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July 13, 2021

## New Constructs

# How COVID-19 Scrambles Earnings Reports: Most Misleading EPS in the S&P 500

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# How COVID-19 Scrambles Earnings

Most Overstated and Understated EPS in the S&P 500

# AGENDA

- 1. Unscrubbed Earnings are Flawed**
- 2. Case Studies: Most Understated EPS in the S&P 500**
- 3. Case Studies: Most Overstated EPS in the S&P 500**
- 4. Stocks More Likely to Miss Street EPS in 2Q21**
- 5. How To Protect Yourself From Misleading EPS**

## Part 1



# Unscrubbed Earnings Measures are Flawed

# What Causes Differences in Earnings Measures?

## Unusual **items** in the footnotes & MD&A of financial filings

- Hidden Expenses/Income
- Unrecorded Goodwill
- Impairments
- Unconsolidated Subsidiaries
- Minority Interests
- Unrealized Gains/Losses
- Changes in Accounting Rules
- Derivatives Exposure
- Employee Stock Options
- Option Valuation Assumptions
- Operating Leases
- Loan Loss/LIFO Reserves
- Pension Assumptions
- Pension Over/Under Funding
- Carrying Value vs Fair Value
- Mid-year acquisitions

## Theory vs. Reality: Street Earnings

Most investors are not aware that SPGI Operating Earnings and Street Earnings suffer from significant flaws when compared to Core Earnings, a better measure of earnings because they exclude material unusual gains/losses missed by Wall Street.

### In Theory:

Wall Street analysts adjust Street EPS for unusual gains and losses that distort corporate EPS.



### In Reality:

They don't.

Without adjusting for these items, investors don't get an accurate picture of a company's true profits.

“

*Street Earnings adjustments are not necessarily complete or comparable across firms.”*

-Page 16, 3rd paragraph  
Core Earnings: New Data and Evidence

# The Problem: More Data = More Complexity

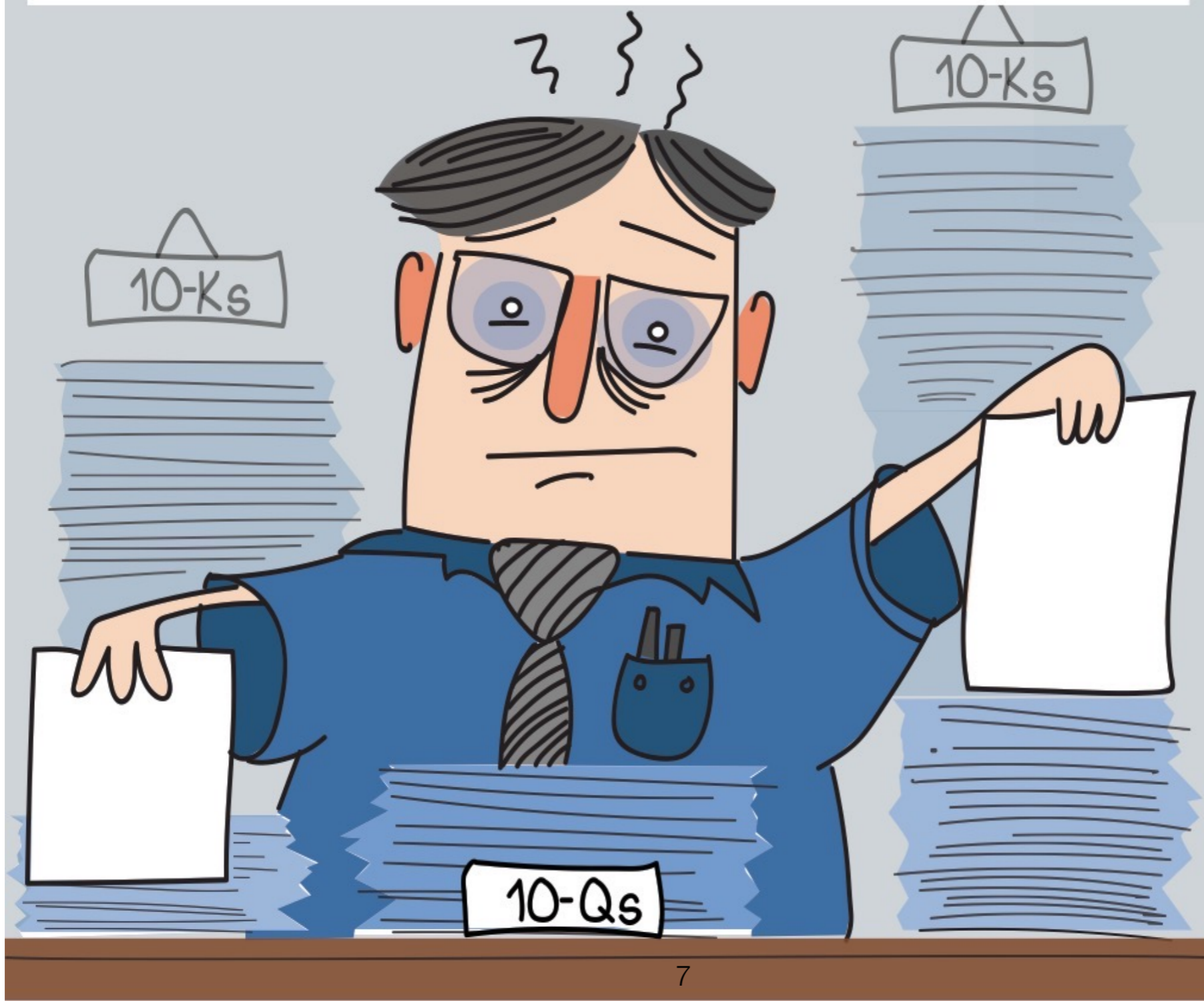
## To challenge investors

- **Filings have grown to 200+ pages**  
*(That's longer than the average novel.)*
- **Increasingly complex and time-consuming work**
- **Accounting rules are constantly changing**





# WHO HAS TIME TO READ 200+ PAGE FILINGS?



## The Result: Misleading Earnings

47% of S&P 500 firms OVERstate EPS by > 10%.  
12% of S&P 500 firms UNDERstate their EPS by >10%.

	Street Distortion > 10%	Average Street Distortion
Overstated EPS	237 companies	31%
Understated EPS	58 companies	-55%

The reverse [kitchen sink](#): We expect companies to continue overstating EPS going forward by sneaking unusual gains (often from rising public/private investments in a hot stock market) into EPS in efforts to prolong the post-Covid-19 earnings euphoria.

