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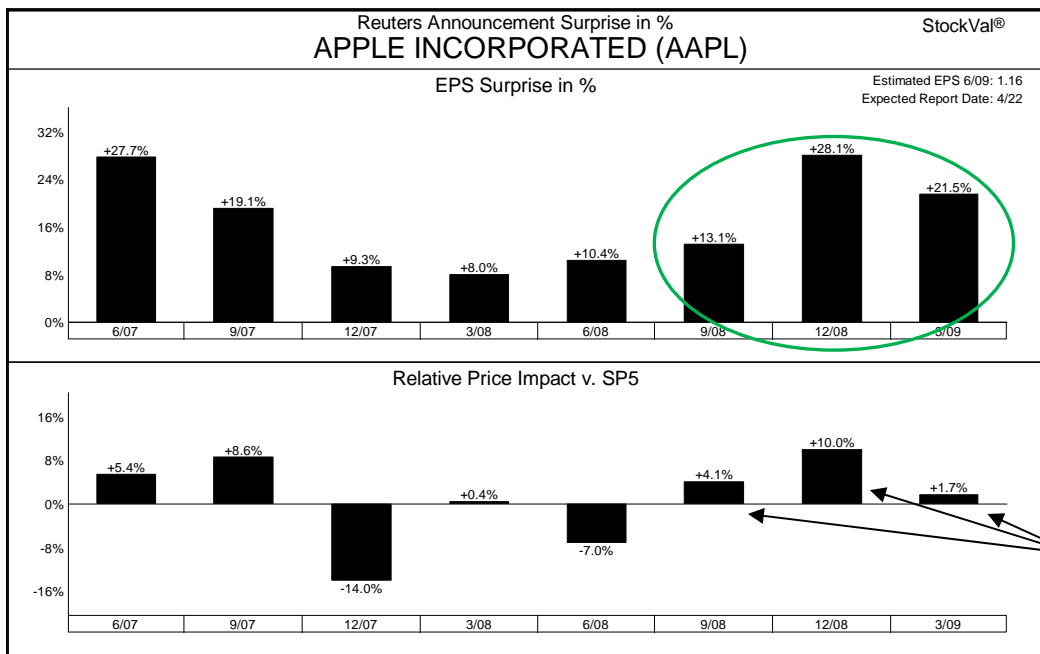
Risky Business: **The “Cockroach Theory” – Who Will (and Won’t) Likely Beat Expectations?** *(Part Five, update from March 30, 2009)*

Welcome to Risky Business -- our Traders' Notes devoted to what we view as important risk management issues currently faced by equity portfolio managers. This publication will serve as a window into our current thoughts and actions as we actively risk-manage our Riverfront portfolios.

This piece is a continuation of pieces published on March 30, 2009, July 28, 2008, and December 29, 2008 (in the Equity View) and July 16, 2008 and October 22, 2008 (in Traders' Notes). We plan on refreshing this theme at the beginning of each earnings season in order to help investors looking to bolster portfolio quality and reduce the risk of negative surprises during earnings season. We use a series of quantitative screens with a technical analysis overlay to attempt to locate stocks that could potentially disappoint in earnings, as well as a group that may have a better-than-average chance of beating numbers.

Companies in Motion Tend to Stay in Motion...

We presage our discussion with an admission -- we tend to believe that, more often than not, companies that beat earnings last quarter, particularly by a wider-than-average margin, have a higher-than-average chance of doing it again. First, earnings reports that beat expectations should be taken seriously, in most cases, as a sign that something good is likely happening in the company's business trends and/or margin management. As companies have been dealing with economic dislocation for more than a year and a half now, we think these times will continue to distinguish the “haves” from the “have nots” so to speak; making the contrast fairly dramatic between the companies able to power through and those that aren't able to do so. Examples of “have” types of companies we list, such as Apple Inc (AAPL), IBM (IBM), and Dollar Tree (DLTR) have indeed continued to pleasantly surprise investors in recent quarters despite widespread economic dislocation. (see chart below).



