

## Rising estimates boost stocks

As investors, we like to see earnings estimates increase. When analysts become more optimistic about a stock, we expect to see that stock rise. As is so often the case on Wall Street, intuition is borne out by research. Companies with rising earnings estimates do tend to outperform. The Quadrix® Earnings Estimates score considers growth targets and the dispersion of estimates, but the bulk of the score is determined by trends in estimate revisions.

Based on a backtest of stock returns in the 18 rolling 12-month periods since February 2004, the top 20% of companies in the S&P 1500 Index as measured by the Earnings Estimates score outperformed the average S&P 1500 stock by an average of 4.9%. Top scorers outperformed in 17 of the 18 periods.

While the Earnings Estimates score appears to work well for broad indexes like the S&P 1500, its effectiveness varies greatly from sector to sector. Revision trends are particularly good at ferreting out strong stocks in the consumer-discretionary, materials, and utilities sectors, but fare less well in the consumer-staples, industrials, and technology sectors.

A note of caution: While our backtest suggests the Earnings Estimates score is effective, we only have data back to February 2004. But other researchers have shown earnings-estimate trends can help identify winners over the long haul. Moreover, we do not use the Earnings Estimates score as the sole factor in our investment decisions, but instead as one part of the process.

Investors should also consider the volatility of Earnings Estimates scores because estimates often change quickly, then hold near the new level. For example: A company that issues strong profit guidance in mid-July may see estimates rise 20%, boosting the Earnings Estimates score that month. But if the estimate stabilizes at the higher number, by the end of August, the four-week change will be 0%, and the Earnings Estimates score could fall.

The bottom line: Companies with consistent increases in earnings estimates stand out from the pack.