Sources: New Constructs, LLC, Refinitiv, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.

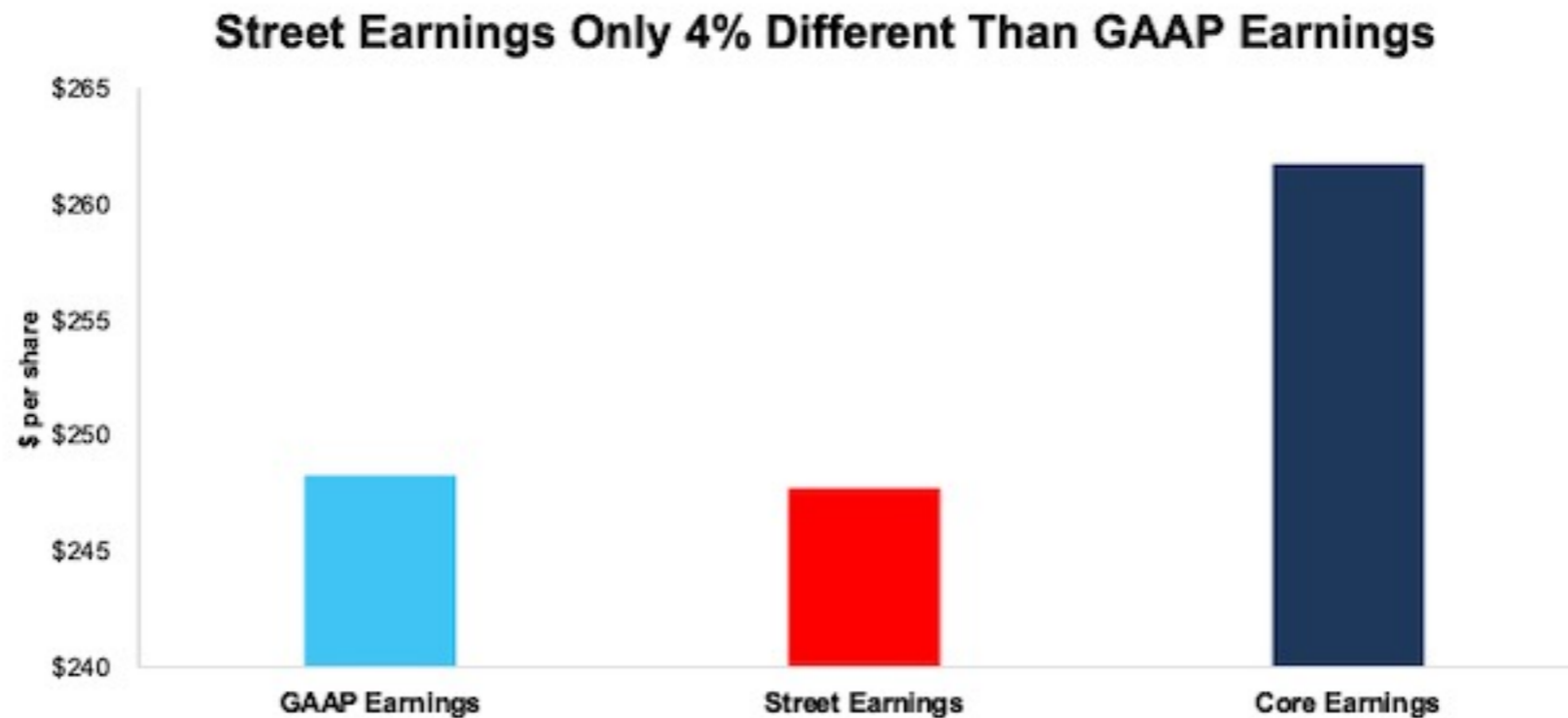
## Part 2



# Case Studies: Most Understated Earnings in the S&P 500

## NVR Inc. (NVR): Understated Street Eps

- The Street Distortion, or difference between NVR's Street EPS (\$274.75/share) and Core Earnings (\$261.74/share), is -\$13.99/share or 6% of Street EPS.
- NVR's GAAP EPS are \$261.74/share, so the GAAP Distortion, or difference between reported GAAP EPS and Core EPS, is \$13.43/share or 5% of GAAP EPS.
- Overall, Core EPS are 6% higher than Street EPS.



Sources: New Constructs, LLC, Refinitiv, and company filings.

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## NVR Inc. (NVR): Understated Street Eps - details

- Since Street Distortion and GAAP Distortion are about the same, it is clear that Street Earnings are not adding a lot of value by removing the unusual expenses that materially distort GAAP Earnings.

	TTM (\$ per share)
<b>GAAP Earnings</b>	<b>\$248.31</b>
- Hidden Unusual Items	-\$5.51
- Reported Unusual Items	\$0.00
- Tax Distortion	-\$7.92
<b>Core Earnings</b>	<b>\$261.74</b>

Sources: New Constructs, LLC, Refinitiv, and company filings.

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## NVR Inc. (NVR): Understated Street Eps - details

### **Hidden Unusual Expenses, Net = -\$5.51/per share, which equals -\$22 million**

- [-\\$0.2 million](#) in the TTM for capitalized interest charged to cost of sales – Page 7 1Q21 10-Q
- -\$19.2 million in the TTM period based on [\\$25.6 million](#) of impairment of lot deposits due to deteriorating market conditions – Page 53 2020 10-K
- -\$2.2 million in the TTM period based on [\\$2.9 million](#) of capitalized interest charged to cost of sales – Page 54 2020 10-K

