

HOW EARNINGS MOMENTUM LET DOWN INVESTORS

Executive Summary

Inspired by a study regarding the persistence of earnings by Sanford Bernstein analysts¹, we analyzed earnings and returns over the last 20+ years to understand the factors playing out in the market today. Specifically, we explored the deterioration of earnings momentum persistence, the inversion of the signal and performance in an environment dominated by uncertainty and reversion. Earnings-driven investors seek to identify stocks undergoing sustainable and positive earnings improvement with earnings growth prospects not fully appreciated by consensus forecasts. A primary quantitative attribute of such stocks is **earnings momentum**, which we define as rising expectations (positive EPS estimate revisions by Wall Street analysts). Historically, stocks with the strongest earnings momentum have outperformed, but this has not been the case since 2008.

We found that the economic recovery since the 2008 recession has not produced consistent earnings growth and leadership among stocks, severely impairing the performance of earnings momentum investment factors and strategies. Why have earnings momentum strategies endured such an extreme period of difficulty since 2008? Based on the known cyclicity of earnings and earnings momentum, we asked ourselves what factors have led to the lengthened cycle and what factors may lead to a normalization.

Background - Cyclicity Exists

Figure 1: Quarterly Excess Return by Earnings Momentum

	Best Quintile	Worst Quintile	Return Spread
1990 - 1999	0.4%	-0.5%	0.9%
2000 - 2002	-0.2%	0.8%	-1.0%
2003 - 2007	0.7%	0.2%	0.5%
2009 - 1Q 2013	-1.3%	1.5%	-2.8%

Source: FactSet, S&P 500 Universe

Figure 1 lists the average quarterly excess returns earned by best and worst stocks ranked by earnings momentum over various periods since 1990. The factor exhibits cyclical efficacy, working well in trending economic environments like the 1990s and 2003-2007 (quarterly excess returns of 0.4% and 0.7%, respectively, for the best quintile, i.e. top 20%) while struggling in periods of uncertainty, such as the recession/recovery of 2000-2002 and since 2008 (excess returns -0.2% and -1.3%, respectively). Paradoxically, the worst quintile (stocks with the weakest earnings momentum) logged strong returns in 2000-2002 and since 2008.

Analysis

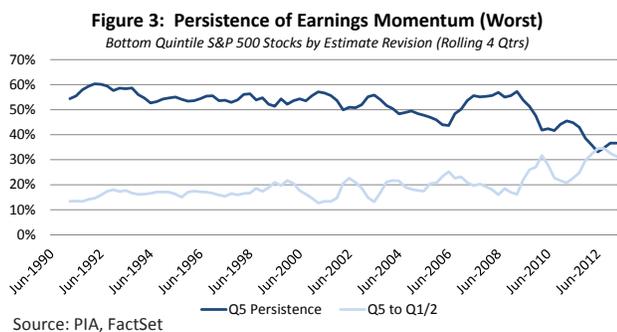
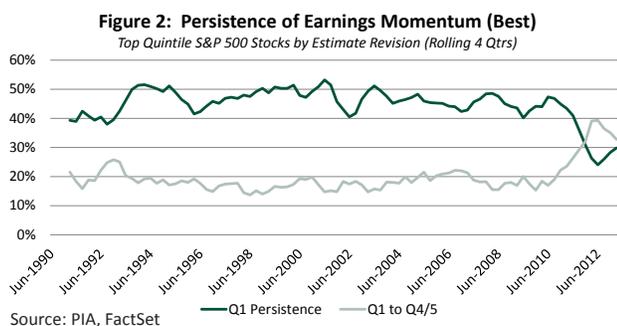
We quantified **earnings persistence**, i.e., the extent to which stocks with rising consensus earnings expectations repeat that behavior. This is the core premise of earnings momentum as an investment strategy. To accomplish this, we tracked the stability of the rankings of an estimate revisions model:

- Persistence is defined as the percentage of stocks in the top quintile (Q1) at time T which remain in the top quintile at time T+3 months.
- Earnings Momentum factor includes the number of Wall Street analysts increasing/decreasing estimates and the magnitude of change of FY1 and FY2 consensus forecasts;
- Universe: S&P 500 (over the last 20+ years)

The Beginning of the End

The consistency of earnings momentum has deteriorated significantly in comparison to historic norms over the last 20+ years (Figure 2). Until 2008, persistence at both ends of the spectrum was reasonably stable, hovering around 50%. That means that an investor using this factor would have a 50/50 chance that a stock's earnings momentum trend would continue. Since 2009, earnings persistence has deteriorated. By the middle of 2012, persistence of Q1 stocks (best) had fallen to roughly 25%, meaning only one-fourth of stocks with strong earnings momentum repeated that behavior. **Said another way, three out of four stocks with rising earnings expectations experienced flat or declining**

earnings estimates within just three months! Q5 (worst) persistence slipped to 33% (Figure 3).



Led Astray

The odds of success had turned sharply against investors seeking to identify repeatable earnings growth trends. In fact, forecasts have been more likely to go from one extreme to the other than persist. We can see this in Figure 2. By 2012, an average of 40% of the Q1 stocks fell to Q4 or Q5 three months later, meaning analysts not only stopped raising earnings estimates, they cut expectations. The market has lacked sustained earnings leadership among stocks.

Additional Evidence

The following charts illustrate this lack of leadership from the perspective of price momentum factors:

- **Relative Strength** (Best Quintile): Stocks in a measurable uptrend (Top 20% of stocks ranked by the ratio of 30-week average price divided by 75-week average price);
- **Price Reversal** (Worst Quintile): Worst 20% of stocks as ranked by their performance over the prior 90 days.

In order for the price reversal factor to outperform, there must be constant rotation within the market. If the losers of

Figure 4: Relative Strength vs. Price Reversal Since 1997
(source: FactSet)



Figure 4 shows the performance of these groups of stocks over the long run: Winners keep winning (strong relative strength), and losers continue to underperform (price reversal). This has not been the case since 2009 (Figure 5), a period dominated by reversal and rotation.

Figure 5: Relative Strength vs. Price Reversal Since 2008
(source: FactSet)



Summary

Poor performance of the earnings momentum factor is a reflection of the lack of sustainable earnings growth in Corporate America, evidenced by the oscillation of analysts' estimates and rotating market leadership. There are various theoretical and practical reasons:

- Economic and political uncertainty has prolonged recovery from recession. This uncertainty has caused companies to hoard cash and delay investment and expansion of their businesses, leading to volatile and less predictable earnings growth.
- Fiscal intervention has fueled the recovery of global markets, but has not yet produced sustainable growth of the economy or corporate profits.

The "risk on, risk off" rotation of the markets has exacerbated the poor performance of earnings momentum and led to the longest economic trough we have observed.

Footnotes: 1 Vadim Zlotnikov, Ann Marie Larson, Lin Lin, CFA, "Quantitative Research: How to profit from earnings estimate revisions in a challenging environment," Bernstein Research (February 15, 2012)

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