Are All Earnings Surprises Equal?

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As we finish another quarterly earnings season, statistics show that companies are generally beating their EPS targets with ease, yet we are not really getting positive stock price reactions from these supposed positive earnings surprise. Positive earnings surprises occur when actual reported earnings are significantly above the forecasted earnings per share. Negative earnings surprises occur when reported earnings per share are significantly below the earnings expectations. Often missing the analysts' estimate by a few cents can send a stock price down sharply, while the opposite happens with an earnings beat.

Factset reports that as of May 11, 2016, 71.8% of companies have beaten EPS estimates for the first quarter of 2016. That companies have surpassed consensus earnings estimates should not be a surprise to investors. Factset notes that on average, 68.5% of companies in the S&P 500 have beaten their quarterly EPS estimates since 2014.

Companies try to manage (temper) expectations so can produce a positive earnings surprise. The market has preferences for companies that underpromise and overdeliver. Analysts are now looking past quarterly earnings surprises and looking at reported revenue versus consensus revenue estimates and whether the company is raising or lowing its guidance looking forward.

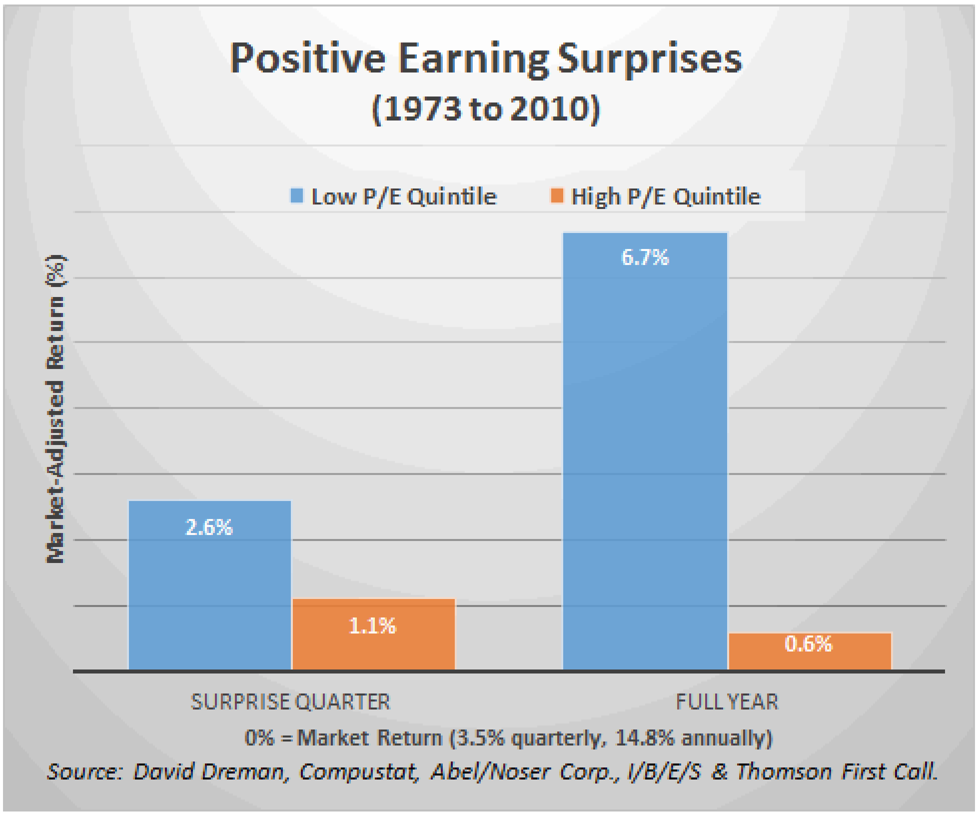
David Dreman has carefully studied earnings surprises and their impact on stock prices. I have had the pleasure of seeing him speak over the years and even recall a presentation at the 1999 AAII Investor conference in which the described the “Two-Tiered Market” and noted the likelihood of being in an internet bubble at the time. It was not a popular position at the time but proved to be an accurate assessment.

David Dreman founded the investment company **Dreman Value Management**. For over 30 years, he has written a regularly published Forbes column entitled “**The Contrarian**.” He also authored several books, including “**Contrarian Investment Strategies: The Psychological Edge**” (Free Press, 2011), in which he examines the impact of earnings surprise on value stocks versus growth stocks.

Dreman notes that all of the advances in finance have not helped analysts provide more accurate earnings estimates. In a study of quarterly earnings estimates, Dreman found an average error of 40% annually. Dreman examined these quarterly estimates from 1973 through 2010. Only 29.5% of the estimates were within plus or minus 5% of the actual earnings announcement, 46.9% were within 10% plus or minus of the actual earnings figure, and 57.8% were within a 15% plus or minus band. That means that there is a high probability that you will experience an earnings surprise for a company that you own.