### **Tax Distortion = -\$7.92/per share , which equals -\$31 million**

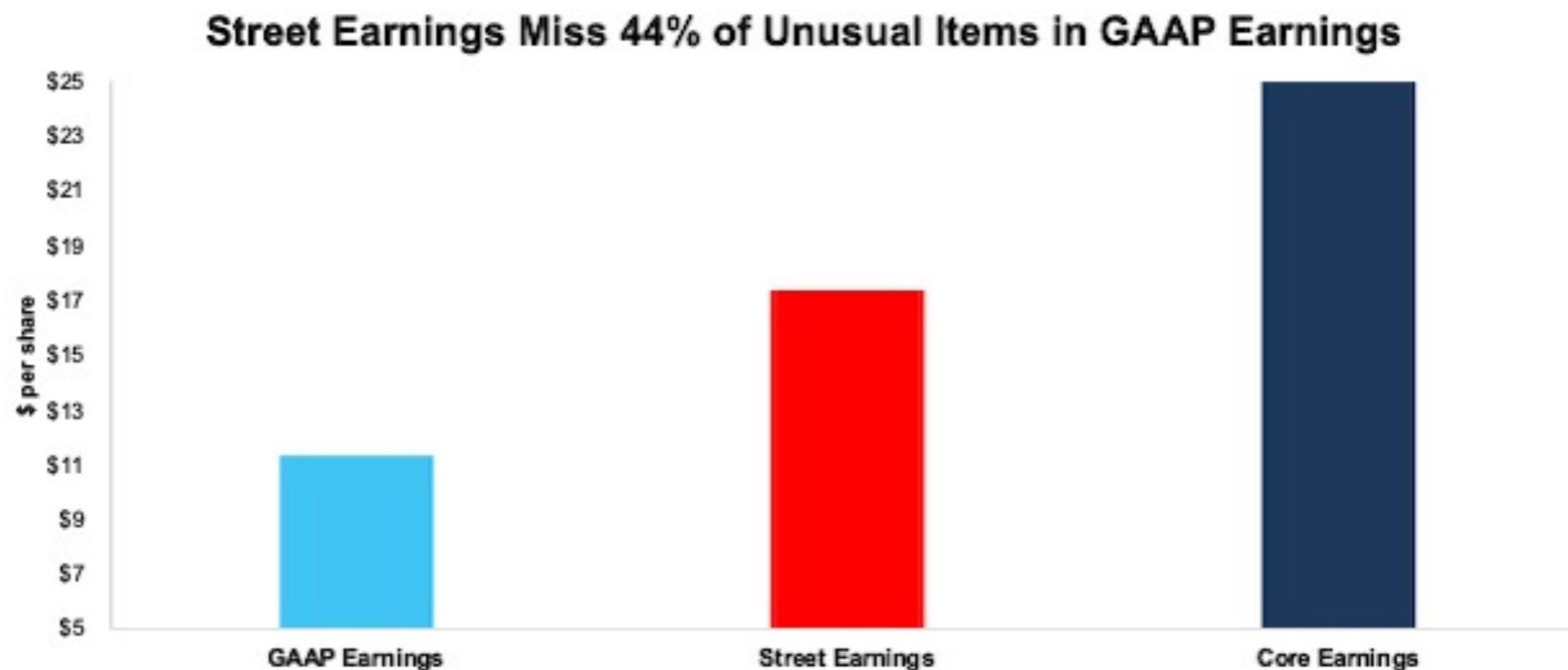
- We remove the tax impact of unusual items on reported taxes when we calculate Core Earnings. It is important that taxes get adjusted so they are appropriate for adjusted pre-tax earnings.

Sources: New Constructs, LLC, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.

## Allstate (ALL): Understated Street Eps

- The Street Distortion in Allstate's 1Q21 TTM EPS is  $-\$7.64/\text{share}$  (44% of Street EPS), which is 44% less than the  $-\$13.65/\text{share}$  (120% of GAAP EPS) in GAAP Distortion.
- Street Earnings do a better job of capturing unusual items for Allstate than NVR, but they still miss 44% of the unusual items in GAAP Earnings.
- Overall, Core EPS are 44% higher than Street EPS.



Sources: New Constructs, LLC, Refinitiv, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.

## Allstate (ALL): Understated Street Eps - details

- Unlike NVR, majority of unusual items that Street and GAAP EPS fail to account for are reported.
- In theory, they should be easier to identify than the hidden items found in NVR's filings.

	TTM (\$ per share)
<b>GAAP Earnings</b>	<b>\$11.36</b>
- Hidden Unusual Items	\$0.30
- Reported Unusual Items Pre-Tax	-\$2.02
- Reported Unusual Items After-Tax	-\$12.18
- Tax Distortion	\$0.25
<b>Core Earnings</b>	<b>\$25.02</b>

Sources: New Constructs, LLC, Refinitiv, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.



# Allstate (ALL): Understated Street Eps - details

## **Hidden Unusual Gains, Net = \$0.30/per share , which equals \$92 million**

- \$92 million in the TTM period based on [\\$123 million](#) in realized capital gains – Page 42 2020 10-K

## **Reported Unusual Expenses Pre-Tax, Net = -\$2.02/per share, which equals -\$629 million**

- [-\\$738 million](#) for Shelter-in-Place Payback expenses – 2Q20 10-Q
- \$679 million for pension and other postretirement remeasurement gains in the TTM period, based on
  - [-\\$73 million](#) loss in 2Q20
  - [\\$71 million](#) gain in 3Q20
  - [\\$371 million](#) gain in 4Q20
  - [\\$310 million](#) gain in 1Q21
- -\$305 million in restructuring and related charges in the TTM period, based on
  - [-\\$14 million](#) in 2Q20
  - [-\\$200 million](#) in 3Q20
  - [-\\$40 million](#) in 4Q20
  - [-\\$51 million](#) in 1Q21
- \$268 million contra adjustment for [recurring pension costs](#). These recurring expenses are reported in non-recurring line items, so we add them back and exclude them from Earnings Distortion.
- \$3 million gain in the TTM period based on a [\\$4 million](#) gain on disposition of operations – 2020 10-K

## **Reported Unusual Expenses After-Tax, Net = -\$12.18/per share, which equals -\$3.8 billion**

- [-\\$3.8 billion](#) loss from discontinued operations – 1Q21 10-Q

## **Tax Distortion = \$0.25/per share, which equals \$77 million**

- We remove the tax impact of unusual items on reported taxes when we calculate Core Earnings. It is important that taxes get adjusted so they are appropriate for adjusted pre-tax earnings.

Sources: New Constructs, LLC, and company filings.

