



An educational review of basic investment concepts and techniques—in easy-to-understand terms.

Great Expectations: Earnings Estimates and Their Impact on Stock Prices

How often have you seen a stock's price fall after the company announced increased earnings?

Or, just recently, why did the stock of investment banking firm Lehman Brothers soar after it announced that its fiscal first-quarter earnings fell 57%?

In these instances, actual earnings did not turn out as the market expected.

In fact, expectations play a key role in determining if a stock's price "gains" or "loses" when actual earnings are reported.

Expectations Count

The stock market is forward looking. That is, stock prices are established based on the expectations that prospective investors have for the future earnings power of the firm.

The future earnings power of any company involves the interaction of many company, industry, and economic forces. Earnings estimates embody investors' opinions of factors such as sales growth, product demand, competitive industry environment, profit margins and cost controls. Stock prices adjust as these expectations change or are proven wrong.

Just whose expectations are we talking about?

The actual expectations embodied in a stock's price are those of millions of investors—collectively "the market." Needless to say, it is impossible to measure the exact expectations of all of these investors at one point in time.

The more practical proxy for the market's expectations is analysts' consensus earnings estimates. Many services provide consensus earnings estimates by tracking the estimates of the thousands of investment analysts who are employed by brokerage firms providing stock research for their customers. These analysts have two primary functions: to provide earnings per share estimates and to provide buy/hold/sell recommendations for the companies they track. The brokerage firm uses the research developed by their analysts to attract and retain brokerage customers and create investment banking opportunities.

[For sources of information on analyst earnings estimates, go to the AAI Guides area of AAI.com

and select the "Top Web Sites Guide." This information also appeared in the September 2007 issue of the *AAII Journal*.]

Consensus Estimates

Stocks with earnings estimates may have from one to as many as 40 or more analysts tracking and analyzing them. The consensus estimate refers to the average earnings per share estimate. The number of estimates provides a feel for the depth of coverage for a company.

When examining earnings estimates, the first rule to keep in mind is that the current price usually reflects the consensus earnings estimate. For investors, there is nothing to be gained by investing in a company simply because it has a high level of expected earnings growth because of the high price you must pay for those expectations. In fact, studies show that over the long run, stocks with high expected earnings growth tend to underperform stocks with low growth rates and low expectations because it is difficult to meet and exceed high expectations over an extended period of time.

The impact on stock prices comes when actual earnings differ from the consensus expectations—that is, when there are earnings "surprises" and revisions in earnings estimates.

Earnings Surprises

Earnings surprises occur when a company reports actual earnings that differ from consensus earnings estimates. Listed companies are required to file quarterly reports with the 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. The fiscal periods for most companies coincide with the calendar quarters.

Institutional investors and analysts work at a frenzied pace for about three weeks starting mid-month in January, April, July, and October as major companies report their earnings from the previous quarter. During the earnings

reporting season, financial newspapers and Web sites provide daily reports on earnings announcements. Firms with significant earnings surprises are often highlighted.

Earnings surprises are either positive or negative:

- 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.

What is the impact on stock prices?

Price changes resulting from an earnings surprise can be felt immediately. Studies indicate that the stock prices of firms with significant positive earnings surprises show above-average performance, while those with negative surprises have below-average performance.

Although the surprise has an immediate impact on the stock's price, it may also have a long-term effect. In fact, studies indicate that the effect can persist for as long as a year after the announcement.

That means it may not be too late to buy a stock that has had a positive earnings surprise, even though you can't act right at the time of the initial surprise. 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 firms tend to adjust to surprises faster than small firms do. That's because larger firms are tracked by more analysts and portfolio managers, who tend to act quickly.

Earnings surprises also tend to follow the "cockroach effect"—like cockroaches, you rarely see just one earnings surprise. So, firms with a significant earnings surprise in one quarter will also often have earnings surprises in subsequent quarters.

Since both positive and negative earnings surprises have lingering long-term effects, a rewarding investment tactic would be to avoid stocks you believe will have negative earnings surprises or those that have had negative earnings surprises. Similarly, selecting positive earnings surprise stocks before and even after the earnings come in may be profitable.

