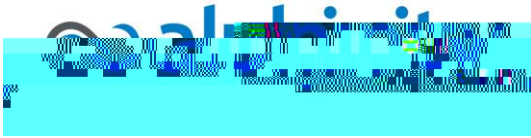


Alphinity Investment Management

November 2016

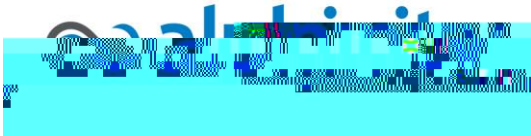


Finding alpha in an earnings upgrade cycle

About Alphinity

Alphinity Investment Management (Alphinity) is a boutique investment manager whose goal is to add value through an investment philosophy and process that is distinctive, rigorous and disciplined.

attractively valued, qual



Research by Van Wyk (2012)³ measured the performance of an equally weighted portfolio of Australian positive earnings surprise stocks. This portfolio outperformed the market by an average of 25.1% (t-stat 5.75, highly significant) in the following 12 months. The performance of the portfolio is demonstrated in the chart below.

Figure 1: Cumulative equity return 12 months after positive earnings surprise

Source RBS Australia

This study was neutral to industry, size, volatility and beta. Positive earnings surprises were defined as stock specific return greater than two standard deviations in the three days around an earnings announcement.

The impact of negative earnings surprises on stock prices has also been tested. Research by UBS Australia⁴ provides valuable evidence of the serial correlation of earnings revisions or how earnings revisions are typically sustained for an extended period of time.

Measured over a period from December 1991 to November 2012 the UBS study showed:

- ◁ 74% of downgrade cycles consist of more than one downgrade.
- ◁ The average downgrade cycle in Australia over this period is 4.8 downgrades, and the maximum number is 34. Downgrades have

³ Van Wyk (2012) Capturing the trend after reporting season: RBS Equities (Australia) p2

⁴ Balasubramanian (2012) Mythbusting the downgrade cycle, UBS Securities (Australia) cycle p1

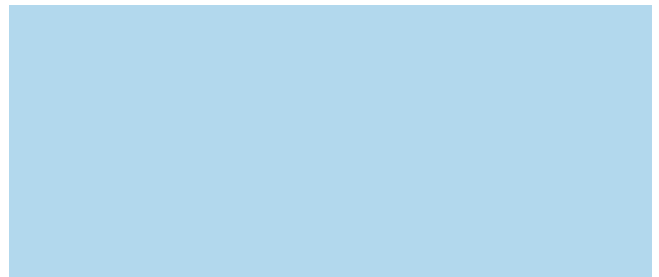
⁵ Buffet (2014) Berkshire Hathaway Annual Report p18

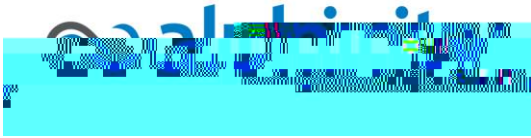
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lasted between 1 and 53 months, the average being 9.4 months.

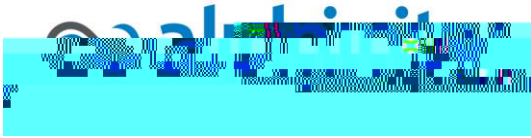
- ◁ Stocks in a downgrade cycle underperformed the market by 4.5% on average for the duration they are in the downgrade cycle.

Warren Buffett referenced this correlation of



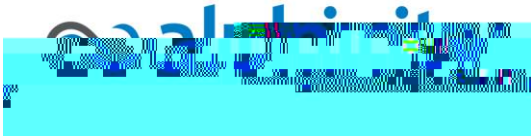


Finding alpha in an earnings upgrade cycle



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- ◁ **Anchoring:** Analysts naturally anchor to their old earnings estimates until there is overwhelming evidence the earnings change is due to permanent rather than temporary factors. This leads to subsequent upgrades.
- ◁ **Framing:** New information is framed in the context of past events. Tversky and Kahneman (1981) showed the psychological principles that govern the perception of decision making. Market participants need to know the full story to get comfortable with why the earnings have changed.



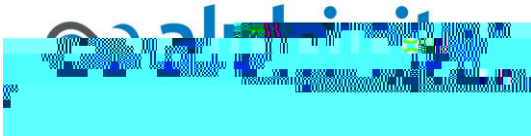
accruals and income provisioning. The key to a quality company is the strong sustainability of its cash flows over long periods of time across various economic environments. In addition being good stewards of investor capital, and generating a good return for shareholders.

Quality can be observed by an improving return on equity, stable and sustainably increasing profit margins, increasing balance sheet capacity and consistent free cash flow generation. These factors increase the likelihood and sustainability of future positive earnings surprises whilst a deterioration in these factors can indicate potential negative future earnings surprises.

Valuation

Research and experience shows that combining Value and Momentum (measured in the form of earnings revisions and price momentum) will deliver superior outperformance. The conclusion of a study into value and momentum operating together by Asness et al (2009) states:

expected abnormal returns in a variety of markets and asset classes, their combination performs even better than



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Important information

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