Smith Group
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Earnings Confidence Revisited

RICK VILLARS, CFA

Late in 2008 and early in 2009 it was not uncommon to hear strategists using the phrase, "no one really believes consensus estimates are achievable". Earnings were judged inaccurate because each downward revision was soon followed by another and the snowball picked up steam as it progressed down the hill. Finally, investors just gave up on using earnings as the denominator in valuation calculations and the normal link between earnings and stock prices disconnected.

The Smith Group process is designed to identify companies growing earnings faster than expectations, so it is important to recognize when there is a lack of confidence in earnings estimates. It takes a linkage between earnings expectations and stock prices for earnings-based processes to be effective over time. This is especially so for the Smith Group Growth Outlook stock selection metrics, which we struggled with during that time period.

As a result we developed an Earnings Confidence Indicator (ECI) to flag when investors may be likely to have lost confidence in consensus earnings estimates. The theory behind it is that if companies suffer an overwhelming number of negative revisions, as indicated by the FY2 diffusion index* falling below -1 standard deviation (SD) for an extended period of time, the possibility of an earnings confidence crisis increases. Historically, a threshold of eight of the last thirteen weeks with the FY2 diffusion index below -1 SD has been loosely associated with difficult periods for Growth Outlook metrics. Therefore, at these times our vigilance in assessing Growth Outlook effectiveness should be intensified with the potential of reducing portfolio risk exposure to market factors.

The first quarter of 2015 saw a flood of downward revisions for an extended period of time so our attention to the ECI has been heightened, but has resulted in no impact on portfolio construction.

First, the negative revision action was concentrated in the Energy Sector and among Industrials with heavy foreign sales exposure negatively impacted by the dramatic rise in the U.S. Dollar. This is quite different than the broad-based negative revision history of the 2008/2009 period. The recent concentrated Energy downgrade is very evident in exhibit #1 where the average Energy diffusion ratio was almost twice as extreme as the next worst sector average. The impact of export-heavy Industrials is not as evident because their negative revisions were offset with some very positive revisions in the transports, leaving the Industrials sector with the third worst average diffusion. This is in contrast to exhibit #2, which shows the average for all sectors during the dramatic September 2008 to April 2009 drawdown was worse than -0.35. To put that in perspective, the best sector average during that period would have been the third worst in the 2015 period. While there is currently some disbelief in the sustainability of earnings in the Energy sector, strategist challenges to the

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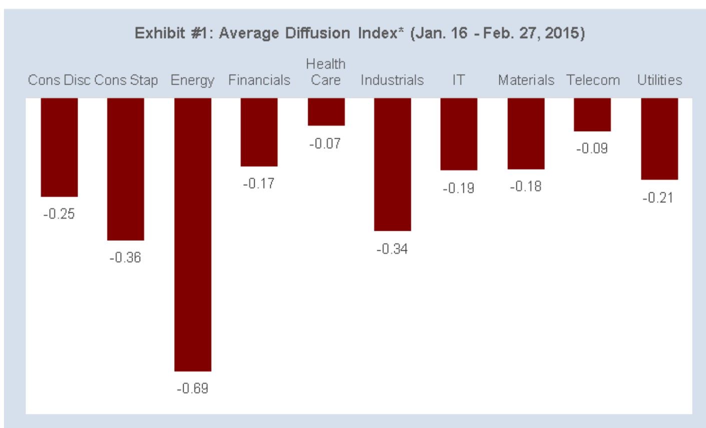

