

The Matras Increasing Earnings Approach

by Charles Rotblut, CFA

Article Highlights

- Kevin Matras uses earnings momentum to find stocks with the potential for upward price movement.
- This screen requires six quarters of historical sequential profit growth, plus expectations for the trend to continue.
- Passing stocks are also required to have a minimum price of \$5, so that they may appeal to portfolio managers also.

Kevin Matras, a vice president with Zacks Investment Research and author of “Finding #1 Stocks: Screening, Backtesting and Time-Proven Strategies” (John Wiley & Sons, 2011), is a big advocate of stock screens. He strongly believes that a stock screen is necessary for finding good stocks.



Matras is an active trader, preferring to turn his portfolio over quickly rather than engage in long-term positions. This comes from his preference for stocks showing a potential to move upward in price over the short term. Though he does look at charts, Matras relies heavily on the concept of earnings momentum to find what he considers to be good stocks. This may include past earnings growth, recent upward revisions to earnings estimates or a combination of the two.

Many of Matras' strategies are presented in his book. A large number of these screens are based on the proprietary Zacks Rank indicator, which looks at changes to earnings estimates and earnings surprises (see the sidebar on page 32 for more information). Some of them are not, including the screen featured in this article, Increasing Earnings.

Earnings Momentum

Matras emphasizes a positive trend in earnings because, as he puts it, “In good markets or bad, strong earnings are one of the most important things that influence stock

prices.” He considers rising earnings to be a key factor that separates great stocks from merely good ones. His Increasing Earnings screen applies this concept by looking for six consecutive quarters of rising earnings and the expectation that earnings will rise for at least an additional two quarters.

The logic behind this screen is that the company with rising earnings is doing something right. These are companies that are experiencing positive business trends; trends that may have momentum and could continue to be positive. Matras notes in his book that many of the passing companies also have a history of topping earnings expectations.

The screen demands consistent excellent performance for several quarters. As such, it can be very restrictive. For example, companies whose businesses are influenced by seasonal patterns are less likely to pass. Because business trends for many companies can vary by the time of year (e.g., retailers are most busy between Thanksgiving and Christmas), it is more common to see earnings growth measured on a year-over-year basis. Screening for sequential quarterly growth requires very strong secular growth that overcomes seasonality.

Currently, the strategy is only finding nine companies (using data as of June 3, 2011). During periods of economic duress, even fewer companies could pass.

Matras prefers screens that are restrictive, identifying only those stocks that best match the spirit of the screen. His strategy is to buy all of the passing companies and sell them when they no longer pass. In his book, he suggests running the screens on a regular basis—such as once a

Table 1. Matras Increasing Earnings Portfolio Characteristics

Portfolio Characteristics (Median)	Increasing Earnings Screen	Exchange-Listed Stocks
Price-earnings ratio (X)	25.6	17.0
Price-to-book value ratio (X)	4.0	1.6
Sales 3-yr. historical growth rate (%)	7.8	3.1
EPS 3-yr. historical growth rate (%)	12.4	1.9
EPS forecast growth current year (%)	88.7	17.7
EPS forecast growth next year (%)	25.4	19.9
Market cap (\$ million)	1,941	546
52-week relative strength vs. S&P* (%)	64	(2)
Beta (x)	1.42	1.14

*S&P index = 0.
Data as of June 3, 2011.

week or once every four weeks—and rebalancing the portfolio accordingly. Matras believes this type of strategy helps lessen the need to use stop-limit orders and simplifies the process of investing.

It also puts a great deal of reliance on the screen itself. Though Matras relies heavily on backtesting to decide whether a screen's criteria make sense (as opposed to simply looking for anomalies and constructing a screen to exploit them), Matras thinks that to truly benefit from a screen, investors should buy all of the passing stocks, whereas other investors often view a screen as simply a filter, the results of which serve as a basis for further research.

The Criteria

The primary basis for the Increasing Earnings screen is a history of rising earnings. Specifically, the screen requires companies to have achieved quarterly growth for six consecutive quarters. Identifying such companies simply requires comparing earnings on a quarter-by-quarter basis:

- Continuing diluted earnings (EPS) for the most recently completed quarter is greater than continuing diluted earnings for one quarter ago,
- Continuing diluted earnings for one quarter ago is greater than continuing diluted earnings for two quarters ago,

- Continuing diluted earnings for two quarters ago is greater than continuing diluted earnings for three quarters ago,
- Continuing diluted earnings for three quarters ago is greater than continuing diluted earnings for four quarters ago,
- Continuing diluted earnings for four quarters ago is greater than continuing diluted earnings for five quarters ago, and
- Continuing diluted earnings for five quarters ago is greater than continuing diluted earnings for six quarters ago.

[Continuing diluted earnings refers to earnings per share from continuing operations that reflects the potential dilution that could occur if securities with rights to issue common stock (convertibles) were exercised or converted into common stock, thereby reducing earnings for a given share.]

