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**HEADLINE:** Market optimism vs. executive gloom;
Stock analysts are pumped up after 2nd-quarter profit reports; corporate managers beg to differ

**BYLINE:** By Bill Barnhart, Tribune markets columnist.

**BODY:**
To hear Wall Street tell it, companies have entered the sweet spot of the corporate earnings cycle--a period when profit growth and stock prices should accelerate in the wake of the 2001 recession.

The message reflects the recent historical pattern as well as the congenital optimism of stock analysts, but it is not being echoed in many corporate boardrooms.

"We can't ignore the positive news in second-quarter earnings data," analyst Steven Wieting of Citigroup said in a report last week. "Profits are rising more than we expected in the first half of 2003. ... An acceleration in profits seems very likely over the next few quarters."

The view from many corporate offices is different.

"In spite of many economists calling for a second-half recovery, we remain concerned about the prospect of a meaningful recovery," Jon Kinney, chief financial officer of Illinois Tool Works Inc., told analysts in a conference call last week.

Glenview-based ITW, a highly diversified global manufacturer, posted a gain in second-quarter profits and higher revenues. But the increases reflected the positive effect of a weaker dollar, acquisitions and income from leases and investments, not growth in ITW's core businesses here and abroad.

Factoring out acquisitions, currency effects and other special factors, "both North American and international base revenues were softer than in the last quarter," he said. He sees no pick-up so far in July. His concerns are widely shared, especially in the manufacturing sector.

With two-thirds of the 500 companies in the Standard & Poor's 500 index reporting second-quarter results, operating profits for the latest three months should be up about 10 percent and should beat analyst estimates by about 6 percent--both strong numbers, said Charles Hill, research director at Thomson Financial/First Call, which tracks earnings and earnings forecasts.

Contrary to the normal pattern, moreover, analysts aren't cutting their estimates of profits for the current quarter and are decidedly optimistic about the fourth quarter, he added.

But the persistently cautious tone of outlooks by company officials leads Hill to ask, "Where's the beef?"

The contrast between the sentiment of stock analysts and front-line company managers helps explain why the stock market rally that began in mid-March stalled in mid-June.

Despite generally upbeat Wall Street commentary about second-quarter results, stocks have not gained traction in the last two weeks.

History provides a guide--in opposite directions--to the outlook for profits.

Looking at earnings trends after two previous recessions, in 1990-1991 and 1982, corporate profit growth cranked up about six quarters after the trough in the earnings cycle.

We're at that point now, as Wieting's optimism demonstrates. But there are at least two possible outcomes.

In the early 1990s, when profits finally rebounded, the pace of recovery expanded for many quarters. In contrast, the profit rebound of the mid-1980s stalled a year after it began.

Profits hit hard this downturn

This time, the profit recession was far more severe than either of those downturns. Operating profits of the Standard & Poor's 500 companies sank 32 percent from the third quarter of 2000 through the fourth quarter of 2001.

By contrast, the decline reached 19 percent in the first quarter of 1983 and 24 percent in the fourth quarter of 1991.

Jack Tilton, market analyst for Mast Investment Advisors, said the recent batch of quarterly reports and estimates for second-quarter results not yet reported indicate that companies are ahead of the rebound of the mid-1990s.

"Right now, expectations are that profits will follow more the path from 1990-91 than the 1980s," he said. "If earnings were to increase along the lines of the expectations, most people think stocks will do nicely."

Investors betting on a 1990s-style rebound must keep two words in mind: profits and expectations.

Corporate scandals of the last few years focused investor attention on the definition of corporate profits. Ordinary investors learned to their chagrin that profit reports may be flavored to suit many purposes, even if they are touted as "clean."

"Clean is a relative statement," said Howard Silverblatt, an analyst for Standard & Poor's. Bullish investors treat the quality of earnings reports differently from bearish investors, he said.

A year ago, as new federal laws governing corporate behavior went into effect, Standard & Poor's introduced a new method of presenting corporate profits that it said responded to investors concerns.

Among other things, the S&P "core" earnings subtracted from profits the cost of employee stock options and the shortfall in company pension funds between what the fund earned and what it needed to earn to meet its obligations.

The result was a dramatic 31 percent decline in the profits of the S&P 500 companies a year ago and a resulting sharp increase in the price-earnings ratio of the index.

