Surprise! It Still Works!

AUTHOR

Joseph Kinnison, CFA
Director of Equity Research

Joe coordinates JAG's equity research activities and serves as Senior Analyst on JAG's managed equity strategies.

What is better than a surprise birthday party? Answer: Your equity investments reporting unexpected profits.

Stocks frequently appreciate following unexpected good news. Recognizing this phenomenon, investment industry databases have created variables designed to identify earnings surprises, measure the degree of surprise, and keep track of a series of surprises. Due to the relationship between positive earnings surprise and positive subsequent stock performance, consideration of earnings surprise has become a factor in good investment decision making. Earnings surprise meets the common sense test as well. It's hard to argue that unexpected and higher earnings would be a negative for stock valuations. Earnings surprise is a key component of JAG Capital Management's multi-factor model.

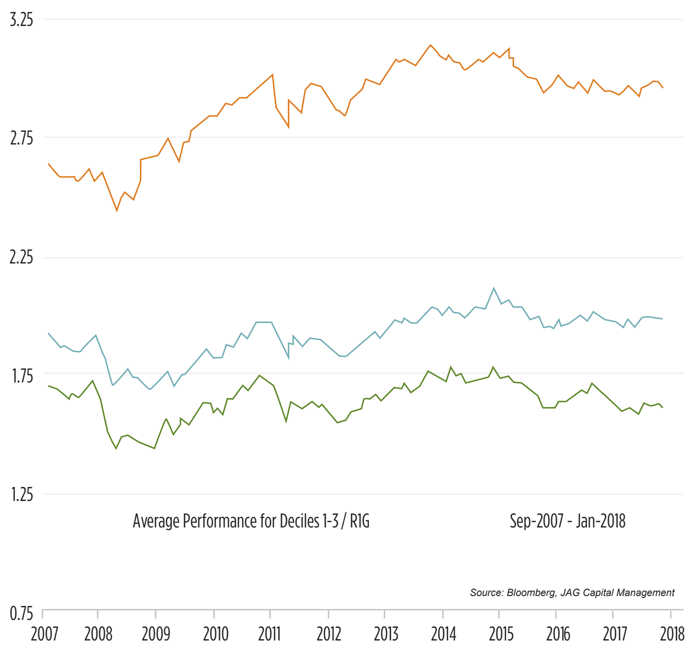
Earnings surprise has been considered a positive investment factor since 1968 when Ball and Brown identified a phenomenon entitled, "post earnings drift." Similar studies in 1984 and again in 1995 affirmed the earliest findings. An anomaly persisted for over 30 years that stocks continued to appreciate for as long as 60 days following a positive earnings surprise. Among several theories to explain this finding, the most often cited is that it likely takes time for the market to fully disseminate good news.

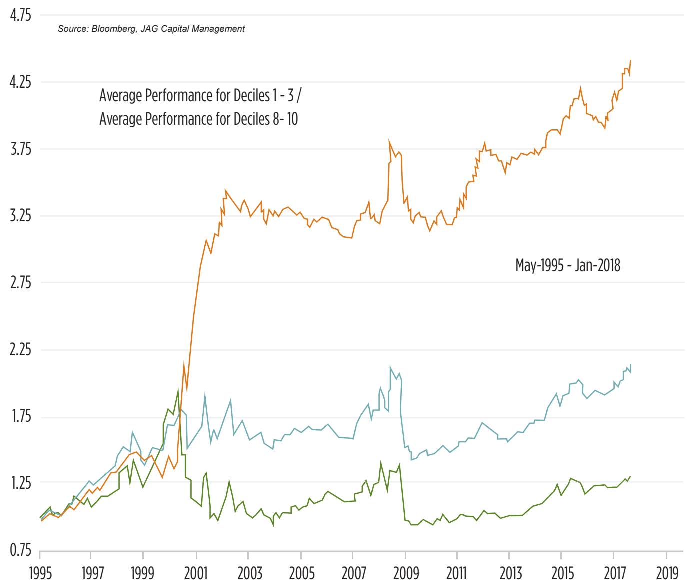
While the earnings surprise factor has worked well for decades, it did have time periods where the factor was less successful. One of those times occurred in the late 1990's. Such periods are not atypical as discreet factors can lose power as more and more investors understand and attempt to exploit a market anomaly. During one of those down times for the earnings surprise factor, investment practitioners sought to improve the indicator. Several new studies were published near the turn of the century which attempted to isolate items ranging from the number of analyst estimates for a stock, to whether the stock was a value or a growth stock, to events subsequent to the earnings surprise.