Matras wants signs that the earnings momentum will continue. The criteria below increase the number of quarters with actual or forecast rising earnings to eight:

- The consensus earnings estimate for the current quarter is greater than continuing diluted earnings for the last quarter, and
- The consensus earnings estimate for next quarter is greater than the earnings estimate for the current quarter.

Table 2. Companies Passing the Matras Increasing Earnings Screen

Company (Ticker)	Current Price (\$)	P/E Ratio (X)	P/B Ratio (X)	3-Yr Growth		Beta (X)	Rel Strgth 52-Wk (%)	Price Chg 13-Wk (%)	Market Cap (\$)	Description
				Sales (%)	Earnings (%)					
RPC, Inc. (RES)	25.20	18.7	6.28	16.7	19.2	1.49	174	23	3,738.4	oilfield services
Ultratech, Inc. (UTEK)	31.50	35.4	3.27	7.8	165.7	0.49	85	20	792.1	thermal process equip
Prosperity Bancshares (PRSP)	41.41	14.8	1.31	4.1	12.1	0.67	(3)	3	1,941.5	financial holding co.
Gulfport Energy (GPOR)	28.12	21.5	4.04	6.2	1.9	2.40	87	(1)	1,334.1	oil & natural gas
PACCAR Inc (PCAR)	47.37	29.8	3.07	(12.2)	(27.6)	1.35	(6)	(4)	17,312.3	trucks; finan & lease
Las Vegas Sands (LVS)	42.08	56.1	4.47	32.4	15.6	3.87	43	(4)	30,675.4	Vegas resort casinos
Rockwell Automation (ROK)	81.38	20.8	6.41	(1.0)	(4.8)	1.67	26	(7)	11,743.8	control & info solutions
51job, Inc. (ADR) (JOBS)	56.17	38.2	5.87	8.9	31.4	0.93	142	(7)	1,587.1	human resource servs
Demand Media Inc (DMD)	14.17	nmf	2.05	35.2	12.4	nmf	nmf	(42)	1,179.0	online content creation

Source: AAI's Stock Investor Pro/Reuters Research, Inc. Data as of June 3, 2011.

What It Takes: Matras Increasing Earnings Criteria

- Diluted earnings per share from continuing operations for the quarter is higher than that for the previous quarter for the last six consecutive quarters (Q1 to Q2, Q2 to Q3, etc.)
- The consensus earnings estimate for the current quarter (Q0) is greater than continuing diluted earnings for the last quarter (Q1)
- The consensus earnings estimate for next quarter (Q1) is greater than the earnings estimate for the previous quarter (Q0)
- Current price is greater than \$5
- Average daily 10-day volume is greater than 50,000 shares

See the online version of this article for the *Stock Investor Pro* criteria for this screen.

There are two final criteria:

- Current price is greater than \$5, and
- Average daily 10-day volume is greater than 50,000 shares.

The minimum price requirement of \$5 is used because many portfolio managers and institutional investors will not look at stocks priced below that amount. (It is the minimum price level required to maintain a listing on a major exchange, such as the New York Stock Exchange.) Matras reasons that, since institutional investors are the ones who move the market, he should focus on the stocks that are likely to appear on their radar screens.

The volume requirement is used to ensure that there is enough daily liquidity to quickly buy and sell.

Profile of Passing Companies

The Matras Increasing Earnings screen was run using AAI's *Stock Investor Pro* fundamental stock screening and research database with data as of June 3, 2011. The screen is designed to look for growth, and the profile of the passing companies presented in Table 1 shows that it succeeds in this goal. The passing companies have experienced a median 12.4% increase in earnings over the past three years, versus 1.9% for all exchange-listed stocks. The median three-year revenue growth has also been comparatively strong at 7.8% for the screen's passing companies, versus 3.1% for all exchange-listed companies.

Looking forward, analysts expect earnings growth to remain strong. The

screen's passing companies should enjoy a median rise in profits of 88.7% this fiscal year and 25.4% next year. In contrast, the median exchange-listed stock is forecast to realize 17.7% profit growth this year and 19.9% growth next year.

The strong pace of growth is not going unnoticed. Passing companies have a median relative strength score of 64%, which means they have outperformed the S&P 500 by a significant amount. The relative strength score for the median exchange-listed stock is -2%, a result of underperformance by small- and mid-cap stocks.

The growth and price performance comes at a cost, however. The median price-earnings (P/E) and price-to-book (P/B) ratios for the passing companies are 25.6 and 4.0, respectively. These are significant premiums compared to the 17.0 and 1.6 valuation ratios at which the median exchange-listed company trades.

Furthermore, the stocks found by the screen may experience an above-average level of volatility. The median beta of the passing companies is 1.42 versus a median of 1.14 for all exchange-listed stocks. A beta of 1.0 means a stock has experienced the same level of volatility as the S&P 500. Betas above 1.0 signal more volatility and betas below 1.0 signal less volatility. A higher beta stock may experience larger price fluctuations.