This year, the gap between reported net income per share and S&P's core earnings per

share has narrowed. "Next year, core earnings will be more than 'as reported' earnings," Silverblatt predicted.

That's because fewer employee stock options are being awarded, as companies shift to other forms of compensation.

And pension funds are doing a better job of covering their obligations, thanks to lower interest rates and the stock market rally, even though corporate pensions are underfunded by a whopping $226 billion, Silverblatt said.

The future of profit reporting depends to a great extent on whether Congress grants relief to employers in accounting for their pension obligations and whether accounting regulators force companies to count employee option awards as a direct expense.

Another big factor in improved profits this year is a reduction in giant write-offs companies took last year to more accurately reflect the value of troubled assets on their balance sheets.

Last year's unprecedented $45 billion write-off by AOL Time Warner Inc. depressed profits for the entire S&P 500 index. Write-offs of such magnitude are not expected this year or next.

Moreover, second-quarter reports by multinational conglomerates, such as ITW, Peoria-based Caterpillar Inc. and 3M Co., reflect the positive effect of the decline this spring in the value of the dollar, especially against the euro.

Sales and profits achieved overseas translate into higher dollar-denominated profits when the dollar weakens.

According to S&P data and estimates, upbeat second-quarter results and outlooks for the second half are being driven by just three sectors: information technology, energy and financial services.

In short, several special factors are creating improved year-over-year comparisons for quarterly profits.

Forecasts by company officials have turned slightly rosier so far in July, as second-quarter reports were issued, compared with a comparable period in April, when first-quarter reports were being released.

Fewer earnings warnings

Of 870 company forecasts tracked this month by Bloomberg News, 35 percent were warnings and 25 percent guided analysts to better results. In the April period, 40 percent of 907 company forecasts were warnings, compared with 22 percent improved outlooks.

The good news has prompted analysts to boost their forecasts of third-quarter profits for about a third of the S&P 500 companies, according to First Call and Bloomberg News. They include Caterpillar, Hoffman Estates-based Sears, Roebuck and Co., Bank of America Corp., Merrill Lynch & Co. and ChevronTexaco Corp.

But the optimism is not universal. In recent weeks, analysts trimmed third-quarter forecasts for about 100 S&P 500 companies, including ITW, Warrenville-based Navistar International Corp., Eastman Kodak Co., General Motors Corp. and International Paper Co.

The ability of stock prices to get a second wind, fueled by upbeat commentary about second-quarter financial reports, depends on many factors.

Perhaps the greatest concern is the fear that nascent signs of economic growth and yawning federal budget deficits will push interest rates much higher, taking wind out of the sails of a stock market rally.

On the other hand, the innate bullishness of Wall Street analysts could give the market the lift it needs to sustain a rally through at least the end of the year.

Comparisons of earnings forecasts and actual earnings reports over many years prove that analysts are overoptimistic.

"There is massive optimism as you move further back [from the actual reports]." In the last couple of months before the actual reports are issued, "the errors are in the direction of caution," said Werner **DeBondt,** professor of behavioral finance at DePaul University.

"Should you still pay attention to what analysts say? Sure, because they influence [stock] prices," he said.

An investor with a perfect crystal ball, who could predict corporate profits to the exact penny per share, would lose money in the stock market if he or she failed to correctly assess the impact of earnings forecasts and forecast revisions by analysts, **DeBondt** said.

"It's not as good as the truth, but when stocks are hyped, it works," he said.

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**HEADLINE:** BEATING THE MARKET ISN'T FOR THE LIKES OF INDIVIDUAL INVESTORS

**BYLINE:** Chern Yeh Kwok Of The Post-Dispatch

**BODY:**
The bulls are back?

Investors are growing optimistic, and the markets are up again. The economy will be rosier in the latter half of this year, they say, and the signs are there.

With low inflation, a depreciating dollar, historically low interest rates and a tax cut that soon will kick in, economists are projecting stronger economic growth.

The optimism has driven up the major indexes for the year. The Dow Jones industrial average has risen 8.73 percent, the Standard & Poor's 500 index has spiked 12.03 percent and the Nasdaq composite index has surged 24.56 percent.

But are investors getting ahead of themselves? Are the good times really back? Perhaps a more relevant question: Do the markets reflect the fundamentals?