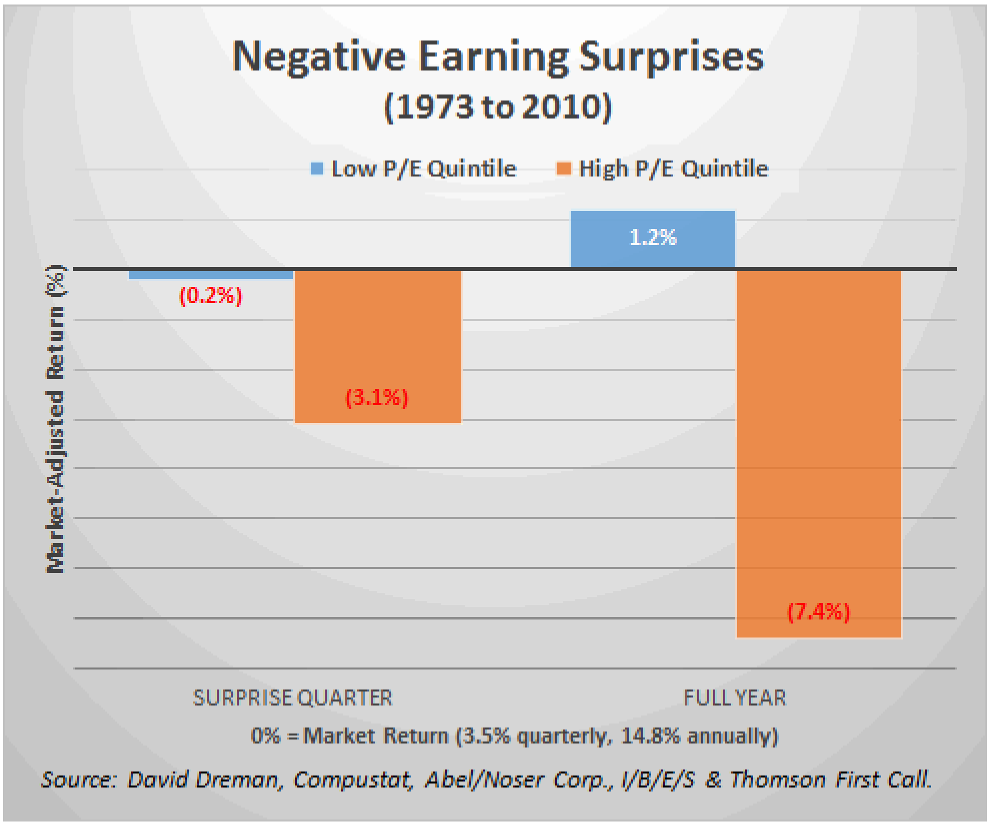
Dreman looked at industry groups to see if some industries were easier to forecast than others. The error rate for industry groups was lower than that of individual companies, but it was still greater than 30% annually and almost one out of 10 industries had surprises that averaged over 40%. Dreman did not observe greater “visibility” for any notable industry groups.

Dreman feels that part of the tendency toward high estimates and recommendations can be explained by the pressure to support the underwriting efforts of brokerage firms with investment banking divisions. Overall, Dreman feels that it is impossible to accurately forecast the future given the dynamic economy with its ever-changing political, economic, industrial, and company conditions. Investors should take the errors as a given and try to profit from the surprise errors and not treat the estimates themselves as reasons to buy or sell a stock.



Dreman finds that the best way to take advantage of the high rate of analyst forecast errors is to simply invest in out-of-favor stocks. In his studies of earnings surprises, David Dreman found that stocks with low price-earnings ratios reacted more strongly to positive earnings surprises than did high price-earnings stocks. As it turns out, a positive earnings surprise for a stock with high expectations is not truly a surprise. It is a reinforcing event that does not change perceptions about a stock. As the positive earnings surprise chart above from Dreman's book shows, stocks with high price-earnings ratios outpaced the market by 1.1% during surprise quarter, but by the end of the year, the group is outpacing the market by just 0.6%. In contrast, positive earnings surprises for out-of-favor stocks are perceived by the market as significant events. Dreman terms them "event triggers" because they initiate a perceptual change among investors. The low price-earnings stocks in the positive earnings surprise chart moved up 2.6% higher than the market during the surprise quarter and surpassed the market return by 6.7% for the full year after the surprise.

The impact of a negative earnings surprise is reversed. Out-of-favor stocks barely flinch, while highly favored stocks generally have significant declines. In the negative earnings surprises chart to the right, low price-earnings stocks are down 0.2% less than the market during the surprise quarter and actually typically outpace the market by 1.2% for the full year.



With out-of-favor stocks, negative surprises are reinforcing events that do not lead to reevaluations. However, negative earnings surprises are event triggers for highly valued stocks that typically lead to a downward reevaluation of the firm's prospects. As the negative earnings surprise chart shows, high price-earnings stocks averaged a 3.1% decline below the market during the surprise quarter and then continued to underperform the market, down 7.4% below the market return for the full year.

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Changes in stock price resulting from an earnings surprise can be felt immediately, but the surprise also has a long-term effect. Studies indicate that the effect can persist for as long as a year after the announcement. This means that it does not make sense to buy a stock after the initial price decline due to a negative earnings surprise. There is a good chance that the stock will continue to underperform the market for some time. It also indicates that it may not be too late to buy into an attractive company after a better than expected earnings report is released.

Dreman argues that people are far too confident in their ability to predict complex future outcomes and surprises are an inevitable consequence. As such he makes a strong case for investing in out-of-favor stocks to take advantage of the physiological biases of market participants.

John Bajkowski is also is a regular contributor to the AAII Journal, which is one of the many **benefits** of AAII membership. If you are not an AAII member, simply take a **risk-free 30-day Trial AAII Membership** and start becoming an effective manager of your own assets.