When looking at the profile in Table 1, keep in mind the small number of companies that pass this screen. High numbers for one or two companies can skew the median values for profile criteria upward. For instance, Las Vegas

Sands (LVS) trades at 56.1 times trailing 12-month earnings, pushing the median price-earnings ratio up significantly.

A Look at Specific Stocks

Table 2 lists all of the companies identified by the screen as of June 3, 2011. The list is sorted by 13-week price performance. Though this particular screen does not use a price performance component, several of the other momentum screens listed in Matras' book use four-week and 12-week performance as criteria. Often, Matras is narrowing results down to those stocks with the best four- or 12-week price change. Rather than eliminate those stocks that have lost ground, he looks for relative performance. This allows the screens to find stocks even when the markets are declining, as they did throughout this past May.

RPC, Inc. (RES) has the best 13-week price performance, rising 23%. The company provides specialized oilfield services and equipment such as pressure pumping, coiled tubing, hydraulic workover (aka snubbing) and nitrogen services. It also rents drill pipe and other equipment. RPC, Inc. is a beneficiary of \$100 per barrel oil as high crude prices make it worthwhile for exploration and production companies to spend more money on projects.

Quarterly earnings have rebounded from an eight-cent loss eight quarters ago to a 45-cent profit for the first quarter of 2011. As of press time, analysts expect the upward trend to

Incorporating the Zacks Rank

Many of the screens presented in Matras' book include the Zacks Rank as a criterion.

The Zacks Rank is a proprietary indicator that considers changes in earnings estimates and earnings surprises. Specifically, it looks for revisions to full-year earnings estimates, the timing of those changes (revisions made within the past 30 days are given more weight), the magnitude of the changes, the proportion of covering analysts who altered their estimates and whether actual earnings were better, worse or the same as earnings projections. A company that has topped earnings expectations and has had their earnings estimate revised significantly higher by all of the covering analysts will have a better Zacks Rank than a company that is seeing its earnings estimates revised down. Disagreement among analysts as to whether projections should be raised or cut also adversely impacts the Zacks Rank.

The indicator does not consider anything outside of earnings estimates and earnings surprises. Important characteristics such as valuation and profit growth are excluded. The figure is calculated daily and is designed to be a short-term indicator. Furthermore, at any given point, there are more than 200 stocks assigned the best rating—a Zacks Rank of 1. Therefore, it is merely a starting point, not a sole indicator that can be used to select stocks.

Though the indicator is proprietary, AAIL.com does have screening strategies that identify stocks with posi-

tive or negative revisions. In addition, users of AAIL's *Stock Investor Pro* program can incorporate Zacks Rank concepts into their screens. The "Earnings Estimates" category of *Stock Investor Pro* lists a variety of relevant criteria, including the percent change to revisions, the number of positive and negative revisions and the latest earnings surprise. Just be aware that each criterion added to a screen reduces the number of companies it may identify.

To capture the spirit of the Zacks Rank, add the following criteria to a screen:

- The most recent consensus earnings estimate for the current fiscal year is greater than it was three months ago,
- The percentage change over the last month in the consensus earnings estimate for the current fiscal year is greater than or equal to zero,
- The most recent consensus earnings estimate for the next fiscal year is greater than it was three months ago,
- The percentage change over the last month in the consensus earnings estimate for the next fiscal year is greater than or equal to zero, and
- The percentage difference between the latest reported quarterly earnings and the consensus estimate for that period is greater than zero.

Though not exactly replicating the Zacks Rank, these criteria will find stocks with many of the same positive characteristics that the indicator tries to identify.

continue with second-quarter earnings forecast to reach \$0.49 per share. The consensus forecast for third-quarter profits is at \$0.54 per share. Two analysts raised their forecasts for full-year 2011 earnings during the past month and four analysts recently raised their 2012 earnings forecasts.

Las Vegas Sands (LVS) is the priciest stock on the list with a price-earning ratio of 56.1. The company returned to profitability just four quarters ago, depressing the earnings figure used for calculating the price-earnings ratio. Since the screen looks for a relative improvement in earnings and not absolute profitability, it is possible for a company

to lose money and still pass. The key is for the size of the loss to be dwindling, as was the case with Las Vegas Sands for several quarters.

The casino and resort operator's price-to-book ratio of 4.47 is not cheap, either. This high ratio reveals two other factors that the screen does not look for. The first is the valuation of the stock. As long as companies are showing consistent earnings growth, they pass, regardless of how cheap or dear their valuations are. The second is that the screen does not consider the strength or weakness of the balance sheet. Las Vegas Sands has a debt-to-equity ratio of 134.7, which is high. This is why

investors should conduct additional research before buying a stock from this or any other screen.

Conclusion

This strategy seeks out companies that are currently experiencing positive business trends, as well as rising earnings that could drive their stock prices higher. It is an aggressive strategy that is best suited for investors who seek out momentum stocks. Because it does not consider valuation or balance sheet strength, it may find stocks with higher risk profiles than desired by investors focused on more conservative, long-term strategies. ▲

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