Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Raising The Bar On Earnings Surprise

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The Smith Group was founded on the belief that if we find high quality companies growing faster than expectations, we will be rewarded. After all, a portfolio of companies with underappreciated earnings growth is bound to rise as higher potential profits are realized. Historically, the event where that price appreciation is most evident is around the time of an earnings announcement and the response to a positive earnings surprise..

We have been very successful at selecting a high portion of companies that deliver positive earnings surprises, so the question becomes, "is the objective of finding companies with positive earnings surprises and avoiding those that disappoint still a profitable strategy?" Updating the Smith Group earnings surprise study, we found that the concept of stock price reaction to a positive or negative earnings surprise is alive and well. But there has been an evolution in the price pattern around the earnings announcement event itself.

Steve Smith's early studies showed prices moved in a more gradual sloping trajectory as seen in the 1980's graph on the next page. Information leakage ahead of the report date led to stock prices trending up or down in the days leading up to the actual report and there was minimal movement on the day of the actual report. Then in the following days as content was digested the trend continued, albeit at a slower pace. There was a clear gap between large positive and negative surprises, with a more modest performance pick-up between marginal positive and negative results. This research was the basis for predicting positive earnings surprises.

In the 1990's the pattern was similar but more exaggerated around report date. The potential value of differentiation between large positive and negative surprises grew from 3.7% to 5.7%. The difference between marginal positive and negatives improved from 1.2% to 1.7%. Clearly, the reward for being right grew.

In the latest decade, price patterns have mutated some and have become more erratic, especially during periods of economic turmoil. Yet, the average return differential between large positive and negative surprises remains virtually the same at around 5.8%. The gap for marginal positive and negative surprises is slightly wider at 1.9%. The reward for holding companies with large positive surprises is similar to the 1990's but the move is concentrated around report date (the dark blue line in the graphs on the next page). On the other hand, marginal positive surprises have added no value (the light blue line). **The main shift is in the magnitude of value in avoiding both marginal and large negative surprises** (the red lines). While the drop on the day of the report has amplified significantly, the value associated with selling after the fact has become inconsistent. In fact, during strong market rallies it was not unusual for a negative surprise to rebound strongly and end positive 30 days later.

Regulation FD, enacted in October, 2000, is one factor impacting information flow that may help explain changes. It mandated dissemination of relevant information to all investors simultaneously. Concurrent investor action means price movement has become concentrated and more pronounced.

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It would also logically result in the lack of follow through after the event as the information vacuum resumes. The only pattern it really does not seem to explain is the price rebound for companies reporting a negative surprise. The dramatically negative price reaction to large negative surprises supports the behaviorist theory that human avoidance emotions are stronger than attraction, and recovery is a rational upshot of an overreaction. Yet, the recovery pattern is actually quite erratic and very different from quarter-to-quarter. An alternative theory relates to the information vacuum following a report that allows stocks to begin trading on market factors instead of stock specific news.

In summary, the value of predicting large earnings surprises has grown and the payoff for avoiding negative surprises has become even more important. Recognizing these changes has focused our research efforts to determine how to more accurately predict these events in the future.