Asset Growth and Analysts’ Multi-Period Earnings Forecasts*

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ABSTRACT: Using analysts’ multi-period earnings forecasts, we examine whether analyst forecast bias is related to asset growth. We find that analyst forecasts are more optimistic for firms with higher asset growth. This relation is particularly noticeable for longer-term (e.g., two- and three-year-ahead) forecasts than for shorter-term (e.g., one-year-ahead) forecasts. Moreover, analyst optimism for high-growth firms is greater for 1) firms that have maintained similar levels of growth over recent periods, 2) firms with higher information uncertainty, and 3) forecasts with longer forecast horizons (e.g., forecasts issued far before the fiscal year-end). We examine to what extent analyst optimism for high-growth firms explains the asset growth effect (i.e.,

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a negative association between asset growth and subsequent stock returns). Controlling for forecast bias in a growth-return regression substantially attenuates the asset growth effect, suggesting that forecast bias plays an important role in the asset growth effect. Path analysis further suggests that analysts' long-term (but not short-term) forecast bias is an important mediator through which biased expectations about asset growth are incorporated into stock prices. Overall, our findings are consistent with the extrapolation bias explanation for the asset growth effect.

Keywords: extrapolation bias, asset growth anomaly, analysts' forecast, forecast bias, forecast horizons

I. Introduction

The empirical irregularity of a negative relation between asset growth and subsequent stock returns (i.e., the asset growth effect) has provoked sharp debates in the literature. For example, Cooper et al. (2008) find that the asset growth effect is robust to controlling for other growth measures, such as book-to-market (B/M) ratios, growth in sales (Lakonishok et al. 1994), accruals (Sloan 1996), and growth in net operating assets (Hirshleifer et al. 2004). This is because asset growth captures all the subcomponents of firm growth that result from investment and financing activities. Although some papers suggest that the asset growth effect is merely a reflection of risk (e.g., Watanabe et al. 2013), others support the mispricing view in which systematic bias exists in market expectations about the implications of current growth for future firm performance (Cooper et al. 2008; Lipson et al. 2011; Mao and Wei 2016).

The extrapolation bias hypothesis has been key to the support of the mispricing explanation for the asset growth effect. It suggests that investors tend to extrapolate past information too far into the future and therefore form biased expectations of a firm's economic prospects (De Bondt and Thaler 1985; Lakonishok et al. 1994). An important prediction under this hypothesis is that such a bias will be amplified for long-term projections