Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Leaving Landmines Behind

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Earnings reporting season is quickly approaching and companies' finance departments are working overtime to ensure that they match or beat market expectations. Preannouncements and accounting levers are common tools employed to either adjust expectations or enhance the reported number, but why? While the market rewards companies for reporting earnings in excess of expectations, the penalty for missing has far greater consequences to overall shareholder wealth. The near term excess stock return of companies missing earnings expectations is nearly twice the reward for beating. With more data available on the subject and many painful selling bouts resulting from a poor earnings report, companies have learned a miss is unpleasant and to be avoided. This has led to the percentage of companies reporting a large negative surprise steadily declining for 25 years (chart #1), while the penalty for a negative report remains constant (see chart #2).

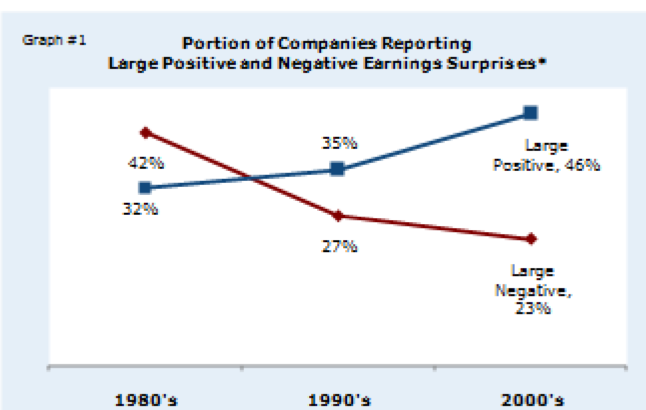
After reporting a large negative surprise, management often suggests the worst is behind them and the company's prospects are turning around. However, our research shows that a company reporting a large negative surprise is almost twice as likely to report another negative surprise. With all the accounting levers the CFO can pull, an earnings miss is often an implied admission that business is worse than it appears on the surface and is not likely to get better soon. Although, 'habitual' may be too strong of a word, there is a tendency for bad news to be serial in the short term.

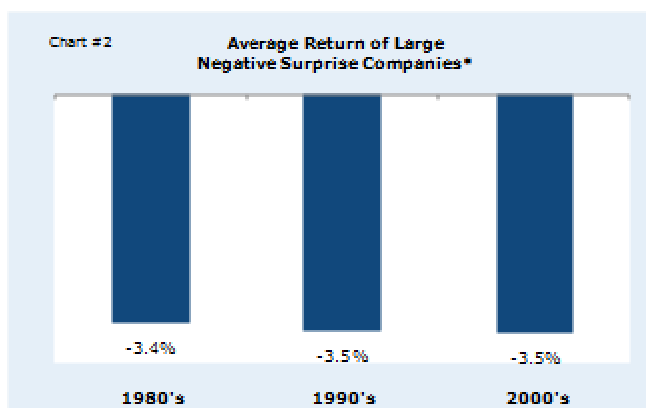
Without suggesting cause and effect, we have been looking at the characteristics of companies preceding a large negative surprise to see if we can strengthen our already solid record of avoiding those landmines in our portfolio. Our research continues, but a few of the characteristics identified include;

- negative earnings revision activity prior to the report
- high and increasing short interest
- high valuations
- poor earnings quality on multiple metrics
- small companies are more likely to miss than large companies

It is logical that small companies could be less predictable given less coverage and less accounting expertise to manage earnings. It is also instructive to see that the inverse of many of our buy characteristics are predictive of a negative surprise. As a general statement, high expectations (high valuations) coupled with deteriorating fundamentals (negative revisions and earnings quality) seem to be a recipe for trouble.

As this research progresses we will update you on our findings.





* A large positive or negative earnings surprise is defined as a quarterly earnings report that differs from the current consensus estimate by more than plus or minus 5%. Average return to negative surprise companies is the relative return of those companies over the 60 days following each quarterly report date.