Smith Group
ASSET MANAGEMENT

RESEARCH PERSPECTIVES

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Missing Quarterly Expectations - The Rising Penalty

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Theoretically a successful active equity manager is one that has a higher number of stocks performing better than the benchmark compared to the number performing worse. Of course, that is a bit of a simplification in today's world of active weights, active share, market risk factors, etc. One factor that has had an increasing impact on performance is the market reaction to positive and negative announcements about earnings. In this article we explore how investors on average react to quarterly earnings announcements during three different time periods. The first being the 1990's, the second the 2000's before the financial crisis, and the third the period after the financial crisis beginning in 2011. The period 2008-2010 has been excluded due to the substantial distortion associated with the earnings meltdown and initial snapback.

Exhibit #1 (right) shows the relative return over the five days after report date for ***large*** cap companies that beat (blue bar) consensus expectations and those that miss (red bar). The reward for reporting better than expected earnings has remained fairly steady over time, but the penalty for falling short has grown progressively more severe. In the most recent period the penalty for missing is more than twice the reward for beating expectations.

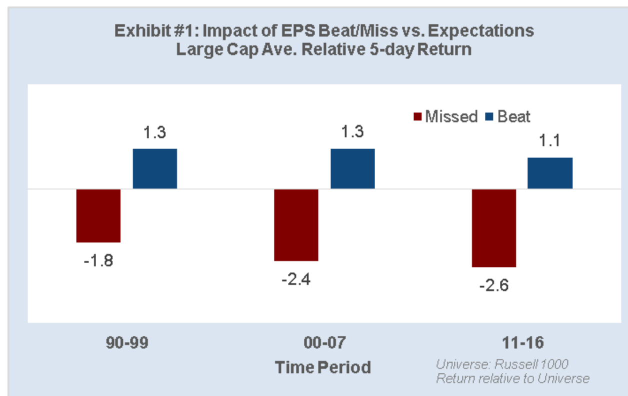


Exhibit #1: Impact of EPS Beat/Miss vs. Expectations
Large Cap Ave. Relative 5-day Return

Exhibit #2 (right) shows the same relative return comparison for ***small*** cap companies. The reward for reporting better than expected earnings has progressively gotten larger over time. In the most recent period it is more than double what it was in the 1990's. Similarly, the penalty for falling short is more severe than it was in the 1990's.

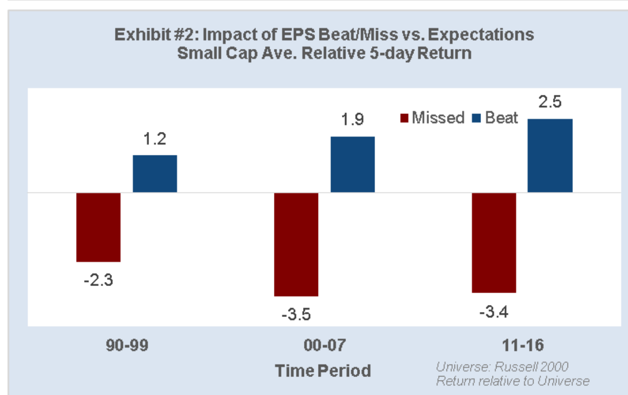
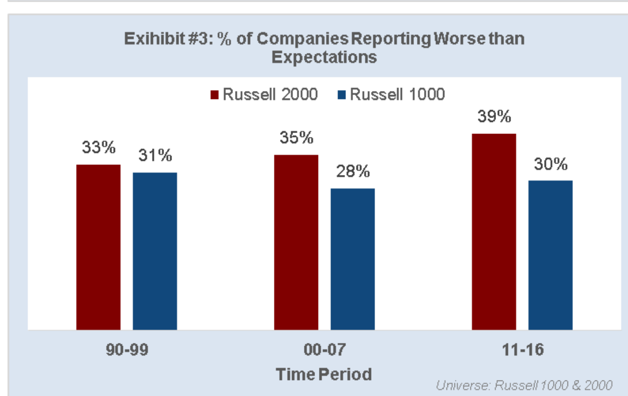


Exhibit #2: Impact of EPS Beat/Miss vs. Expectations
Small Cap Ave. Relative 5-day Return

For both large and small companies, the penalty for missing is larger than the reward for reporting better than expectations. This may be because there are many more companies that beat than miss, so when a company does fall short the surprise has a larger psychological impact. There is also a widespread belief that company managers try to manipulate consensus expectations so that they can beat them. If investors believe this they may be less forgiving of a business that misses managed expectations. For investors, the importance of avoiding those that report disappointing earnings has gotten greater. Now it takes more winners to offset the losers, because the losers in this context fall further than the winners appreciate.