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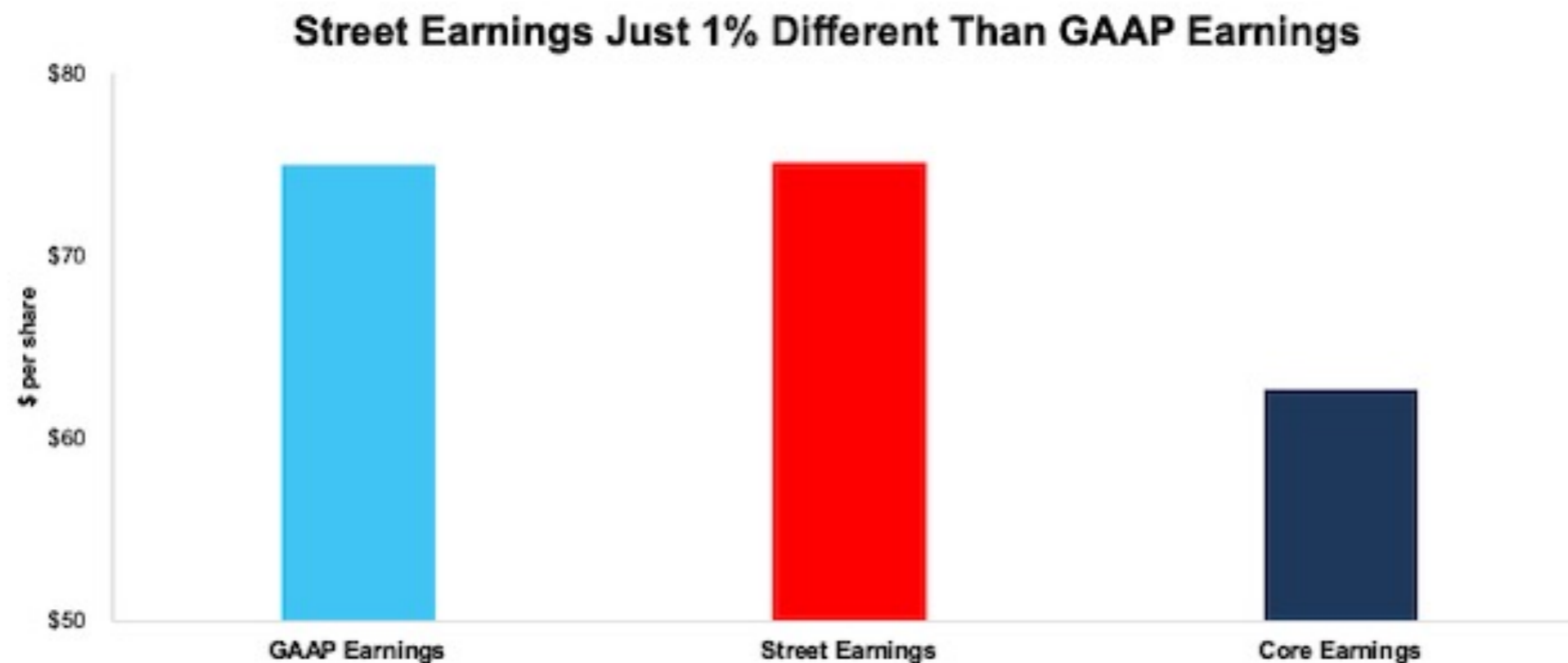
## Part 3



# Case Studies: Most Overstated Earnings in the S&P 500

# Alphabet (GOOGL): Overstated Street Eps

- The Street Distortion in Alphabet's 1Q21 TTM EPS is \$12.45/share (17% of Street EPS), which is \$.08/share (1%) more than GAAP Distortion.
- Alphabet's GAAP EPS are \$75.04/share, so the "GAAP Distortion" is \$12.37/share (16% of GAAP EPS), or just \$0.08/share less than the Street Distortion.
- Street Distortion is actually worse than GAAP Distortion, and Street Earnings are more overstated than GAAP Earnings.
- Overall, Core EPS are 17% lower than Street EPS.



Sources: New Constructs, LLC, Refinitiv, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.

## Alphabet (GOOGL): Overstated Street Eps - Details

- The majority, \$8.63/share, of the unusual income that Street Earnings fail to capture is very clearly non-core.
- It appears below the “Income From Operations” line of Alphabet’s income statement in both the 1Q21 10-Q and 2020 10-K.

	TTM (\$ per share)
<b>GAAP Earnings</b>	<b>\$75.04</b>
- Hidden Unusual Items	\$0
- Reported Unusual Items	\$14.84
- Tax Distortion	-\$2.47
<b>Core Earnings</b>	<b>\$62.67</b>

Sources: New Constructs, LLC, Refinitiv, and company filings.

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# Alphabet (GOOGL): Overstated Street Eps - Details

## **Reported Unusual Gains, Net = \$14.84/per share, which equals \$10.2 billion**

- \$4.3 billion or \$6.28/per share in the TTM period based on a [\\$4.3 billion](#) unrealized gain on equity securities – 2020 10-K
- Items detailed on next slide

## **Tax Distortion = -\$2.47/per share, which equals -\$1.7 billion**

- We remove the tax impact of unusual items on reported taxes when we calculate Core Earnings. It is important that taxes get adjusted so they are appropriate for adjusted pre-tax earnings.

Sources: New Constructs, LLC, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.

# Alphabet (GOOGL): Overstated Street Eps - Details

## Reported Unusual Gains, Net = \$14.84/per share, which equals \$10.2 billion

Each of the following is included in Other income (expense) on the income statement. We found these details in the footnotes:

- \$7.6 billion gain on debt & equity securities in the TTM period, based on
  - [\\$1.5 billion](#) gain on equity securities in 2Q20
  - [\\$387 million](#) gain on debt securities in 2Q20
  - [\\$1.9 billion](#) gain on equity securities in 3Q20
  - [\\$116 million](#) gain on debt securities in 3Q20
  - [-\\$991 million](#) loss on equity and debt securities in 4Q20
  - [\\$4.8 billion](#) gain on equity securities in 1Q21
  - [-\\$86 million](#) loss on debt securities in 1Q21
- -\$1.3 billion in performance fees in the TTM period, based on
  - [-\\$75 million](#) in 2Q20
  - [-\\$135 million](#) in 3Q20
  - [-\\$405 million](#) in 4Q20
  - [-\\$665 million](#) in 1Q21
- -\$282 million in Other Expense (income) in the TTM period, based on
  - [\\$147 million](#) expense in 2Q20
  - [-\\$88 million](#) expense in 3Q20
  - [-\\$420 million](#) expense in 4Q20
  - [\\$373 million](#) income in 1Q21
- -\$150 million in foreign currency exchange losses in the TTM period, based on
  - [-\\$92 million](#) loss in 2Q20
  - [-\\$84 million](#) loss in 3Q20
  - [-\\$87 million](#) loss in 4Q20
  - [\\$113 million](#) gain in 1Q21

Sources: New Constructs, LLC, and company filings.

