Smith Group
ASSET MANAGEMENT

MARKET PERSPECTIVES EXCERPT

Return of the Wishbone Offense

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The Smith Group was founded on the belief if we found high quality companies growing faster than expectations, we would be rewarded. After all, a portfolio of companies with underappreciated earnings growth was bound to rise as potential profits were realized. Historically, an event where growth above expectations is recognized results in a positive earnings surprise.

We have been very successful at selecting a high proportion of companies delivering positive earnings surprises. When we refreshed our study about stock price reactions to a positive or negative earnings announcement in 2009 we found an interesting phenomenon. On average, there is still significant value to be gained from having more positive surprise companies than negative, but there are anomalous periods where the relationship actually reverses as seen in the first part of 2009 in the graph at right. As you would expect on and immediately after report dates, mostly in late January and early February, stocks reporting positive surprises were rewarded and negative surprises were punished. In fact, negative surprises were actually crushed by some of the steepest declines in history. But as the next three months unfolded, companies that had reported the worst negative surprises became more attractive to investors than those that had yielded happy news on report date. In reality, March of 2009 was the market bottom and price movements were more tied to a reversal of price momentum than to fundamentals. Thus, *returns were not related to earnings and this normally leading relationship was instead coincident*.

Thankfully for earnings driven investors the linkage is beginning to normalize. The pattern for companies reporting in the last three quarters of 2010 shows a much more typical wishbone character around earnings report date, as seen in the graph below. Unexpected positive profit is once again rewarded, while a disappointment in the current environment is frowned upon. The return spread between positive and negative is still somewhat muted at 3.4% per quarter, but we expect it to widen further to levels more akin to our experience in the early 2000's, of 4 to 5%. This widening amplified by four quarters would further enhance the incremental value to be gained.

Of interest is the reward for avoiding disappointing company earnings is actually greater than that associated with an earnings beat, illustrated by the depth of the price drop for negative surprise companies. We recognize that fact so our process is designed to find attractive companies likely to report a positive surprise and to avoid those with a higher probability of reporting a negative.

With our focus on finding companies that will deliver better than expected earnings and avoiding those apt to disappoint, the current environment is much more conducive to positive relative performance. We believe our process will always find companies with those desired characteristics and welcome the return to a more rational market where they are rewarded.

** average cumulative excess return of companies reporting positive & negative earnings surprises beginning 5 days before report date to 60 days after*