Smith Group
ASSET MANAGEMENT

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Is 'Better Than Expected' Profitable?

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"Our fundamental belief is that reasonably valued companies that can sustainably grow earnings faster than expected will have strong price appreciation."

The Smith Group philosophy and processes are built around this belief. One of the ways we measure our quarterly performance is our success in finding this type of company. But is the belief valid? Do companies that exceed expectations outperform? Is this belief a quantifiable feature or is it just an idea that sounds logical? We have recently updated the research that validates the return advantage these companies deliver, reaffirming our focus on this market anomaly.

To validate the advantage we looked at earnings growth expectations for Russell 1000 and Russell 2000 constituents at the beginning of each year for the years 1996 – 2013 and compared that to the earnings each company actually delivered for the year. We then ranked companies by those that exceeded earnings growth expectations by the most down to those that fell short by the widest margin and divided them into quintiles. Looking at the average relative return of those quintiles shows a notable excess return to the top one-fifth of companies that exceed expectations and underperformance for those that delivered earnings short of expectations.

Exhibit #1 shows the average relative return for each quintile for the period measured for Russell 1000 constituents. The 20% average relative return over the index of the top quintile outpaces the rest of the universe by a healthy margin, with each of the next four quintiles delivering progressively less excess return.

As exhibit #2 shows, the return advantage is even wider within the Russell 2000 small cap universe. Not only is the average relative return of the best ranked stock higher than large cap peers, but the laggards suffered a more onerous return penalty, twice the underperformance of large cap stragglers.

But is the return advantage of companies that deliver earnings above expectations consistent, or the result of a few good years? Looking at the annual average returns of the top quintile (top 1/5th) compared to the average returns of the rest of the universe in exhibit #3 on page 7, we see there is a consistent positive differential. The top quintile ranked stocks for both the Russell 1000 and Russell 2000 had a return greater than the average stock ranked in the second through fifth quintiles in every year of the study.

Exhibit #2: Companies Ranked by Magnitude of Earnings Growth Better or Worst than Expected Average Quintile Relative Return - R2000

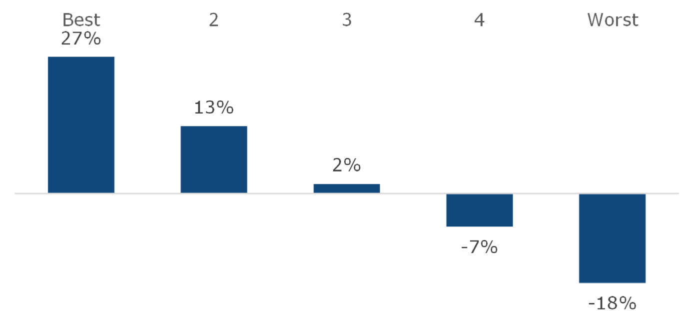
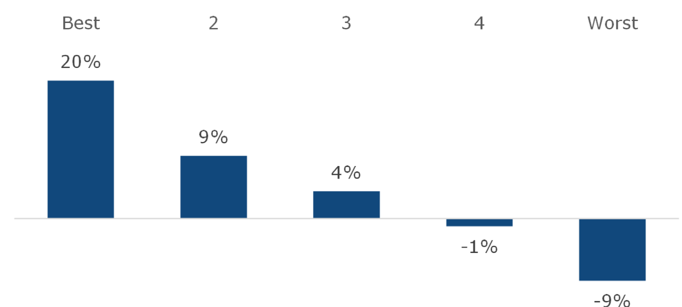


Exhibit #1: Companies Ranked by Magnitude of Earnings Growth Better or Worst than Expected Average Quintile Relative Return - R1000



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Calculation: Ranked by magnitude of 12 months earnings growth delivered relative to earnings growth expected at beginning of the period, then sorted into five quintile groups. Average return of each quintile is an equal weighted average of the total return for the period of all the constituents in the group.

Time period: 1996—2013

(Continued from Page 1)

That means a manager successful at only holding the top 20% of stocks would have outperformed every year.

While having perfect foresight to identify the best one-fifth of companies is an unachievable hurdle, the goal of populating a portfolio with a high proportion of them is a profitable goal if achieved. Our process is focused on identifying companies likely to exceed expectations and it has consistently succeeded in that goal. Our concentration on this feature or anomaly in the market is key to the long-term success of our portfolios.