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Investing

Behind the Numbers, Part 4: Earnings momentum

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There are many ways to measure growth. For a young child, we might first think of using the change in height. But there are other ways, such as physical coordination or speaking ability.

Similarly, there is more than one way to measure a company's growth. In this fourth part of our series "Behind the Numbers," we are going to discuss *earnings momentum* – which refers to the growth in earnings of a company. When evaluating companies on growth, we focus on three things: quarterly earnings momentum, earnings surprises and estimate revisions.

Quarterly earnings momentum is the quarterly rate of change in annual earnings. For example, let's say a company's annual earnings were $2.20 per share. And, a quarter ago, the annual earnings were $2.00. This implies that annual earnings have grown 10% in the quarter. In the short term, stocks with strong earnings growth generally outperform those with weak earnings growth.

Earnings surprises looks at how much the most recent earnings were above or below expected earnings. In other words, how much analysts were surprised. Suppose a company recently reported earnings of 70 cents per quarter, resulting in clean earnings of 66 cents, after adjusting for one-time gains (or losses). If analysts had expected earnings of 60 cents, then this company had an earnings surprise of 10%. In the short term, stocks that beat expectations generally outperform those that miss expectations.

You will have noticed in this last example that the earnings number needed adjusting. This is why having clean numbers is important! Without the adjustment, the earnings growth would have been overstated. Usually the numbers we see in the newspaper or on the Internet are unadjusted. While we can still use those numbers for discussions, it's generally not a good idea to use them for making decisions as they may not be accurate.

Estimate revisions looks at how analysts' earnings estimates have changed. Have their estimates increased, decreased or stayed the same? In our example, the company had good earnings that were above expectations. This could result in analysts revising their future numbers upwards. The analysts might have been expecting $3 per share for next year. But now, after the seeing the latest results, they might revise their future expectations higher – perhaps to $3.30, resulting in a positive earnings revision, and a 10% increase in their estimates. In the short term, stocks with increasing earnings expectations generally outperform those with decreasing expectations.

In a long-term study using these three variables, researchers divided all Canadian stocks into five groups, sorted by earnings momentum, and calculated returns generated by each group. Here's how the returns looked from 1985 to 2018 (33 years):

Variable	Top Group	Bottom Group
Quarterly earnings momentum	10.0%	-0.4%
Earnings surprise	13.1%	-1.0%
Estimate revision	12.5%	-2.6%
TSX benchmark return: 8.1%		

Source: CPMS

As you can see, the overall results from investing in high-earnings momentum stocks (the top group) are very good and outperformed the market. Conversely, the returns from stocks with low momentum are relatively poor.

Now, this might make momentum investing look easy: Buy high momentum and avoid low momentum. But keep in mind that, unlike value investing, which is slow and steady, using only momentum variables also means high volatility and high turnover. This is why we use a combination of variables, including value and momentum, to get the best of both worlds. We'll talk about this some more next time. ■

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