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Earnings Surprise

Information Technology & Industrials Sectors Showing Greatest % in Positive Surprises

- Quantitative Analysis

- **What's New** — We added a new section analyzing the price impact of earnings surprise for each of the 10 S&P 500 GICS sectors during the current reporting period. The table highlights excess returns by sector and around their earnings results during the concurrent period associated with earnings announcement and the post earnings announcement drift.

- **Earnings Season** — Peak second quarter 2011 earnings continues through this week, as approximately 37% of the S&P 1500 are schedule to report between August 2 and August 31.

- **Earnings Scorecard** — In the month of July, approximately 58% of the companies in the S&P 500 Index have reported earnings for Q2 2011. Of those that reported, approximately 72% have resulted in a positive surprise, while 19% reported negative surprises and 9% reported in line.

- **Second Quarter Earnings Growth** — The second quarter 2011 estimated growth rate for the S&P 500 stands at 12.1%. On April 1st, the second quarter estimated growth rate was 14.8%. The increase is attributed to better-than-expected earnings reported by multiple companies within several sectors.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Earnings Surprise Forecast Model

In the first part of this report, we provide the lists of our latest forecasted earnings surprise candidates, and we summarize the historical performance of the earnings surprise forecast model in the second part. In the third part, we present an earnings scorecard and its price impact from their earnings surprise during this current reporting period. Next, we present the weekly performance of Russell 1000 stocks as a function of their earnings surprises from 12 weeks before their report dates to 12 weeks after their report dates. Our research continues to show that the rewards from accurately forecasting earnings surprises are much greater in the weeks before the earnings report than they are in the weeks after the earnings report. Furthermore, the most significant rewards are obtained by correctly forecasting surprises from 2 to 5 weeks before the earnings report to the week of the report. This observation underscores the importance of accurately forecasting second quarter 2011 earnings surprises at about this stage of the earnings cycle for the companies that will report between August 2 and August 31 (approximately 37% of the S&P 1500 members and 30% of the S&P 500 members). Finally, we offer a description of our earnings surprise model in the fifth part of this section.

Current Earnings Surprise Candidates

This month's earnings surprise candidates are those members of the First Call universe that are covered by at least two analysts, are covered by Citi Investment Research and Analysis analysts, and will be reporting their earnings between August 2 and August 31. We also require that negative surprise candidates have negative forecasted SUEs. Most of the companies reporting earnings during that period have fiscal quarters ending in April through June. Figure 1 contains our list of negative earnings surprise candidates, and Figure 2 contains our list of positive earnings surprise candidates. Also shown in the figures for each stock are the GICS sector, the market cap, the next earnings report date, the latest First Call EPS estimate for the next report period, our forecasted SUE, the CIRA rating, and the July 29th closing price.

Figure 1. Companies with Forecasted Negative Earnings Surprises

Ticker	Company Name	Sector	Market Cap (USD Million)	Expected Reporting Date	First Call Quarterly Estimate	Forecasted SUE	CIRA Rating	Closing Price (7/29/11)
DPM	DCP MIDSTREAM PARTNERS UNT	Energy	1,812.7	03-Aug-11	0.24	-0.59	1H	$41.12
REG	REGENCY CENTERS REIT	Financials	4,022.3	03-Aug-11	0.62	-1.24	1M	$44.92
CEDC	CENTRAL EUROPEAN DISTRIBUTION	Consumer Staples	701.5	04-Aug-11	-0.12	-0.46	1H	$9.68
FSS	FEDERAL SIGNAL	Industrials	358.9	04-Aug-11	0.08	-0.53	2H	$5.78
TREE	TREE.COM	Financials	61.1	12-Aug-11	-0.40	-1.25	2S	$5.56