With investors heightened sensitivity to earnings reports one might expect company managers to increase their efforts to ensure they do not miss expectations. However, if that is the case they are not doing a very good job of it. Exhibit #3 (right) shows that the portion of large cap companies that report worse than expected quarterly earnings is only marginally lower in the most



Exihibit #3: % of Companies Reporting Worse than Expectations

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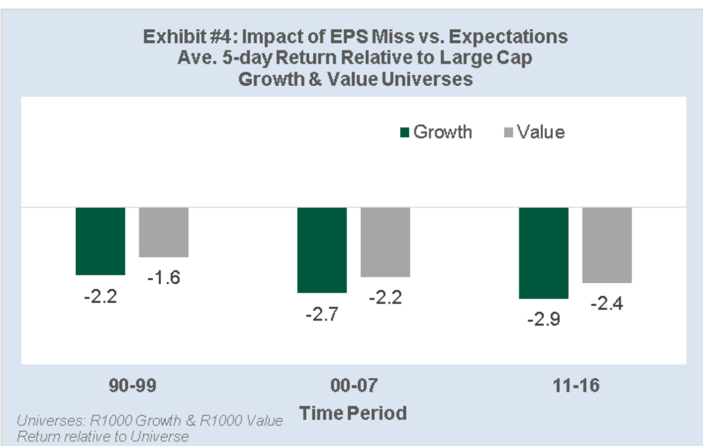
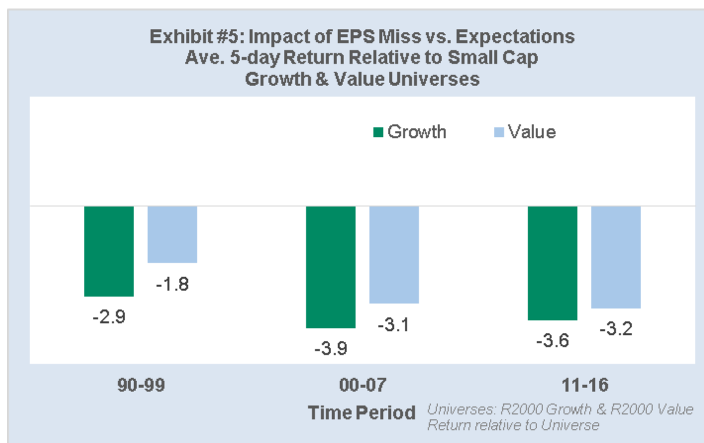
recent period compared to the 1990's, while the percentage of small cap companies struggling to meet expectations has been incrementally rising. Either company executives are ignoring the pitfalls of a miss or they are finding it harder to guide analysts to a more conservative estimate, if in fact that is what they are trying to do.

Comparing value and growth universes is also instructive in investor behavior. While there is not much difference in how value and growth investors react to a positive earnings surprise, there are some interesting comparisons when the earnings report falls short.

Exhibit #4 compares the penalty for missing quarterly expectations for large cap value stock and growth stocks. In all time periods growth investors were harder on a company that disappointed them than value investors, and the penalty for a miss has been incrementally growing. In Exhibit #5, it is obvious that small cap growth investors are the most critical of companies missing expectations and they are more so today than two decades ago. Interestingly, in the 1990's it appears that small cap value investors were equally as forgiving as their large cap brethren. But they have since become much quicker to punish management for failing to meet quarterly expectations. The 1990's average -1.8% penalty for a miss by a small cap value stock has almost doubled to -3.2%

The increasing penalty for missing expectations has important implications for how a portfolio is managed as avoiding these torpedoes can bring a significant advantage to a mangers ability to outperform. A manager's sell discipline is critical in this environment. At Smith Group, one of the goals of our investment process is to identify companies with deteriorating growth relative to expectations. While over-focusing on short-term results brings its own set of consequences, the evolution in investors' reactions to negative earnings news appears to be getting stronger, forcing managers to scrutinize results even more closely.





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