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STRATEGIES

Report Earnings, and Watch the Stock Fall

By MARK HULBERT

MOMENTUM investing — a bet that what has gone up will keep going up — is risky at any time. But it is especially so during earnings season, when stocks often move up and down very abruptly; in fact, the top-performing stocks are particularly vulnerable during these periods. And a new study has found that these highfliers tend to fall immediately after their companies announce their earnings — whether those earnings are good or bad.

The study, "Limited Attention and the Earnings Announcement Returns of Past Stock Market Winners," has been circulating for several months in academic circles as a working paper. Its authors are David Aboody and Brett Trueman, both professors of accounting at the University of California, Los Angeles, and Reuven Lehavy, a professor of accounting at the University of Michigan.

Their findings serve as a warning about the risks of buying stocks whose prices have been pushed unjustifiably high by mass enthusiasm.

The professors looked at stocks that had been the very best performers over 12-month periods. Such stocks — those whose trailing 12-month returns were in the top 1 percent of stocks traded on American exchanges — tend to rise quite predictably in the days leading up to their companies' earnings announcements — and then to abruptly give up all of those gains. The professors reached this conclusion after studying each earnings season from January 1971 through September 2005.

The patterns they found were quite pronounced. Consider two hypothetical portfolios that the professors built from this group of stocks.

The first bought each stock five business days before its earnings were to be announced, and sold each one just before the actual announcement. The second portfolio bought each stock immediately after the earnings announcement and held the stock for five business days. The first portfolio beat the market by an annualized rate of 47 percentage points, according to the professors, while the second lagged the market by an annualized rate of 43 percentage points.

(These rates of return reflect the effect of bid-asked spreads. Though they don't take brokerage commissions into effect, the professors say the portfolios would still beat or lag the market by large margins even after such costs.)

The professors did not find nearly as pronounced a run-up and drop-back among stocks whose 12-month performance was only slightly behind that of the stocks that led the momentum hit parade. Why was this pattern concentrated among such a small group of top performers?

The professors surmise that this is the answer: As earnings season begins, these stocks receive a disproportionate share of attention from small investors, no doubt largely because they are at the top of the leader board for 12-month returns. This appears to lead many of those investors into bidding these stocks even higher, to levels that may be unsustainable.

The stocks decline when reality sets in — after the excitement of a positive earnings report ebbs, or, more sharply, after an earnings report disappoints the market.

These results would seem to illustrate a hazard of momentum investing — that it works only as long as it works. When momentum reverses itself, a stock may plummet.

IT'S theoretically possible that after dropping back in the wake of earnings announcements, this group of stocks will recover over the following few months, Professor Trueman said in an interview. But he said that this study didn't investigate possible recovery trends, so investors would be going out on a limb in betting on one.

Another option for momentum traders would be to avoid altogether the stocks at the top 1 percent of the rankings, betting instead on those that have performed just slightly behind those leaders — and thus were less likely to be magnets for some small investors. As a result, Professor Trueman said, their prices will be less likely to be thrown out of whack.

Over all, though, the study suggests just how risky momentum strategies can be. Stocks that rise sharply may

fall in just a few days' time. And they most definitely are not for the weak of heart.

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