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## Part 4



# Stocks More Likely to Miss Street EPS in 2Q21

## 3 firms More likely to miss 2q21 EPS Estimates

- Alphabet (GOOGL), Amazon (AMZN) and PayPal (PYPL) maintain investments in public and private companies that are not necessarily core to their businesses.
- Gains from these investments distort the company's EPS and Wall Street's EPS expectations.

## Overstated EPS -> overstated EPS

Ticker	Name	Consensus Earnings Estimates for 2Q21	Core EPS Estimate for 2Q21*	Consensus Estimate Overstated by
PYPL	PayPal Holdings	\$1.13	\$0.70	38%
GOOGL	Alphabet, Inc.	\$19.21	\$16.03	17%
AMZN	Amazon.com Inc.	\$12.22	\$11.03	10%

\*Assumes Street Distortion as a percent of Core EPS is same for 2Q21 EPS as for 1Q21 TTM EPS.

Sources: New Constructs, LLC, Refinitiv, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.



## More Likely to Miss: PayPal (PYPL)

- PayPal's 2Q21 street EPS estimate of \$1.13 is overstated by \$0.43/share, or 38% of 2Q21 street EPS estimate.
- Our Core EPS estimate is \$0.70.
- Street EPS estimates are overstated b/c they are based on prior historical EPS data that are overstated from billions of dollars of gains in what the company calls strategic investments, or stakes in publicly and privately held companies.

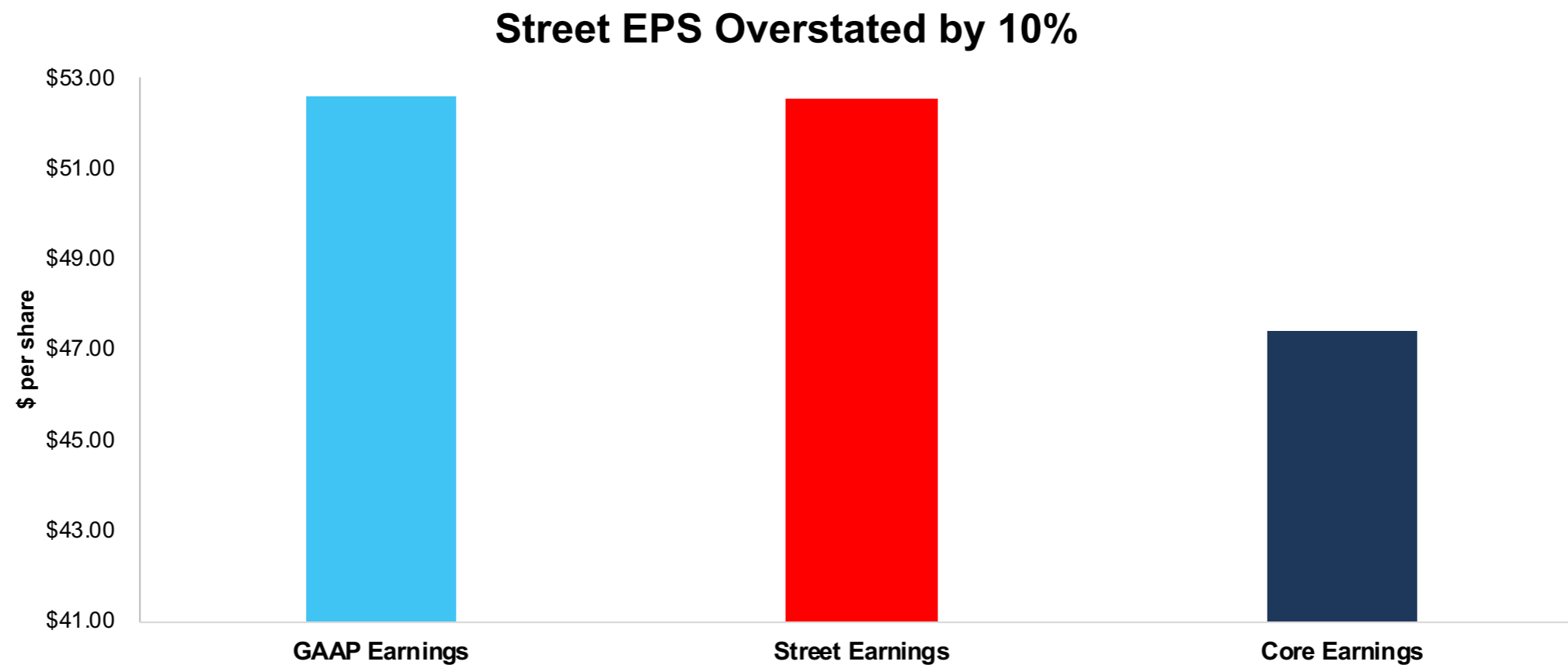


Sources: New Constructs, LLC, Refinitiv, and company filings.

Any trading symbols displayed are for illustrative purposes only and are not intended to portray recommendations. Past performance is not necessarily indicative of future results.

## More Likely to Miss: Amazon (AMZN)

- Amazon's 2Q21 consensus EPS estimate of \$12.22/share is overstated by \$1.19/share, or 10% of 2Q21 street EPS estimate.
- Our Core EPS estimate is \$11.03.
- Street EPS estimates are based on recent consensus earnings that include billions of dollars of non-core 'other income' and gains from its investments in private companies.



Sources: New Constructs, LLC, Refinitiv, and company filings.