Source: Citi Investment Research and Analysis and First Call

Figure 2. Companies with Forecasted Positive Earnings Surprises

Ticker	Company Name	Sector	Market Cap (USD Million)	Expected Reporting Date	First Call Quarterly Estimate	Forecasted SUE	CIRA Rating	Closing Price (7/29/11)
BPI	BRIDGEPOINT EDUCATION	Consumer Discretionary	1,304.7	02-Aug-11	0.69	3.04	1H	$24.76
CTSH	COGNIZANT TECHNOLOGY SOLUTN CL A	Information Technology	21,255.2	02-Aug-11	0.66	2.79	1M	$69.87
BEN	FRANKLIN RESOURCES	Financials	28,165.2	02-Aug-11	2.17	3.41	1L	$126.96
LNC	LINCOLN NATIONAL	Financials	8,306.6	02-Aug-11	0.94	2.85	2H	$26.50
WBMD	WEBMD HEALTH	Information Technology	2,037.5	02-Aug-11	0.28	5.01	2H	$35.25
EQY	EQUITY ONE REIT	Financials	2,065.4	03-Aug-11	0.27	7.73	3H	$19.40
DTV	DIRECTV CL A	Consumer Discretionary	39,444.8	04-Aug-11	0.85	2.90	2M	$50.68
HUN	HUNTSMAN	Materials	4,565.5	04-Aug-11	0.49	3.39	2H	$19.10
MCHP	MICROCHIP TECHNOLOGY	Information Technology	6,397.0	04-Aug-11	0.54	2.71	2M	$33.75
PSA	PUBLIC STORAGE REIT	Financials	20,273.8	04-Aug-11	1.37	3.20	1M	$119.63
TLEO	TALEO CL A	Information Technology	1,354.7	04-Aug-11	0.21	4.35	1H	$33.10
PPL	PPL	Utilities	13,520.8	05-Aug-11	0.45	2.93	2M	$27.90
WTW	WEIGHT WATCHERS INTERNATIONAL	Consumer Discretionary	5,637.1	05-Aug-11	1.12	2.70	2H	$77.19
DISH	DISH NETWORK CL A	Consumer Discretionary	13,139.9	09-Aug-11	0.79	2.98	1M	$29.63
MDSO	MEDIDATA SOLUTIONS	Health Care	494.3	09-Aug-11	0.33	7.66	2H	$20.43
AVT	AVNET	Information Technology	4,476.0	10-Aug-11	1.15	3.00	1H	$29.30
CSCO	CISCO SYSTEMS	Information Technology	87,851.0	10-Aug-11	0.38	3.02	2M	$15.97
M	MACYS	Consumer Discretionary	12,275.5	10-Aug-11	0.49	2.95	1H	$28.87
EL	ESTEE LAUDER CL A	Consumer Staples	20,676.7	15-Aug-11	0.24	3.08	1M	$104.91
ADI	ANALOG DEVICES	Information Technology	10,307.4	16-Aug-11	0.74	2.68	1M	$34.40
DELL	DELL	Information Technology	30,839.8	16-Aug-11	0.48	3.32	1M	$16.24
TW	TOWERS WATSON	Industrials	4,524.3	16-Aug-11	1.03	7.31	1H	$61.15
HPQ	HEWLETT PACKARD	Information Technology	74,771.4	18-Aug-11	1.09	2.73	1M	$35.17
BRCD	BROCADE COMMUNICATIONS SYSTEMS	Information Technology	2,612.6	19-Aug-11	0.11	2.90	1S	$5.48
RUE	RUE21	Consumer Discretionary	801.8	22-Aug-11	0.32	3.09	2M	$32.87
DSW	DSW CL A	Consumer Discretionary	1,024.9	29-Aug-11	0.62	3.06	1M	$52.98
COO	COOPER	Health Care	3,589.9	30-Aug-11	1.08	3.64	2H	$76.49
BFb	BROWN FORMAN CL B	Consumer Staples	10,665.5	31-Aug-11	0.83	5.62	1M	$73.56

Source: Citi Investment Research and Analysis and First Call

Historical Performance of the Earnings Surprise Forecast Model

To review our recent earnings surprise forecasting accuracy, we note that we identified 72 companies as positive surprise candidates at the beginning of July. Of those, 70 have reported their earnings, and 50 (71%) actually experienced a positive surprise, while 63% of all the Russell 1000 companies that reported in July had positive surprises. We identified 6 negative surprise candidates last month. Of those, 4 reported their earnings, and 2 (50%) actually experienced a negative surprise versus 37% of all Russell 1000 companies that reported in July.