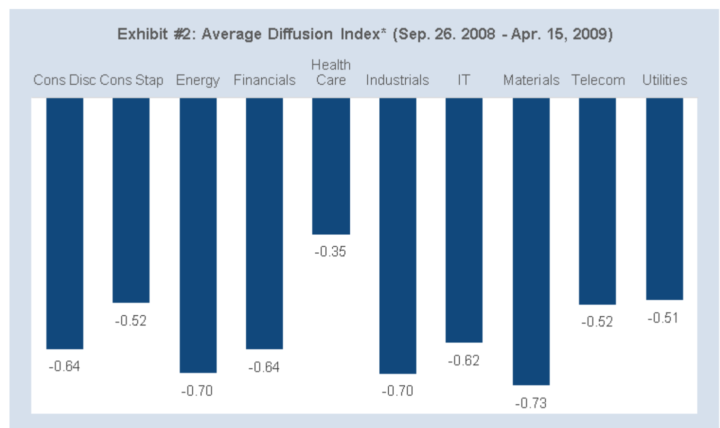

** Diffusion is the number of positive sell-side analyst revisions minus negative revisions during the last 30 days divided by the total number of estimates. FY2 diffusion calculation uses estimates for the next fiscal year. Universe : S&P 500*

Earnings Confidence

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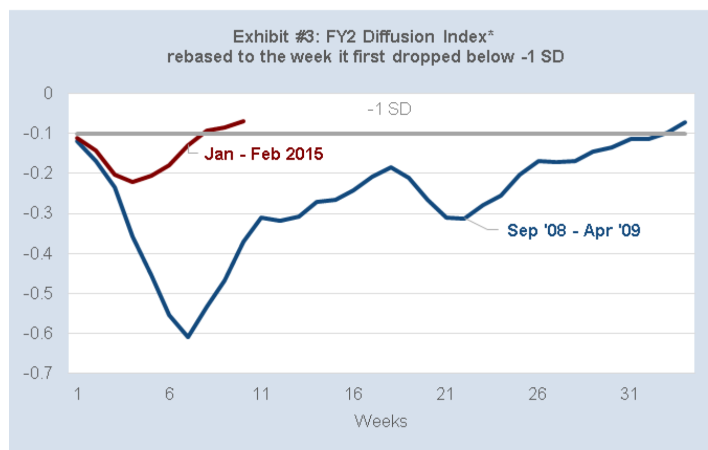
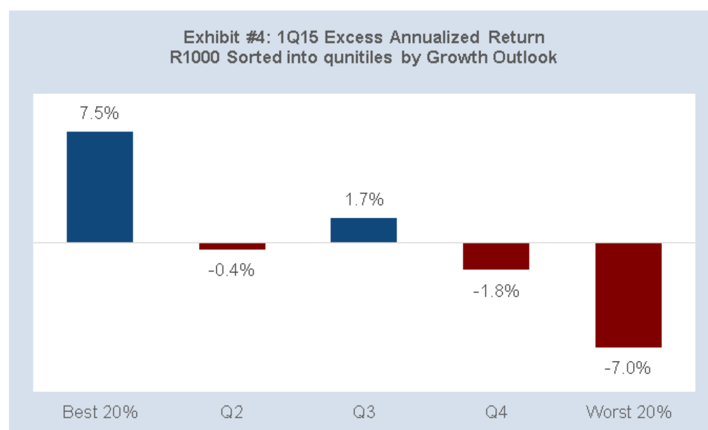
validity of consensus estimates have not been any greater than normal in the first quarter.

Second, the negative diffusion spike was during a seven week period during reporting season, which fell short of the eight week threshold. As seen in exhibit #3, the 2015 drop in diffusion was a relatively insignificant event. Duration seemed to be the key to disbelief in previous negative revision periods. Since this one was sharp but short it appears that analysts have maintained a measure of credibility.

Finally, the Smith Group Growth Outlook metrics continued to work well in the first quarter. Exhibit #4 shows that the best ranked companies by Growth Outlook outpaced the rest of the universe handily, while the worst ranked trailed substantially.

While the current flood of negative revisions has proven to be a nonevent for the Smith Group stock selection criteria, history has taught us that complacency is dangerous. We will continue to monitor the Earnings Confidence Indicator and remain vigilant to any early warning signs the linkage between earnings and stock prices has been broken due to a lack of investor confidence in estimate validity.





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