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## Part 5



# How You Can Protect Yourself From Misleading Earnings

# Auto-generated reports – updated daily

## Leverage auto-parsing expertise into new products and markets



New Constructs®

Analyst Notes

New 10-K & Forecast 3/1/20  
Focus List (Long) Model Portfolio Nov 2019

**ROBO-ANALYST RESEARCH**

Closing Price as of 03/06/2020: \$22.35

Dividend Yield: 3.6%

Period End Date: 12/31/2019

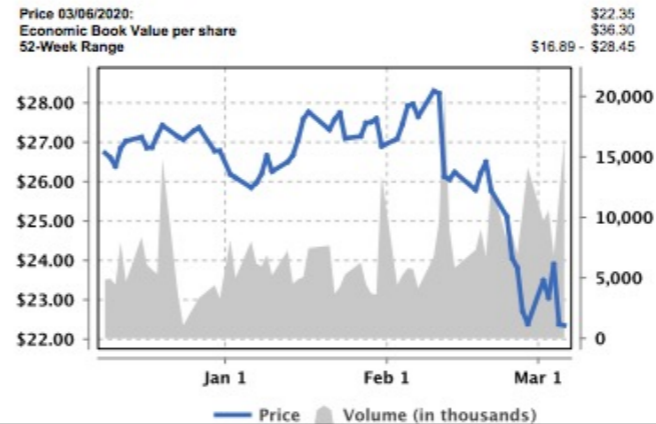
### Western Union Co (The) (WU)

**Neutral**

NYSE - Industrials

#### Investment Recommendation

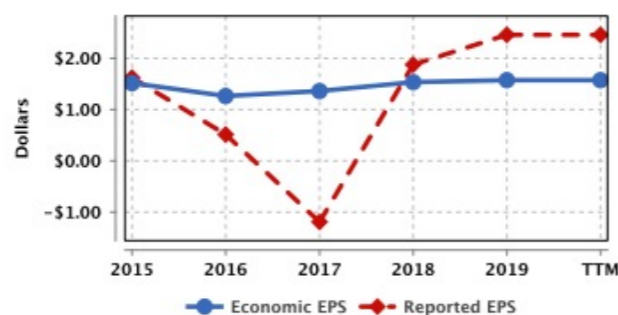
- We do not recommend investors buy WU.
- WU earns our Neutral rating. See Investment Rating Details below.
- A Neutral rating means this stock's upside potential is about equal to its downside risk.
- WU ranks in the 72nd percentile of the 2900+ stocks we cover.
- Ranks 106th out of 416 Industrials Sector stocks.



#### Investment Rating Details

Risk/Reward Rating	Quality of Earnings		Valuation		
	Economic vs Reported EPS	Return on Invested Capital (ROIC)	FCF Yield	Price-to-EBV Ratio	Growth Appreciation Period (yrs)
Very Unattractive	Misleading Trend	Bottom Quintile	<-5%	> 3.5 or <-1 < 0	> 50
Unattractive	False Positive	4th Quintile	-5%<-1%	2.4 < 3.5 or <-1	20 < 50
<b>Neutral</b>	Neutral EE	3rd Quintile	-1%<3%	1.6 < 2.4	10 < 20
Attractive	Positive EE	2nd Quintile	3%<10%	1.1 < 1.6	3 < 10
Very Attractive	Rising EE	Top Quintile	>10%	0 < 1.1	0 < 3
<b>Actual Values</b>	\$1.57 vs. \$2.46	25%	11%	0.6	< 1
<b>Sector ETF (XLI)</b>	Positive EE	10%	5%	1.8	26
<b>S&amp;P 500 ETF (SPY)</b>	Positive EE	20%	2%	2.6	29

#### Economic EPS vs Reported EPS



#### Earnings & Valuation Diligence Summary

- WU's accounting earnings overstate its economic earnings, which equal  $(ROIC - WACC) * \text{Average Invested Capital}$ .
- For WU, we made a total of \$3,681 million in income statement and balance sheet adjustments to convert accounting earnings to economic earnings in FY19.
- We made \$5,220 million in adjustments in our DCF valuation of the stock.
- See Appendix 1 for details on our calculations of key metrics and Appendices 2 and 3 for details on our [adjustments](#).

Stock Performance

Key Market Statistics

Best Data in the Business

# Stock Ratings: details

“Robo-Analysts Best Human Analysts on Investment Picks.”

– Vildana Hajric, Bloomberg News

## Microsoft Corporation (MSFT)

Closing Price: \$227.56 (Mar 03, 2021)  
 Market Value: \$1716.3 Billion  
 Dividend Yield: 1.0%  
 Sector: **Technology**

Earnings Distortion Score : **Miss**

[Switch to Credit Rating](#)

Analyst Notes : None

Risk/Reward Rating ?	Quality of Earnings		Valuation		
	Economic vs Reported EPS ?	ROIC ?	FCF Yield ?	Price to EBV ?	Market-Implied GAP ?
Very Unattractive	Misleading Trend	Bottom Quintile	< -5%	> 3.5 or -1 < 0	> 50
Unattractive	False Positive	4th Quintile	-5% < -1%	2.4 < 3.5 or < -1	20 < 50
<b>Neutral</b>	Neutral EE	3rd Quintile	<b>-1% &lt; 3%</b>	<b>1.6 &lt; 2.4</b>	<b>10 &lt; 20</b>
Attractive	Positive EE	2nd Quintile	3% < 10%	1.1 < 1.6	3 < 10
Very Attractive	<b>Rising EE</b>	<b>Top Quintile</b>	> 10%	0 < 1.1	0 < 3
<b>Actual Values</b>					
<b>MSFT</b>	<b>\$5.79 vs. \$6.71</b>	<b>42%</b>	<b>2%</b>	<b>1.9</b>	<b>16 yrs</b>
<b>Benchmarks ?</b>					
Sector ETF (QQQ)	Positive EE	<b>37%</b>	<b>1%</b>	<b>3.1</b>	<b>31 yrs</b>
S&P 500 ETF (SPY)	Positive EE	<b>24%</b>	<b>2%</b>	<b>2.9</b>	<b>23 yrs</b>
Small Cap ETF (IWM)	Positive EE	<b>4%</b>	<b>1%</b>	<b>3.8</b>	<b>40 yrs</b>

[Add to Portfolio](#) [Company Model](#) [Download XLS](#) [Download Report](#) [Marked-Up Filings](#)