Since the 1960s, many investors have held on to a central tenet: The markets are always right.

The assumption, based on a theory called the efficient markets hypothesis, is rooted in the belief that investors are rational. Markets price in available information, and few investors can beat the markets over the long term.

The conviction in the magic of the markets flourished during the bullish years of the last two decades. Buoyed by the new-economy rhetoric that technology and globalization would spur the rate of growth, investors grew to believe that the surge in stock prices reflected their soaring expectations.

It's clear now that those expectations never could be met. And in the spring of 2000, stock prices began their deepest plunge in decades.

"In a rational world, (the tech bubble) would never have happened," said Richard Thaler, an economics professor at the University of Chicago. "It's very hard to look back at that period and think that prices, especially for tech stocks, were consistent with rational expectations about future cash flows."

Thaler and other economists who specialize in a field called behavioral finance have an answer for this: Investors are irrational.

**Werner De Bondt,** professor of behavioral finance at DePaul University in Chicago, puts it this way: "Human intuition is very fragile, and investor sentiment tends to move with the market."

These economists are melding economics and psychology in their attempt to understand economic decisions. Their research isn't new. They've been documenting aberrations in rational investor behavior for about two decades.

But over the last 50 years, many economists turned to mathematical models to quantify the behavior of the markets.

"Mathematical finance was being invented, and, of course, people get carried away with the excitement of discovery," said Robert Shiller, an economics professor at Yale University.

Examining biases

Now, in the wake of one of the biggest speculative bubbles in decades, the behaviorists' research is gaining ground.

The field doesn't predict when bubbles start or end, the behaviorists are quick to note. Neither does it tell us if the market rally is the start of another bull run or just another surge in a long-term bear market.

Instead, behavioral finance looks at the biases of investors and provides insight into investing behavior.

For one, individual investors tend to ride their losers and cut their gains, exactly the opposite of professional investors. Some behaviorists call it "get-evenitis."

"They want to get even before they get out," said Hersh Shefrin, author of "Beyond Greed and Fear: Understanding Behavioral Finance and the Psycho logy of Investing."

Many investors can't admit to themselves that they made a mistake, Shefrin said. Also, they

place too much emphasis on recent events and bet on trends.

"When markets have been doing well, investors think that the good times will continue," said Shefrin, a professor of finance at Santa Clara University. "When markets have been doing poorly, investors think that the long term is gloomy. ... Their beliefs go in tandem with the markets."

Lack of diversification is another problem, Shefrin said. He cites the example of Enron Corp. employees, many of whom had the majority of their retirement savings tied up in the company's stock.

"If the company goes into trouble, you not only could lose your job, but your retirement wealth could be in jeopardy," he said.

Worst of all, many individual investors tend to get overconfident and believe that they can outsmart the pros. Individual investors should not expect to beat the markets, said Thaler, of the University of Chicago.

"It would be like an amateur golfer who could go out and win the U.S. Open," he said. "They don't play golf like Tiger Woods, so why would they think they would do better than professional investors?"

Asset classes

So, what's an individual investor to do?

Shiller, of Yale University, divides individuals' investments into four asset classes: stocks, bonds, real estate and short-term holdings, such as money-market funds.

"None of those looks particularly promising right now," he said.

Stock prices have spiked in recent months. Bonds and real estate prices have surged through the last three years. Interest rates are at a four-decade low.

"All of these markets show some vulnerability," Shiller said. "The best thing to do is to diversify and evenly lay across them."

Think long term, Shefrin said. Behaviorists consider financial markets too unpredictable in the short term.

"If you're comfortable with 50 percent (of your portfolio) in stocks, you should be 50 percent in stocks regardless if you're in the bull market or bear market," he said.

The behaviorists are advocates of index funds. So are the efficient market theorists, who believe that investors have no chance of beating the markets.

The difference, Shefrin said, is that behaviorists believe there are ways to beat the markets. But those strategies are too complicated for individual investors, he said.

If all that advice sounds like common sense, that's because it is. But don't forget: Many investors are irrational.

"You have to spend time thinking about where you're going financially," Shiller said, "and most people don't get around to that.

"Some people are very smart, but they ruin their lives financially. They don't use their intelligence to plan for their future."