enable them to fight these tendencies toward normal returns, even for many years, but such firms are the unusual cases.

Forecasting should be preceded by a comprehensive business strategy, accounting, and financial analysis. It is important to understand the dynamics of the industry in which the firm operates and its competitive positioning within that industry. Therefore, while general market trends provide a useful benchmark, it is critical that the analyst incorporate the views developed about the firm's prospects to guide the forecasting process.

For some purposes, including short-term planning and security analysis, forecasts for quarterly periods are desirable. One important feature of quarterly data is seasonality; at least some seasonality exists in the sales and earnings data of nearly every industry. An understanding of a firm's intra-year peaks and valleys is a necessary ingredient of a good forecast of performance on a quarterly basis.

Forecasts provide the input for estimating a firm's value, which can be viewed as the best attempt to reflect in a single summary statistic the manager's or analyst's view of the firm's prospects. The process of converting a forecast into a value estimate is labeled valuation and is discussed in the next chapter.

DISCUSSION QUESTIONS

1. Merck is one of the largest pharmaceutical firms in the world, and over an extended period of time in the recent past, it consistently earned higher ROEs than the pharmaceutical industry as a whole. As a pharmaceutical analyst, what factors would you consider to be important in making projections of future ROEs for Merck? In particular, what factors would lead you to expect Merck to continue to be a superior performer in its industry, and what factors would lead you to expect Merck's future performance to revert to that of the industry as a whole?
2. John Right, an analyst with Stock Pickers, Inc., claims, "It is not worth my time to develop detailed forecasts of sales growth, profit margins, et cetera, to make earnings projections. I can be almost as accurate, at virtually no cost, using the random walk model to forecast earnings." What is the random walk model? Do you agree or disagree with John Right's forecast strategy? Why or why not?
3. Which of the following types of businesses do you expect to show a high degree of seasonality in quarterly earnings? Explain why.
   - a supermarket
   - a pharmaceutical company
   - a software company
   - an auto manufacturer
   - a clothing retailer
4. What factors are likely to drive a firm's outlays for new capital (such as plant, property, and equipment) and for working capital (such as receivables and inventory)? What ratios would you use to help generate forecasts of these outlays?
5. How would the following events (reported this year) affect your forecasts of a firm's future net income?
   - an asset write-down
   - a merger or acquisition
   - the sale of a major division
   - the initiation of dividend payments