Revisions

Revisions in earnings estimates reflect changes in expectations of future performance on the part of analysts. Perhaps the economic outlook is better than previously expected, or maybe a new product is selling better than

anticipated.

Revisions to earnings estimates lead to price adjustments similar to earnings surprises:

- When earnings estimates are revised significantly upward—5% or more—stocks tend to show above-average performance.
- Stock prices of firms with downward revisions show below-average performance.

Revisions are often precursors to earnings surprises. As the reporting period approaches, estimates normally converge toward the 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, it is helpful to focus on the number of revisions. When compared to the number of analysts making estimates, this is a confirmation of the significance of the percentage change in estimates. You can put more faith in a revision if a large percentage of the analysts tracking a firm have revised their estimates.

The number of revisions upward indicates how many analysts have revised their estimates upward in the last month. Stock prices of firms with more upward revisions than downward revisions have shown above-average returns, while those with more downward revisions tend to underperform.

Examining the range of estimates provides an indication of the consensus within the group of estimates. A wide range of estimates would point to great disagreement among analysts, indicating greater uncertainty and greater chance for an earnings surprise.

The price move can be more dramatic, however, if an earnings surprise occurs for a firm with a very tight range of earnings estimates.

Whisper Numbers

Whisper numbers garnered much attention a few years ago because of the apparent weight they carried with institutional investors. Originally, whisper earnings, or whispers, were considered to be the actual earnings expectations of the analysts tracking the company—free of any company influence. These unofficial estimates were passed or whispered from analyst to analyst and to the analyst's best customers, but not actually posted to estimate tracking services.

Some studies found that these whisper numbers appeared to better reflect the market's expectations of earnings.

However, the passage of the Sarbanes-Oxley Act and the tightened corporate reporting requirements has led to

a change in the definition of whisper numbers, since the new regulations make it difficult for insiders to pass on insider earnings data.

WhisperNumber.com, one of the leading providers of “whisper” earnings estimates, defines them as: “an average of individual investors’ expectations in regard to public company earnings—used by investors to anticipate post earnings price movement and considered an alternative/comparative number to the analyst consensus estimates.” It states that its numbers are “collected from our registered user base (Influential Individual Investors) through polling and website submission.”

Other Web sites have also been established that try to gather and distribute whisper numbers.

How should an investor view whispers?

Whisper numbers tend to come from unknown

and unnamed sources. They may come from company insiders, perceptive investors, or those who are attempting to manipulate a stock’s price. Sites that collect whisper estimates rarely disclose their sources.

While you may want to examine the numbers, you should not simply take the estimates at face value.

Looking Forward

Earnings estimates are an important element for you to keep in mind when you analyze and select stocks. They are a numerical view of expectations, and changing expectations drive stock prices.

The box below summarizes the main points to keep in mind when you are examining earnings estimates. ▲

Earnings Estimates and Their Impact on Stock Prices

Earnings Estimates

- Firms with high expected earnings growth tend to underperform the market because it is difficult to meet the market’s high expectations. Companies with low earnings expectations tend to do better than expected.
- Realize that the stock price already reflects the general consensus about future earnings. Be aware that if a stock is highly touted, the basis for the recommendation should be an earnings forecast significantly above the prevailing opinion.

Earnings Estimate Revisions

- Stock prices of firms with significant upward revisions (5% or more) generally outperform the market. Firms with significant downward revisions usually underperform the market.
- Earnings revisions are often a precursor to earnings surprises. Stock prices react positively to upward revisions.

Earnings Surprises

- Stock prices of firms that significantly exceed their earnings expectations (positive earnings surprises) outperform the market, while those with negative earnings surprises underperform.
- The earnings surprise effect is long lasting. The greatest impact from the surprise is felt immediately, but the effect of the earnings surprise can be seen for as long as a year. The effect of the surprise tends to be longer lasting for negative earnings surprises.
- The stock prices of large firms adjust to surprises more quickly than those of small firms.
- Earnings surprises often follow earlier surprises in groups—the cockroach effect.
- The chance of an earnings surprise is greater if the range of estimates for a company is wide prior to the announcement. The price move can be more dramatic, however, if an earnings surprise occurs for a firm with a very tight range of earnings estimates.