Is Two Better Than One?

One of the more notable efforts to rescue the earnings surprise factor from perceived both faster market reaction times and faster computers was to combine earnings surprise with an earnings revision factor. JAG recreated this factor merger, and our testing shows a clear deterioration in the performance of the earnings surprise factor when such a combination is used. The first chart below shows performance of the top three deciles of the earnings surprise (orange) and earnings surprise & earnings revision (blue) models compared to the Russell 1000 Growth Index. The second chart shows the difference in performance between the top three and bottom three deciles of the singular and combined factor models. Earnings surprise alone significantly outperforms the same factor modified by earnings revisions.

Combined EPS Surprise and EPS Revisions (blue line), EPS Surprise (orange line), EPS Revisions (green line)



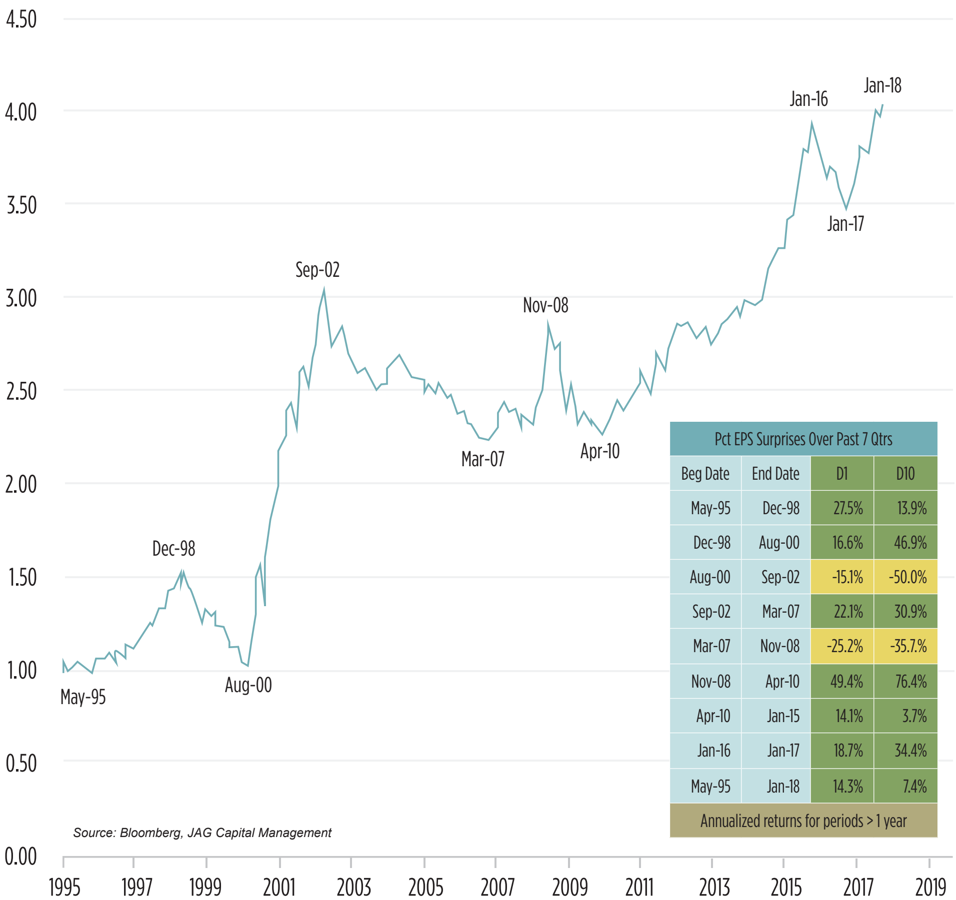


Tick-Tack-Toe: Three in a Row

A more recent effort to modify the earnings surprise factor looked for a series of consecutive surprises instead of one singular surprise. That 2012 study by Shanthikumar found that investors responded to a greater degree to each consecutive earnings surprise (up to four). However, the author says that the investment performance generated by the consecutive surprise model deteriorated after 2002. At JAG, we think that the author may have been on the right track in looking for multiple periods of earnings surprise. However, we do not think earnings surprise needs to be consecutive, nor do we think that three or four earnings periods is the right target term.