From the model’s inception in January 1996 through last month, 75% of the companies we identified as positive surprise candidates actually experienced positive surprises, while only 60% of reporting companies in the Russell 1000 Index had positive surprises. Likewise, 52% of the companies we identified as negative surprise candidates actually experienced negative surprises compared with only 37% of all Russell 1000 constituents. Our model has thus far identified both positive and negative earnings surprises with more accuracy than what could be achieved with random stock selection. However, we note that past performance does not guarantee future results, and the historical returns of our model portfolios do not include transaction costs. Historical forecast details are available on request.

Earnings Scorecard

Figure 3. S&P 500 Earnings Scorecard

	2011 / Q2								
Name	# Cos Reported	# Cos Reported	% Cos Reported	# In-line	% In-line	# Pos Surprise	% Pos Surprise	# Neg Surprise	% Neg Surprise
S&P 500	291	291/500	58.2%	25	8.6%	210	72.2%	56	19.2%
Consumer Discretionary	31	31/78	39.7%	3	9.7%	22	71.0%	6	19.4%
Consumer Staples	17	17/41	41.5%	2	11.8%	13	76.5%	2	11.8%
Energy	25	25/42	59.5%	0	0.0%	16	64.0%	9	36.0%
Financials	56	56/82	68.3%	6	10.7%	38	67.9%	12	21.4%
Health Care	35	35/52	67.3%	6	17.1%	25	71.4%	4	11.4%
Industrials	47	47/60	78.3%	2	4.3%	37	78.7%	8	17.0%
Information Technology	46	46/74	62.2%	2	4.3%	39	84.8%	5	10.9%
Materials	23	23/30	76.7%	4	17.4%	12	52.2%	7	30.4%
Telecommunication Services	3	3/8	37.5%	0	0.0%	2	66.7%	1	33.3%
Utilities	8	8/33	24.2%	0	0.0%	6	75.0%	2	25.0%

Source: Citi Investment Research and Analysis and IBES

In Figure 3, we show the earnings scorecard for the second quarter of 2011, where we track surprises for the companies of the S&P 500 Index.

As of data through July 29th, approximately 58% of the companies within the S&P 500 Index have reported their earnings for Q2 2011. Approximately 72% of the companies reported a positive surprise, 19% of the companies reported negative surprises, and 9% of the companies reported in-line. The companies in the Information Technology, Industrials and Consumer Staples sectors showed the greatest percentage in positive surprises, while the Energy, Telecommunication and Materials sectors showed the greatest negative surprises during this reporting quarter.

In Figure 4, we show the price impact of earnings surprise for each of the 10 S&P 500 GICS sectors during the current reporting period.

Figure 4. Market Excess Returns During Earnings Announcement

	Report Date +1 day			Day 2 to Day 5 after report date		
	Positive	In-Line	Negative	Positive	In-Line	Negative
Consumer Discretionary	1.16	(5.42)	(4.03)	(1.26)	(2.56)	0.69
Consumer Staples	(2.51)	(4.16)	(6.77)	1.10	0.77	1.92
Energy	2.78	NA	(1.19)	(0.38)	NA	(0.77)
Financials	0.91	2.39	0.11	0.01	0.02	0.86
Health Care	1.99	(2.50)	(12.44)	(0.82)	(0.98)	(3.70)
Industrials	1.12	NA	(6.88)	(1.93)	NA	(2.62)
Information Technology	0.12	(8.08)	(0.59)	(0.06)	2.95	(0.00)
Materials	(0.66)	(2.58)	(7.56)	(1.09)	(1.39)	0.25
Telecommunication Services	(2.13)	NA	NA	0.30	NA	NA
Utilities	NA	NA	NA	NA	NA	NA

Source: Citi Investment Research and Analysis and IBES

We examine the impact of earnings announcements on share prices between two periods. The 1st time period (Report Date + 1 Day) shows the concurrent returns associated with earnings announcement. The 2nd time period (Day 2 to Day 5 after report date) captures the post earnings announcement drift.