**Investment Summary**

Rating Breakdown

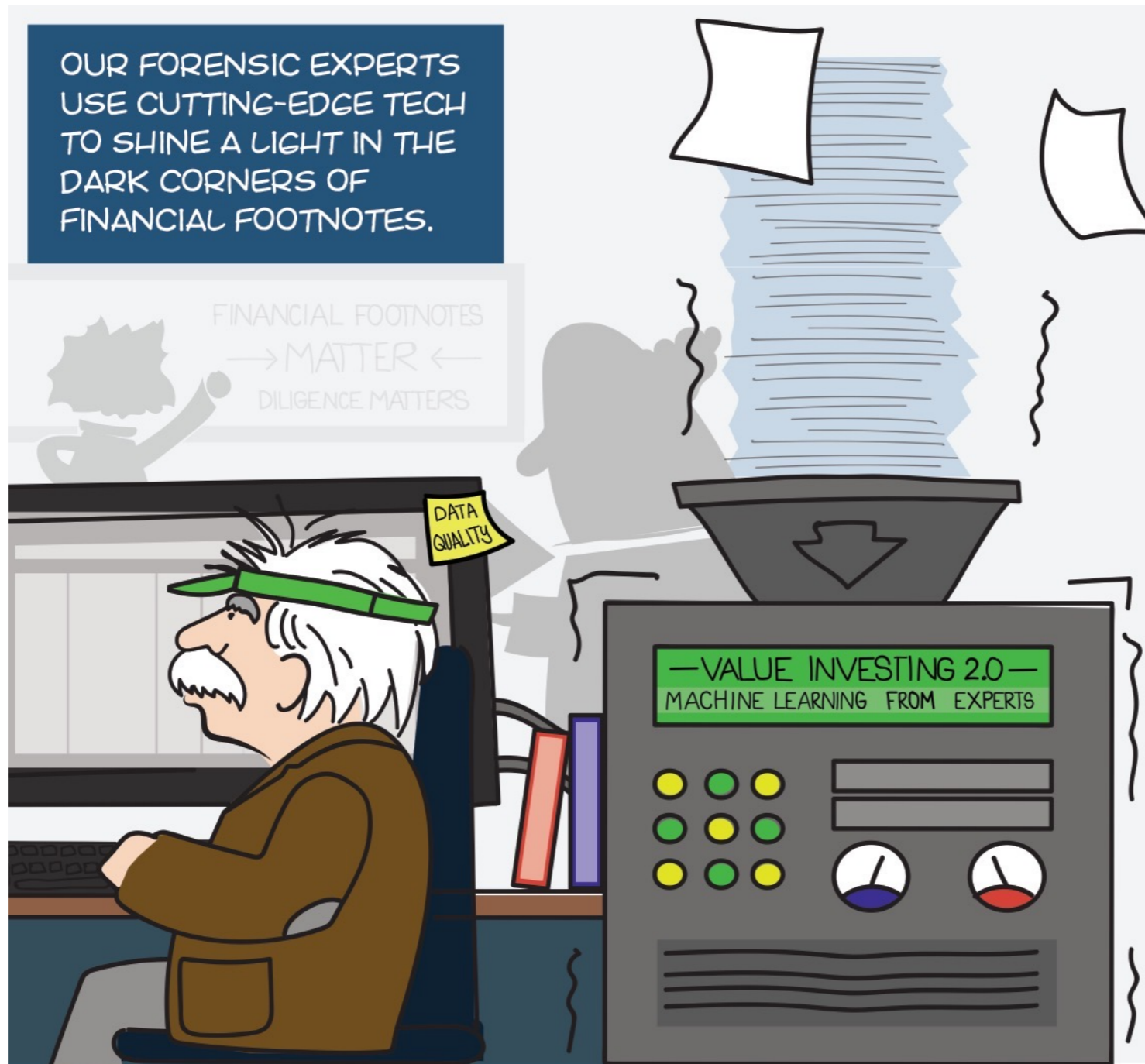
GAAP Reconciliation

Adjustments

Earnings Distortion

# Machine Learnings from experts

Human-Validated parsing instructions from 200,000+ filings



# AI-Enabled Research Automation - Benefits

## The Robo-Analyst



### Better

- Drives alpha
- Only way to analyze footnotes in 200+ page filings
- 100% transparency
- 1-click to audit every number



### Faster

- Cover 10,000s of stocks, bonds, ETFs and mutual funds
- Entire 10-Ks & Qs analyzed in minutes
- Models & APIs updated instantly



### Cheaper

- \$billions/year saved vs. legacy data collection systems
- \$millions/year saved while covering more companies w/ fewer people
- Cost effective fulfillment of fiduciary duties

# Proof of superior fundamental vs SPGI and refinitiv

JOURNAL OF  
Financial  
ECONOMICS

HARVARD  
BUSINESS SCHOOL

MIT  
MANAGEMENT  
SLOAN SCHOOL

## Core Earnings: New Data and Evidence\*

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Harvard Business School

Eric So  
Massachusetts Institute of Technology  
Sloan School of Management

Charles C.Y. Wang  
Harvard Business School

November 2020  
Forthcoming, *Journal of Financial Economics*

### Abstract

Using a novel dataset, we show that components of firms' GAAP earnings stemming from ancillary business activities or transitory shocks are significant in frequency and magnitude. These components have grown over time and are dispersed across various sections of the 10-K. Excluding them from GAAP earnings yields a core earnings measure that distinguishes between the recurring and non-recurring components of net income and forecasts future performance. Analysts and market participants are slow to impound these earnings components' implications, particularly the amounts disclosed in footnotes. Trading strategies that exploit non-core earnings produce abnormal returns of 8% per year.

**Keywords:** Core Earnings; Transitory Earnings; Non-Operating Earnings; Quantitative Disclosures; Fundamental Analysis; Equity Valuation

**JEL:** C14, G10, G18, M40, M41

\*First draft: July 2018. For helpful feedback, we thank Bill Schwert (editor), an anonymous referee, Dirk Black, Ilija Dichev, Vivian Fang (discussant), Trevor Harris, Paul Healy, Juhani Linnainmaa (discussant), Pete Lisowsky, Stephen Penman, Edward Riedl, Doug Skinner, Joe Weber, and workshop participants at Acadian Asset Management, the ASSA/AEA Annual Meeting, Arrowstreet Capital, Boston University, Conference on Financial Economics and Accounting, Dartmouth University, Fuller & Thaler, Global Quantitative and Macro Investment Conference, Harvard Business School, Strategic Global Advisors, University of Arizona, and London School of Economics. We also thank Carolyn Liu and Trang Nguyen for excellent research assistance. We are grateful to David Trainer, Lee Moneta-Koehler, and the New Constructs team for providing their data and offering valuable insights. None of the authors received any financial support or have financial dealings with the data provider or hold any paid or unpaid positions at the organization. The organization provided the data for academic research purposes and did not have the right to review the paper prior to its circulation. One of us, for teaching purposes, wrote a Harvard Business School case on the organization, which was based on field interviews and non-public information sources and fully funded by the school. All errors remain ours.