What if the company in which you are invested posted positive earnings surprises in four out of the last five quarters? Would that company's stock perform better than a stock with a positive surprise in two of the last five quarters? Our work suggests that it would. Second, why would we select five quarters and not three (as the 2012 study) or seven or nine? Well, we tested all of those intervals, and found a particularly powerful result in a plurality of positive surprises over seven quarters. While we do not know for sure why this is true, we suspect that it takes positive results over several quarters to create momentum. The following chart shows the performance of the top decile of stocks sorted by seven quarter surprise percentage compared to the bottom decile of stocks on the same metric. We think this earnings surprise factor is robust.

Pct Positive EPS Surprises Over Past 7 Qtrs: Decile 1 / Decile 10

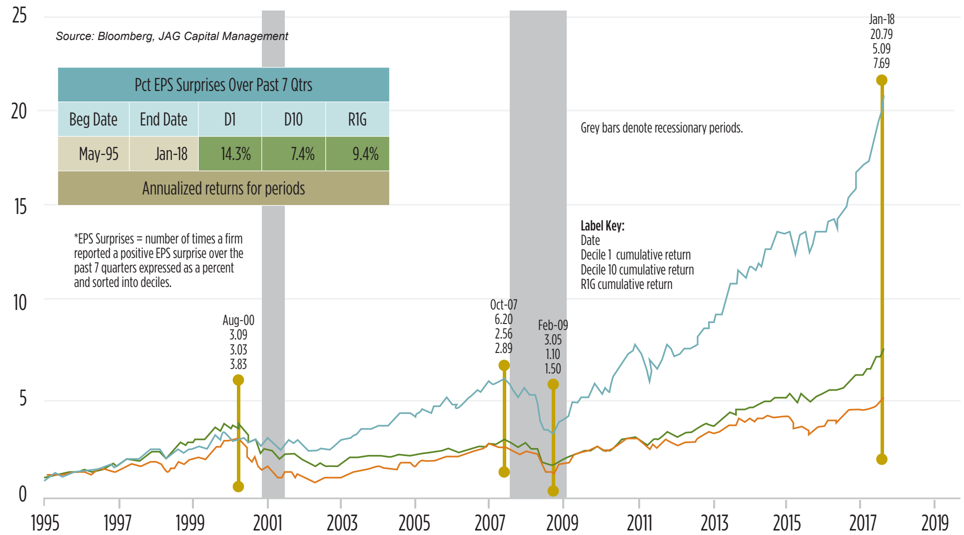


Pct EPS Surprises Over Past 7 Qtrs			
Beg Date	End Date	D1	D10
May-95	Dec-98	27.5%	13.9%
Dec-98	Aug-00	16.6%	46.9%
Aug-00	Sep-02	-15.1%	-50.0%
Sep-02	Mar-07	22.1%	30.9%
Mar-07	Nov-08	-25.2%	-35.7%
Nov-08	Apr-10	49.4%	76.4%
Apr-10	Jan-15	14.1%	3.7%
Jan-16	Jan-17	18.7%	34.4%
May-95	Jan-18	14.3%	7.4%
Annualized returns for periods > 1 year			

Not Only Performance, But Risk Moderation

Perhaps even greater than the consecutive earnings surprise factor performance is what using the factor does for portfolio risk. In our research, the companies exhibiting greater rates of earnings surprise are less volatile and have lower maximum drawdowns than their peer companies. In addition to having lower risk, companies with higher rates of earnings surprise have some counter cyclical characteristics. From the chart that follows, it is evident that the companies with multiple positive surprises outperformed both the Russell 1000 Growth Index and the group of companies with the fewest positive surprises during the 2000-01 recession. That same multiple positive surprise group outperformed the index in the 2007-9 recession, and trounced the few positive surprise group early in the correction.

Cumulative Return for R 1000 Growth Firms Sorted by EPS Surprises*: Many Positive Surprises (blue line), Few Positive Surprises (orange line), Russell 1000 Growth Index (green line)



Conclusion

Earnings surprise has been a powerful investment factor for decades. It works often but not always. Attempts to modify the factor by adding a revisions component and a consecutive surprise component have proven fruitless. However, finding companies who report multiple surprises over long periods both enhances portfolio returns and lowers risk. At JAG, we believe our research keeps our factor model inputs fresh and productive.

ABOUT JAG

JAG Capital Management is an independent, 100% employee-owned registered investment advisor headquartered in St. Louis, Missouri. The firm provides portfolio management services for institutions, individuals, investment advisory firms and corporations. In addition to managing the JAG Large Cap Growth mutual fund, equity and fixed income separate accounts are also offered.

JAG
CAPITAL MANAGEMENT LLC

9841 Clayton Road | St. Louis, MO 63124
800.966.4596 www.jagcapm.com
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