The data shown are excess returns (expressed in % terms) relative to the S&P 500 index and covers the stocks that had their EPS reported between July 11 and July 22 to capture returns for both time periods.

Historical Price Impact of Earnings Surprises

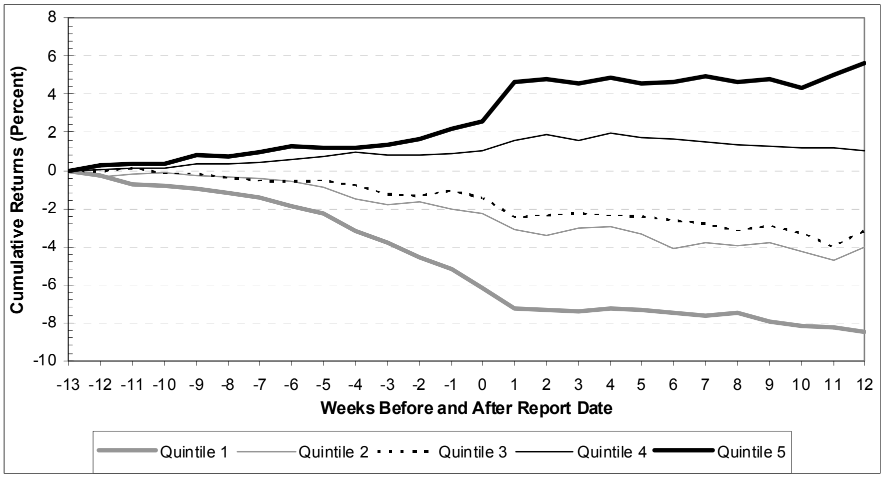
We describe in this section how we measure the price impact of earnings surprises. For a given quarter, we compute the standardized unexpected earnings (SUE) of every company in the Russell 1000 Index. The SUE is defined as the difference between the company's actual reported earnings and the mean of the analysts' estimated earnings, divided by the standard deviation of the estimates. We use the earnings estimates that prevailed six weeks before the report date because we have found that estimates made nearer to the report date are often affected by preannouncements that dilute any subsequent surprises.

We next sort the stocks in ascending order by their SUEs and group them into quintiles. All stocks with both negative surprises and zero standard deviations are placed in the first quintile (largest negative surprises). Likewise, all stocks with both positive surprises and zero standard deviations are placed in the fifth quintile (largest positive surprises). Stocks with zero surprises are placed in the third quintile. If the number of stocks with both negative surprises and zero standard deviations exceeds the normal number of stocks in a quintile (that is, one-fifth of the entire universe), only those stocks are placed in the first quintile. Otherwise, additional stocks with the lowest SUEs and non-zero standard deviations are also placed in the first quintile until the number of stocks equals one-fifth of the total universe. A similar rule applies to the stocks in the fifth quintile.

We then measure the weekly market-relative total return of every stock in each quintile from 12 weeks before their report dates to 12 weeks after their report dates. The market-relative total return is the total return of the stock minus the total return of the equally weighted Russell 1000 benchmark. We then compute the median market-relative total return of each quintile for each week. We repeat this entire procedure for every quarter in the period of interest. Then, for each quintile and each week, we measure the median market-relative return over all the quarters and plot the resulting values versus time.

Figure 5 shows the quintile performance of Russell 1000 stocks from the fourth quarter of 1994 to the fourth quarter of 2010 using the earnings estimates that prevailed six weeks before the report date. We show the returns from 12 weeks before the report date to 12 weeks after the report date. Also, the performance of the quintiles over most of the 25-week period was ordered exactly by quintile number.

