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Nasdaq Blues and Clues

Expectations Analysis for the Nasdaq 100

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- **Since the end of March, 2001 earnings estimates (based on rolling First Call forecasts) have been trimmed about 8%. Earnings estimates rose modestly from year-end 1999 through March. This reduction in earnings represents about 25% of the Nasdaq's correction, by our calculations.**
- **Expectations for future earnings growth rates have dropped about 300 basis points, from just under 22% to about 18.5%, since March. This is by far the most important driver of value. We estimate that about 50% of the Nasdaq's decline stems from this moderation.**
- **We figure that the discount rate has increased about 150 basis points, to roughly 14%, since the end of the first quarter. Given the general concerns about the sector, it is no surprise that investors require a higher return to participate in it. This increase accounts for the final 25% of the index's drop.**

Executive Summary

The Nasdaq is down about 40% since the end of March, leaving investors wondering what has happened and where we are going. We believe our proprietary valuation work offers unique insight into market expectations. Understanding current expectations, and the revisions in those expectations over the past 8 months, provides investors with the necessary calibration to make forward-looking investment decisions.

Value is driven by the future cash flows discounted to a present value at an appropriate discount rate. We can segregate cash flow forecasts into three pieces: a base level of earnings, future growth in earnings, and reinvestment needs. Given that the Nasdaq 100 is largely comprised of capital efficient, knowledge-based companies, capital efficiency plays a very limited role in the sharp expectations revisions. However base earnings, as well as anticipated earnings growth and discount rates are all worthy of discussion. Our analysis shows the following:

- Since the end of March, 2001 earnings estimates (based on rolling First Call forecasts) have been trimmed about 8%. Earnings estimates rose modestly from year-end 1999 through March. This reduction in earnings represents 25% of the Nasdaq's correction, by our calculations.
- Expectations for future earnings growth rates have dropped about 300 basis points, from just under 22% to about 18.5%, since March. This is by far the most important driver of value. We estimate that about 50% of the Nasdaq's decline is due to this reduction. Since most companies in the index are so-called new economy companies, and hence capital efficient, they are extremely sensitive to growth.
- We figure that the discount rate has increased about 150 basis points, to roughly 14%, since the end of the first quarter. Given the general concerns about the sector, it is no surprise that investors require a higher return to participate. This increase is the final 25% of the index's drop.

While this disaggregation sheds some light on past results, the real question is what will happen in the future. Here are some sensitivities that can help in this assessment:

- A future 10% change in aggregate composite earnings equals about a 10% change in the index.
- A 1-percentage point (100 basis point) change in the expected growth rate equates to a 10% delta in the index.
- A 50 basis point change in discount rate represents about a 7% shift in the index value.

In times of turmoil, it is important to go back to basics. Our analysis provides a clear look at the market's current expectations for the Nasdaq, and shows where the points of sensitivity lie. While this is an aggregate view, it provides important context for understanding past performance and anticipating the impact of future expectations revisions.

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