

## Quadrix Earning Estimates scores are worth watching

Since its introduction in 2004, the Quadrix® Earnings Estimates score has proven to be an effective predictor of stock returns. The top one-fifth of stocks in the Dow Jones Total Market Index as measured by the Earning Estimates score averaged 12-month returns 2.8% higher than those of the average stock. The score works particularly well in the basic-materials, consumer-services, telecommunications, utilities, and financials sectors, as shown in the accompanying chart.

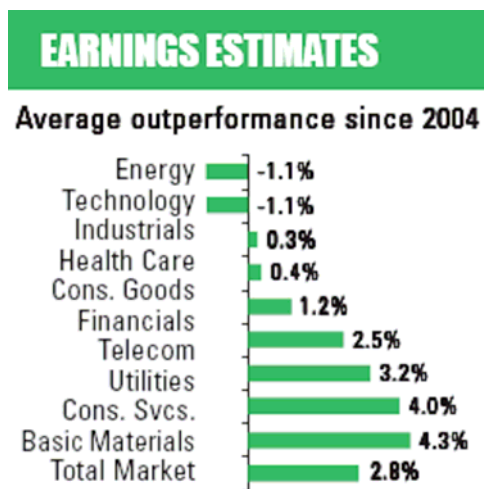
The four-week and 12-week percentage change in per-share profit estimates for the current fiscal year have displayed substantial predictive power, as has the 12-week percentage change in estimates for the next fiscal year.

However, we cannot simply take those returns at face value because we do not have enough history. For the other Quadrix category scores, we have real-time results since the system's introduction in 2000 — and back-tested results to 1990. But our earnings-estimate data only goes back to February 2004. The numbers look good so far, but we can't hang our hat on so little data.

Fortunately, we have other reasons for optimism. Our Earnings Estimates score looks mostly at revision trends, and the effect of earnings-estimate revisions on stock prices has been extensively researched since the 1970s, with encouraging results. Not only do stocks tend to move immediately after estimates change, prices tend to drift for up to nine months.

A 2005 study by SEI Investments tracked calendar-year returns of stocks in the Russell 1000 Index from 1990 through 2003. According to the SEI study and others, estimate revisions are particularly effective during bull markets.

During 1998 and 1999, the top one-fifth of Russell 1000 Index stocks as measured by the percentage change in forward profit estimates outperformed the bottom quintile by more than 80%. While revisions worked less well during downturns, the top one-fifth of stocks outperformed the bottom one-fifth by at least 40% every year.



Stocks in the top one-fifth of the Dow Jones Total Market Index outperformed the average stock by an average of 2.8% in the 28 rolling 12-month periods since February 2004. The score works in most sectors, but is ineffective for energy and technology stocks.

Revision trends, while useful, are not sufficient by themselves to justify the purchase or sale of any stock. Still, the Quadrix Earnings Estimates score serves as a useful barometer of nearterm expectations and can serve several purposes:

**Avoiding weaklings.** While the *Forecasts* focuses on stocks with high Quadrix Overall scores, we generally eliminate any companies with extremely low Earnings Estimates scores from contention. Rapid declines in analyst estimates, which look forward, often signal a change in a company's operating environment. The Earnings Estimates score is volatile, and can be affected by technical factors or a nearterm blip in results. As an added check, we look at the Performance score, which measures stock returns. If a low Earnings Estimates score is confirmed by a low Performance score, real expectations have probably declined.

**Ducking value traps.** Our Quadrix Value score appeals to value investors. A screen for both high Value and Earnings Estimates scores can help identify stocks that are cheap, but gaining in favor.

**Confirming momentum.** Our Momentum score looks at recent operating results, favoring companies that have delivered strong growth in recent quarters. A high Earnings Estimates score may increase our confidence that momentum will continue.