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Is Stock Volatility more prevalent during Earnings Season?

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CNBC has conditioned its viewers to believe that Earnings Season is the primary source of new information for company earnings and by extension, the ultimate determinant of future stock prices. On the surface, this would appear accurate since these quarterly events let investors know what happened during the previous quarter and give management an opportunity to guide expectations for future quarters.

Based on the future drift of stock prices following an earnings announcement, some research has concluded that returns around quarterly earnings announcements are more significant than inter-announcement returns. While not denying the importance of Earnings Season, our research (and experience) suggests that individual companies and entire industry groups have different sensitivities to earnings announcements. These non-earnings events can have a meaningful influence on expectations, stocks prices and the volatility of returns and therefore need to be considered when managing portfolios.

While previous literature has focused on the cumulative abnormal return following an earnings announcement, our research looked at the rolling volatility of excess returns. Specifically, we calculated the rolling 7-day standard deviation of a company's excess return (versus an appropriate benchmark) from 2010 to 2014. Each volatility window was centered so that it included both the previous three days of trading as well as the following three days. From this dataset, we identified the 16 largest spikes in volatility for each stock in the analysis .

To determine if the 16 volatility spikes were coincident with the 16 earnings announcements that were reported during the four year period, we also identified 16 earnings announcement windows that included the date of the report as well as the three days preceding and following the earnings announcement. By examining the intersection of the two datasets, we were able to calculate the percentage of volatility spikes that occurred during the earnings announcement window for individual companies as well as sectors and industry groups.

Assuming stock volatility spikes when the market receives new information and that Earnings Season is the primary source of new information, it might be reasonable to conclude that the majority of the volatility spikes would overlap with Earnings Season.

The chart in Exhibit #1 is limited to a single year, 2014, and shows the 7-day rolling volatility for IBM in blue with the four largest spikes in volatility identified by the green dots. The red bars represent the four earnings announcement windows that occurred in 2014. For IBM, 75% of the 2014 volatility spikes were observed during earnings season. For the full study, the overlap was 56%.

The next chart examines volatility spikes for Ross Stores (ROST), an off-price retailer. Unlike IBM, only one of the spikes coincided with an earnings announcement during

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Exhibits only display 2014 instead of full study for veiwability purposes.

Exhibit #1

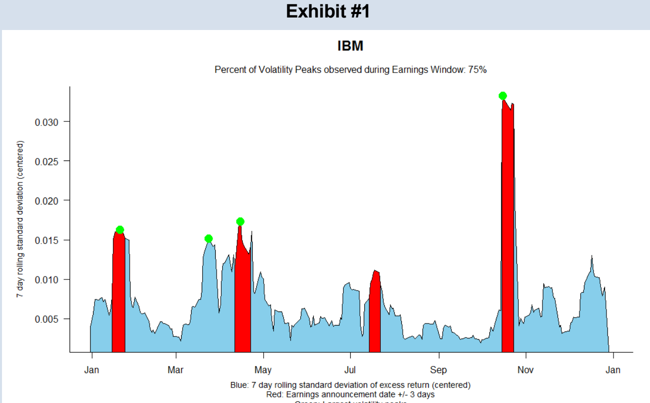
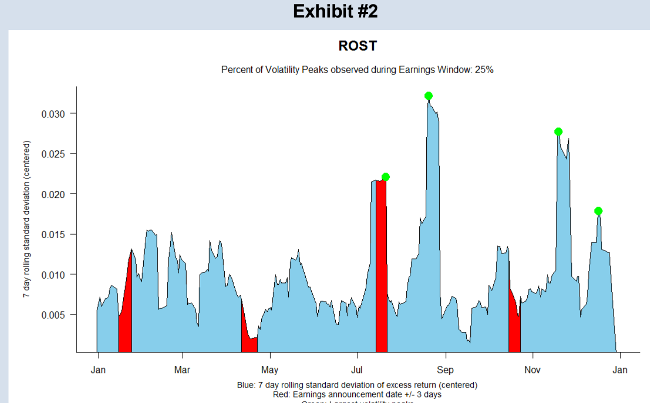


Exhibit #2



Stock Volatility

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2104. For the full study, only 6% of the spikes were observed during an earnings announcement window.

Assuming a company's stock price becomes more volatile as new information enters the public domain, why does the market not respond more aggressively to Ross Stores' earnings announcements?

As it turns out, there are many non-earnings related events investors consider when determining the future trajectory and sustainability of corporate earnings. In the case of ROST (and nearly all retailers), monthly same store sales is a bigger driver of price volatility than reported earnings.

The following is a brief list of non-earnings events that impact stock volatility.

- ♦ Industry specific metrics: same-store-sales (retail), rig counts (energy) and load factors (airlines).
- ♦ Industry conferences: JP Morgan Health Care conference, Howard Weil Energy conference.
- ♦ Pre-announcements: SanDisk recently lowered guidance outside the earnings announcement window and the stock sold off 18%.
- ♦ Investor Day: AmEx recently met with investors hoping to reassure them that the loss of some big accounts was not an indication of larger problems; the stock sold off the next day.
- ♦ Economic releases: While economic news is generally indiscriminant in its impact on markets, some companies can be more sensitive to a particular release than the aggregate. For example, Nonfarm Payrolls, reported by the Department of Labor, can have an outsized impact on payroll services companies like ADP and Paychex depending on the magnitude and direction of an unanticipated announcement.
- ♦ Government Policy: The Obama administration's recommendation to make community college free had an impact on for-profit education companies like Apollo Education Group.
- ♦ Eco-systems: While some relationships are obvious, like Home Depot and Lowe's, others are not so apparent. Genworth Financial, a provider of long-term insurance, recently gained 8% in a day when Biogen, a biotech company, reported promising results on an Alzheimer's drug it is developing; 50% of Genworth's insurance payouts are to policy holders with some form of dementia.

Looking beyond individual companies, our research showed that within the Financials sector, banks were more sensitive to earnings reports than insurance companies or REITs. Within the Information Technology sector, Software & Services companies were less sensitive than Hardware & Equipment companies. (Interestingly, within the entire Technology sector, IBM experienced the most price volatility during the earnings announcement window while Ross Stores' low percentage was typical of all retailers.)

For both empirical and practical reasons, we believe there are many factors that impact stock prices. Thus, the better we are able to look beyond the narrow window of Earnings Season, the more value we can add to the risk/reward proposition of our investment strategies.

For additional information on Smith Group and our investment strategies and capabilities, please visit www.smithasset.com or contact us at 800.582.3435 or info@smithasset.com. The website contains information you may find useful regarding Smith Group including research articles, our economic and financial market outlook and detailed information on our team and investment capabilities.