What your Investment Advisor never told you about Earnings Surprises may surprise you!

The quarterly earnings season is the most important celebration in the stock market's cyclical calendar! It's the ritual feast of capitalism, whereby outperformers are venerated and the blood of the underperformers gushes into the gutters of Wall Street. This so-to-speak thumbs-up or thumbs-down is the means by which scarce capital is reallocated in accordance with investor expectations. But this is not as straight forward as it seems.

How often have you seen a stock price fall after the company has announced increased earnings? Or why did the stock of the now demised Lehman Brothers soar after it announced a 57% fall in its fiscal first-quarter earnings of 2008? In these instances, actual earnings were not in themselves the only expectations that the market was looking for.

In fact, it is the fitness of companies to respond to context dependent expectations that determine whether stock prices gain or lose and not simply the actual earnings themselves.

Expectations Count

Stocks are essentially held in expectation of future capital gains. Consequently, investors tend to prefer companies with healthier track records and growth prospects over those whose earnings potential appear weaker. However, earnings forecasts are subject to a complex array of industrial, economic, environmental and political forces that impact sales growth, product demand, competitiveness, profit margins and cost controls. In view of this complexity and resulting lack of transparency, stock prices are in a continual state of flux as expectations change or are proven wrong.

It is of course impossible to track the earnings estimates of the millions of investors so the market looks to the forecasts of armies of stock analysts, who, based on their research, issue buy, hold or sell recommendations for the companies they monitor.

Consensus Estimates

Listed companies are required to file their quarterly reports with the U.S. Securities and Exchange Commission (SEC) within 40 days of the fiscal quarter end. Most companies announce earnings within one month after the end of the quarter, which usually coincides with the calendar quarters. In the meantime, institutional investors and analysts work at a frenzied pace for about three weeks starting mid-month in January, April, July and October in preparation for the forthcoming earnings season.

Out of the thousands of reports generated, whereby up to 50 or more may evaluate just one company such as Apple, Inc., consensus earnings estimates and recommendations per listed company are collated and published on a continual basis.

When examining any earnings estimates, the first rule for investors to keep in mind is that the current price usually reflects these consensus earnings estimates. However, there is nothing to be gained by investing in a company simply because it has a high level of anticipated earnings growth. In fact, studies have shown that over the long term, such stocks tend to underperform those with lower projected growth rates because of the difficulty to meet or exceed high expectations over a prolonged period of time.

Earnings Surprises

The most important impact on stock prices occurs when the actual earnings differ from consensus expectations, triggering so called earnings surprises, namely:

When reported earnings are significantly above earnings expectations they usually have a positive impact on the share price, and conversely.

When reported earnings are significantly below earnings expectations they usually have a negative effect on the share price.

Although an earnings surprise usually has an immediate impact on its stock price, it may also have a long-term effect. In fact, studies have indicated that the effect can persist for as long as a year after the announcement. This means it may not be too late to buy a stock that has had a positive earnings surprise, if you didn't buy it at that time. However, it also means that it does not make sense to buy a stock after the initial price decline of a negative earnings surprise, since there is a good chance that the stock will continue to underperform the market for some time.

Not surprisingly, large corporations tend to adjust to surprises faster than small ones do. That's because they are tracked by more analysts and portfolio managers, who tend to act quickly.

Earnings surprises also tend to follow a consistent pattern; they are rarely sole occurrences. So, stocks with a significant earnings surprise in one quarter will often have a series in previous and later quarters.

Since both positive and negative earnings surprises have lingering effects, a rewarding strategy would be to avoid stocks that have had a spate of negative earnings surprises in the recent past. Similarly, selecting positive earnings surprise stocks before and even after the earnings are announced may prove to be a profitable strategy.

Earnings Revisions

Adjustments in earnings estimates are made to reflect the perceived changes in a company's economic outlook. Such earnings revisions typically lead to corresponding price adjustments similar to those of earnings surprises. For example, when earnings estimates are revised significantly upward, say 10% or more, a stock price tends to show increased upward momentum. Conversely stocks with downward revisions show below-average performance.

Revisions are often precursors to earnings surprises. As the reporting season approaches, estimates normally converge toward consensus. A flurry of revisions near the reporting period can indicate that analysts missed the mark and are scrambling to improve their estimates.

When examining revisions, focusing on their number is helpful, because you can put more faith in them if a large percentage of the analysts tracking a stock have updated their estimates, and examining the range of estimates provides an indication of the degree of consensus within the group. For example, a wide range would point to great disagreement among analysts, implying both greater uncertainty and a greater chance for an earnings surprise. The price move can be more dramatic however if an earnings surprise occurs for a stock with a very tight range of earnings estimates.

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Within this framework and its mechanisms, much can be gained and lost, but its great merit, in spite of its abuse and proven inaccuracies, is the certainty it gives to listed companies and investors alike that capital redistributions are made as true rewards for success and failure. In fact, when we think about it, it should come as no great surprise to all of us that this is the way capitalism ought to work.