Figure 5. Price Impact of Earnings Surprises: Quintile Performance of Russell 1000 Stocks from Fourth Quarter 1994 to Fourth Quarter 2010



Source: Citi Investment Research and Analysis and I/B/E/S

Figure 6 shows the average difference between the weekly returns of quintile five (the largest positive surprises) and those of quintile one (the largest negative surprises) from 12 weeks before the report date to six weeks before the report date, from five weeks before to the week of the report, and one week after to 12 weeks after report date.

Figure 6. Average Weekly Return Spread (%) Between Quintile Five and Quintile One Before and After Report Date for Two Periods

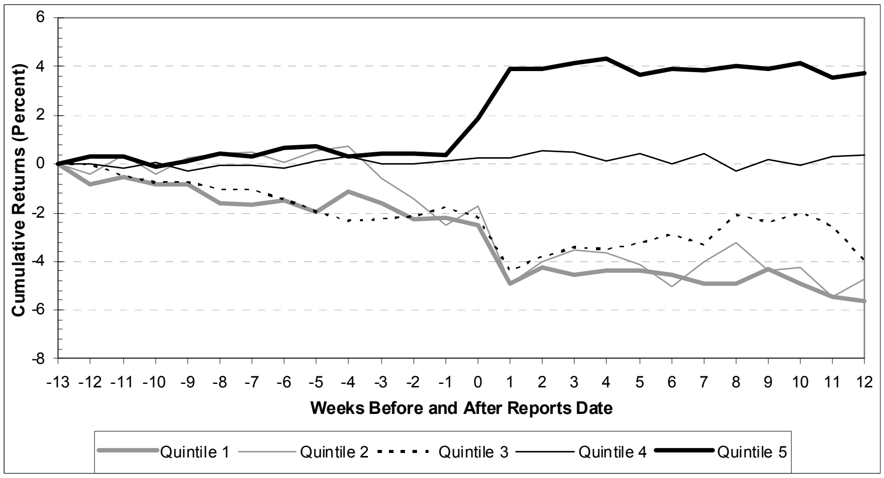
Time Period	12 Weeks Before to 6 Weeks Before Report Date	5 Weeks Before to Week of Report Date	One Week After to 12 Weeks After Report Date
4Q 1994 to 4Q 2010	0.45	0.96	0.45
1Q 2010 to 4Q 2010	0.31	0.37	0.42

Source: Citi Investment Research and Analysis and I/B/E/S

The second column of Figure 6 shows that the average weekly return difference between quintile five and quintile one from 12 weeks before the report date to six weeks before the report date was 0.45 percentage point during the longer period versus 0.31 percentage point during the recent four-quarter period. The next column shows the average weekly return difference from five weeks before to the week of the report date was higher for the longer period (0.96 versus 0.37 percentage point). The last column shows the longer period with 0.45 percentage point for the one week after the report date to 12 weeks after the report date and 0.42 for the shorter period. Currently, the longer period outperformed the four quarter period on all time periods. However, the excess returns from five weeks before the report date to the week of the report date showed the largest excess returns of the two other periods. Therefore, it appears that since the end of 1994 and during the recent four-quarter period that ended last December, the most significant excess returns were obtained by accurately predicting the earnings surprises from five weeks before to week of report date. This observation underscores the importance of accurately forecasting earnings surprises from approximately five weeks before a company reports to just before the actual report date, or at approximately the current stage of the second quarter of 2011 earnings cycle for the companies reporting from August 2 and August 31.

In Figure 7, we show the same quintile performance presented in Figure 5, but for the more recent and shorter four-quarter period from the first quarter of 2010 to the fourth quarter of 2010.

