, which always require the consideration of feasible implementation. On the other hand, street research also serves as an important testing ground and is an extension of the more theoretical academic research.

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In 2002, a wide range of research topics emerged. To name a few: equity risk premium, pension asset/liability gap and associated hedging strategies, renewed interest in global tactical asset allocation, hedge fund investing, asset securitization, the globalization of equity and bond pricing, the impact of industry effect on growth/value premium and global equity returns, corporate governance, etc. However, nothing draws more attention than “earnings quality” and “corporate bond investing.”

Accounting irregularities and scandals, which emerged in late 2001, have induced significant interest from regulatory agents, the media, investors, and corporations. The impact of these events on past and future earnings and ultimately investment returns has become a fertile ground for academic and practitioner research. For example, a series of excellent research reports done by Michael Goldstein (formerly with Sanford Bernstein) during the height of the technology bubble questioned the then-apparent earnings growth.² He quantified the impact of stock options, pension expenses, and non-recurring charges on earnings growth. These items accounted for more than 5% of the reported

9% growth from 1995 to 2000 that would have brought the perceived earnings boom to a level in fact below the average for the period from 1974 to 2000 (6.7%).

More recent equity street research on this topic concentrates mostly on qualitatively identifying potential minefields of earnings misguidance and distortions. For example, a report by Morgan Stanley Dean Witter (2000) provides a detailed list and discussion of early warning measures of sustainability of earnings and revenue. Nevertheless, empirical street research of earnings quality and equity performance has been basic and not comprehensive. Following recent academic finance research about the relationship between equity returns and earnings accruals, Credit Suisse First Boston's study (2002) examines the evidence of equity underperformance due to extreme changes in inventory and accounts receivables. The empirical results cover 1977 onwards and compares this risk indicator across various economic sectors. Chicago Investment Analytics (2001) analyzes the issue of whether components of accruals (asset and liability items) provide better insight than the net figures in explaining asset efficiency, sales growths, and equity return spreads.

Empirical application of earnings quality to accounting valuation and equity portfolio management is still in its infancy, but is expected to grow substantially in the future. However, researchers need to explore several fundamental questions such as different definitions of earnings quality, analysis and estimation of abnormal accruals, quantification of earnings management, and identifying the change in managerial behavior toward earnings accounting practices. Street (and finance) researchers can lean on many accounting studies. An excellent survey by Kothari (2001) and provocative discussions by Dechow and Skinner (2000) and Penman (2002) provide a good starting point.

Throughout 2002, news of corporate bond debacles did not provide a complete picture of the stress, agony, and frustration faced by credit research and bond investors. In the end, we observed:

- persistently high level of credit spread volatility;
- extreme level of default rates and downgrade to upgrade ratio;
- record number of fallen angels;
- large number of bonds traded on a price, rather than on a yield basis;
- unprecedented idiosyncratic risk: large return differentials of corporate bonds with similar quality ratings;
- Equity-like negative returns of telecommunication bonds for three consecutive years despite the interest rate rally;
- one of the widest ranges of quintile performance among investment grade bond portfolios in recent history.

Against such a market background, bond investors scrambled for answers to some basic questions familiar to equity and derivatives researchers: portfolio diversification, risk factor decomposition, quantifying idiosyncratic risk, credit risk pricing, default correlation, the relationship between equity and bond pricing, etc. Unfortunately, in most cases, street research tends to be too comfortable with studying the singular and short-term relationship of relative value trends. Much quantitative research focuses on fine-tuning techniques for valuing the yield curve structure, security, and deals. Portfolio risk construction and backtesting validation are often unheard of or ignored and ultimately replaced by market technicals in the portfolio management process. Hence, quantitative research techniques and frameworks commonly used by equity academics and practitioners can greatly enhance fixed income street research and portfolio management.

However, several buy-side firms such as Barclays Global Investors and Lincoln Capital (with

Peter Knez of Incapture Research, 2001) have incorporated rigorous equity research into credit risk valuation and portfolio management. Specifically, high-frequency cross-sectional signals of firm financial fundamentals found useful by equity investors, such as earnings quality, earnings/price momentum, capital structure, and equity volatilities, are applied to corporate bond research through time-series prediction models and backtesting. This is in contrast to the credit risk pricing framework used by credit derivatives research that relies on longer term default data, rating transition matrices, recovery rate, and limited firm-specific information (e.g. debt/equity, asset size).

Departing from traditional fixed income research, Peter Rappoport of J.P. Morgan (2002) presents an interesting empirical study of evaluating corporate bond trading strategies given the various sources of credit information: rating agency rating, third-party default probability estimates, bond characteristics, and market spread data. Equity returns are used as the second dimension of trading signals. In addition to employing the analytical framework commonly used in empirical equity research, such as backtesting, the study also examines the impact of turnovers and false trading signals.

As for practical portfolio management issues stemming from credit debacles, Lehman Brothers published a series of outstanding empirical studies that highlighted the implications and provided analytical solutions to many of the credit market phenomena mentioned above. The most noticeable and well-circulated piece is related to analyzing the required portfolio diversification in order to achieve

the desired level of downgraded risk (Lehman Brothers, 2002).

Notes

- ¹ As more academic researchers have joined practitioner ranks over the last decade, the direction and methodologies employed by street research has become more academic-like.
- ² Part of the research on this topic is summarized in AllianceBernstein (2002).

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