“ Compustat adjustments explain only 26% to 53% of the variation in Total Adjustments [Earnings Distortion] – Online Appendix pp. 1, 2nd para.

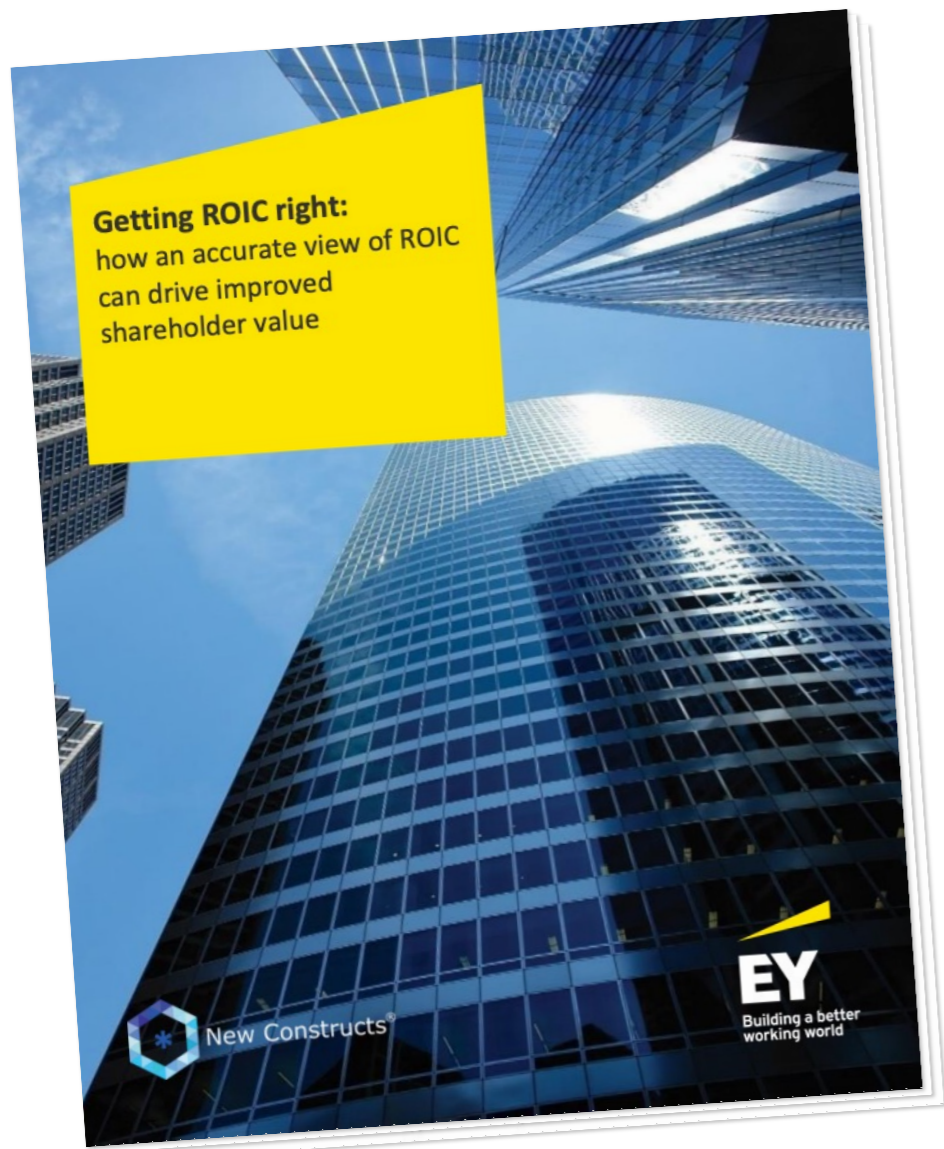
“ we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing Core Earnings.” – pp. 16, 2nd para.

“ The average total non-core-earnings items identified amounts to 19% of average Net Income.” – pp. 3, 2nd para.

Click [here](#) for the paper. Here's a [short summary](#).



# Proof of superior financial models



“ [New Constructs] accounts for a large number of items... which are not included in the other data sets.”  
p. 5

“ The majority of the difference comes from [New Constructs]’s machine learning approach, which leverages technology to applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies. p. 4

“ The other advantage of [New Constructs] is the transparency in disclosing calculations and all the data behind them. It is hard to determine the calculations at a granular level from the reports of many data providers. P. 4

Click [here](#) for the paper.

# Proof of superior stock ratings

## Diligence matters – so does being unconflicted

“ the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant.” – pp. 6, 3rd para.

### Man Versus Machine: A Comparison of Robo-Analyst and Traditional Research Analyst Investment Recommendations

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February 2020

**Abstract:** Advances in financial technology (FinTech) have revolutionized various product offerings in the financial services industry. One area of particular interest for this technology is the production of investment recommendations. Our study provides the first comprehensive analysis of the properties of investment recommendations generated by “Robo-Analysts,” which are human-analyst-assisted computer programs conducting automated research analysis. Our results indicate that Robo-Analyst recommendations differ from those produced by traditional “human” research analysts across several dimensions. First, Robo-Analysts collectively produce a more balanced distribution of buy, hold, and sell recommendations than do human analysts, consistent with them being less subject to behavioral biases and conflicts of interest. Second, consistent with automation facilitating a greater scale of research production, Robo-Analysts revise their recommendations more frequently than human analysts and also adopt different production processes. Their recommendation revisions rely less on earnings announcements, and more on the large volumes of data released in firms’ annual reports. Third, Robo-Analysts’ recommendation revisions exhibit weaker short-window return reactions, suggesting that investors do not trade on their signals. Importantly, portfolios formed based on the buy recommendations of Robo-Analysts appear to outperform those of human analysts, suggesting that their buy calls are more profitable. Overall, our results suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts for investment advice.

JEL Codes: G14, G24

We benefited from comments and suggestions received from Larry Brown, Elizabeth Demers (discussant), Jared Flake, Ryan Johnson, Philip Joos, Stephanie Larocque (discussant), Christian Leuz, Roni Michaely, Brady Twedt, Jim Wahlen, and participants at the 2019 BYU Accounting Research Symposium, 2020 Financial Accounting Reporting Section Midyear Meeting Plenary Session, and the 2020 Swiss Accounting Research Alpine Camp.

“ Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts.” – pp. 20, 3rd para.

Click [here](#) for the paper.

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