Figure 7. Price Impact of Earnings Surprises: Quintile Performance of Russell 1000 Stocks from First Quarter 2010 to Fourth Quarter 2010



Source: Citi Investment Research and Analysis and I/B/E/S

Description of the Citi Investment Research and Analysis Earnings Surprise Forecast Model

The Citi Investment Research and Analysis earnings surprise forecast model attempts to predict which stocks should experience an earnings surprise during the next reporting period and whether the surprise will be positive or negative. We define an earnings surprise as the actual reported quarterly EPS, less the mean consensus EPS estimate, all divided by the standard deviation of the estimates. This ratio is called the standardized unexpected earnings (SUE), and it normalizes earnings surprises by the degree of analyst uncertainty. Thus, a large standard deviation of analysts' estimates for a specific company implies a high degree of uncertainty over the company's earnings prospects. Therefore, any potential surprise is probably already discounted. On the other hand, when the range of estimates is narrow, even a small surprise can be a significant event. We compute the realized SUE of every stock in the First Call universe for the most recent 16 quarters and regress them on the following independent variables:

1. *The realized SUE of the two previous quarters*: Earnings surprises are serially correlated; that is, they tend to repeat in the same direction. We also account for the observation that the magnitude of the correlation differs for positive and negative surprises.
2. *Earnings estimate momentum*: Revisions in earnings estimates tend to precede earnings surprises in the same direction. We use the difference between the latest FY1 consensus estimate and the estimate nine weeks ago, divided by the current stock price, as our measure of estimate momentum.
3. *Price momentum*: Price movements also tend to precede earnings surprises in the same direction. We use the market-relative total return over the prior 20 days as our measure of price momentum.
4. *Equity capitalization*: Larger companies tend to experience positive surprises. We use the natural logarithm of equity capitalization as our size variable.
5. *Sales growth*: A positive surprise often follows an increase in sales over the most recent four quarters. We use the natural logarithm of the ratio of the most recent four quarters' sales to the next most recent four quarters' sales as our growth variable.
6. *Profit margin momentum*: Large increases in profit margin tend to precede large positive earnings surprises. We use the quarterly difference of the natural logarithm of the ratio of the most recent four-quarter earnings to four-quarter sales as our momentum variable.

We then multiply the resulting regression coefficients by the current values of the corresponding variables and sum the products to obtain our forecasted SUEs. We apply the model to every stock in the First Call universe that has at least six months of consensus earnings estimates and is covered by at least two analysts. Stocks are ranked in ascending order by their forecasted SUEs, and those in the five highest percentiles (with the highest forecasted SUEs) whose earnings report date falls within the next six weeks and that are covered by Citi Investment Research and Analysis analysts become members of our current positive earnings surprise list. Stocks in the five lowest percentiles with the lowest forecasted SUEs become members of our current negative earnings surprise list. We also require that members of the negative earnings surprise list have negative forecasted SUEs.

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Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

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	12 Month Rating	Relative Rating

Data current as of 30 Jun 2011	Buy	Hold	Sell	Buy	Hold	Sell
Citi Investment Research & Analysis Global Fundamental Coverage	54%	36%	11%	10%	81%	10%
% of companies in each rating category that are investment banking clients	45%	41%	42%	50%	42%	44%
Citi Investment Research & Analysis Quantitative World Radar Screen Model Coverage	30%	40%	30%			
% of companies in each rating category that are investment banking clients	26%	21%	20%			
Citi Investment Research & Analysis Quantitative Decision Tree Model Coverage	48%	0%	52%			
% of companies in each rating category that are investment banking clients	53%	0%	43%			
Citi Investment Research & Analysis Asia Quantitative Radar Screen Model Coverage	20%	60%	20%			
% of companies in each rating category that are investment banking clients	26%	23%	19%			
Citi Investment Research & Analysis Australia Radar Model Coverage	49%	0%	51%			
% of companies in each rating category that are investment banking clients	35%	0%	8%			

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Investment ratings are a function of CIRA's expectation of total return (forecast price appreciation and dividend yield within the next 12 months) and risk rating.

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