Smith Group
ASSET MANAGEMENT

The Earnings Quality Edge

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MARKET PERSPECTIVES EXCERPT

Investors have grown increasingly skeptical of engineered earnings surprises and appear to be taking to heart the need for companies to truly surprise them with high quality, sustainable growth. In this analysis we will show the performance pattern associated with ''surprising investors'' is highly dependent on the quality of the companies' reported financials, as well as the magnitude of the earnings beat.

By quality we mean the reported financials of a company must be derived using conservative accounting principles and assumptions. This is important because it gives investors confidence that what they are seeing on the books is likely true and won't have to be reversed sometime in the future. There is a long list of examples of the inevitable reversal in both financial statements and stock price performance over the past decade for companies with poor earnings quality. WorldCom, Adelphia Communications and Tyco are prime examples of the destruction of shareholder value associated with restatements. We like to think of earnings quality as a differentiator between those companies with actual improving business prospects vs. those that are using accounting tricks to meet expectations. One is sustainable, the other is not.

For purposes of this analysis we will use the Smith Group proprietary earnings quality (EQ) model as the basis for what we will consider as a good versus bad earnings quality report. Specifically, the top 10% of the investment universe according to our EQ model is considered 'good' versus the bottom 10% as 'bad'. A simplified way to characterize our earnings quality analysis is to define it as the difference between cash flows and earnings. The more closely a company's cash flow matches its reported earnings the better the EQ score they receive. While our model goes well beyond a simple analysis, almost all definitions of earnings quality eventually play out to that relationship on some level.

As the top graph at right displays, companies in the top decile of EQ that report a positive surprise (blue line) actually continue to have increased relative price performance in the days after a positive report. This is in stark contrast to companies who issue a positive report but with poor earnings quality characteristics (red line), which have a consistently negative price response in the days following their earnings reports. The resulting difference in return between the good EQ and bad EQ stocks is more than 3% per quarter. This is a highly significant difference in return when viewed through the lens of a single event. A similar relationship plays out among companies that miss earnings expectations. While it may not seem entirely obvious, high earnings quality companies also have a higher likelihood of reporting an earnings beat. This is evident in the bottom chart. On the surface, this is somewhat counter-intuitive given that poor earnings quality companies often 'borrow' future earnings at the expense of later periods to engineer an earnings surprise. However, evidence suggests that borrowing from future earnings is short-lived and has the consequence of making it harder for companies to realize expectations in future quarters. This leads to the overall surprise rate for low earnings quality companies to lag that of high earnings quality companies.

Using earnings quality as a decision tool in stock selection enhances our ability to find companies with earnings growing faster than expectations. It not only enhances the sustainability of positive earnings trends, but also leads to more credibility when earnings are reported. Investors tend to reward that transparency by corporations. In this age of complex accounting and a propensity of some managements to push the limits, earnings quality is gaining in importance.