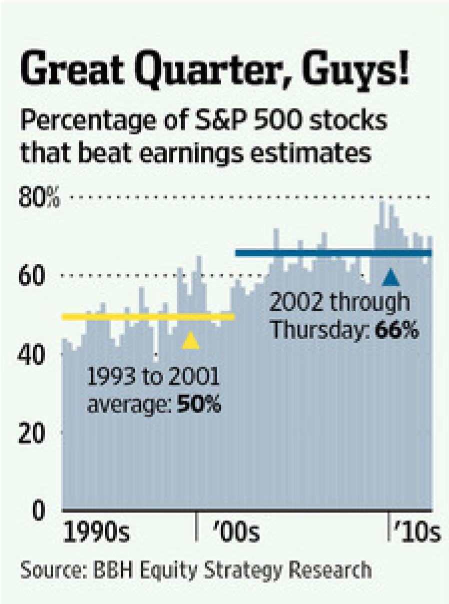
Earnings Surprises Lose Punch

Surprise, surprise, surprise!



Gomer Pyle might have been about as competent an equity strategist as he was a marine. While the knee-jerk reaction to a positive earnings surprise is often, well, positive, gains can be fleeting. The reason is that companies and the analysts who cover them typically set the bar low enough that a "beat" has to be substantial, and not marred by unpleasant news about the outlook, to really have an impact.

Take the current earnings season. Now that a little over four-fifths of S&P 500 companies by market value have reported, Brown Brothers Harriman says 70% of those have beaten estimates. But since Alcoa Inc. AA -2.24%informally kicked off the current reporting season April 10, the S&P 500 is down slightly.

While this "positive surprise ratio" of 70% is above the 20 year average of 58% and also higher than last quarter's tally, it is just middling since the current bull market began in 2009. In the past decade, the ratio only dipped below 60% during the financial crisis. Look before 2002, though, and 70% would have been literally off the chart. From 1993 through 2001, about half of companies had positive surprises, which seems natural.

What changed? One potential reason is the tightening of rules governing analyst contacts with management. Analysts now must rely on publicly available guidance or, gasp, figure things out by themselves. That puts companies, with an incentive to set the bar low so that earnings are received positively, in the driver's seat. While that makes managers look good short-term, there is no lasting benefit for buy-and-hold investors. In fact, an October study by CXO Advisory Group found that the average weekly index return during earnings season has been slightly negative since 2000, while it has been positive for the rest of the year.

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The important statistic is actual corporate profits. BBH estimates the S&P 500 recorded operating earnings of $25.31 a share last quarter. That is about $1.50 higher than analyst consensus estimates a month ago but around $1.00 below last July's estimate. That is a typical pattern as expectations start out too optimistic and, by the time actual earnings approach, are too low. When the ink is dry, though, actual profits rarely make it to where expectations first began.

As Gomer would exclaim: "Well gaw-lee."

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