In the case of Apple, the company has put together a strong record of beating earnings expectations, and the last three quarters in particular bear this out. The stock beat consensus earnings expectations and has outperformed the S&P 500 on its day of earnings each of the last three quarters.

This performance is particularly impressive, in our view, given the sharp downturn in US and global consumer spending over the same timeframe.

Chart courtesy of Reuters StockVal; Past performance is no guarantee of future results.

Our conclusion is that an earnings report that is above expectations (particularly by a wide margin, and particularly in today's economic conditions) could be a sign that a company may have more than adequate reserve fuel in its tank, and potentially a strong next quarter (or more) still left in it. The painful part for investors is the flip side of this scenario; i.e., companies that have recently disappointed investors on earnings are likely to do so again. We call it the “cockroach” theory (if you see one operating issue with a

company, there are likely to be more you haven't seen yet), and despite the disgustingly descriptive title of this piece, it's surprisingly apt, for similar reasons to those mentioned above.

Buying Earnings Momentum More Difficult to Swallow than “Bottom-Fishing”...But Can Often be the Right Move

So, why isn't this strategy more widely accepted? Does buying strong earnings momentum stories require investors to buy stocks well off their lows? Often times, the answer is yes, which is why the process is frowned upon by many “value” investors who choose to try and predict business model turnarounds, or “bottom-fish,” in common investing parlance. Of course, if an investor is highly skilled at predicting when poor business trends in a company are about to improve significantly, then there are considerable gains to be made by “bottom-fishing.” However, we've only seen a few investors who are able to time these improvements consistently (and we wouldn't count ourselves among them). We think the higher efficacy decision is to focus less on prediction and more on the process of building the foundation of one's portfolio with companies whose business models are hitting on all cylinders, particularly when economic headwinds are blowing.

Recommended Action: Build your portfolio foundation on companies that appear to have gas left in the tank

We used a series of quantitative screens to help ascertain which companies might have “gas left in the tank” for continued earnings upside in the future, and which might be out of gas (i.e. candidates for “cockroach” status). The screens primarily searched for recent earnings surprises well in excess of, or well below, historical patterns. We cross-referenced these rankings with screens that ranked companies on their amount of leverage and general balance sheet liquidity (a very relevant metric, in our view, in today's liquidity-constrained environment). From there, we also used technical analysis to arrive at two separate lists -- a list that we consider to be attractive, as well as a list of stocks to avoid heading into earnings season.

A Recent Evolution of Our “Cockroach” Screen Methodologies

We believe that quantitative screens, while emotionally pure, often have potential problematic areas, and ours are no different. Therefore, for the newest edition of the “Cockroach Theory,” we've attempted to identify and address a couple potential shortcomings in our previous process:

- **Need to Account for “So Bad, They're Good” Stocks:** This refers to stocks for which expectations are so low (from both sell-side analyst as well as buy-side investor perspectives) that very pessimistic views are already “priced in,” rendering the stock primed for upside share price surprises if the news comes in even slightly less terrible than predicted. We think this risk can be amplified in deep bear markets due to many stocks residing at historically depressed valuation levels.
 - To help combat this, we integrated a check using what quantitative research provider Ned Davis Research calls the “Earnings Torpedo” measure; this measure takes a consensus forward earnings estimate and compares it to earnings performance over the last four quarters; low scores indicate low expectations going forward. Therefore, if a particular stock's embedded expectations were singled out as low on this NDR screen, we removed it from the “Avoid” list.
- **Are pre-announcements and guidance muting the impact of earnings performance as a stock price driver?** Formal earnings pre-announcements by companies could potentially cloud our methodology for finding “cockroaches,” because consensus almost immediately changes to fit the new view of reality. Therefore, by the time the stock gets to the *actual* earnings call, the impact of the released earnings performance and the subsequent variation from the now-altered consensus estimates can be severely lessened, muting the “surprise” factor. Also, while a company may beat earnings, stock performance often hinges these days on the forward earnings guidance that many management teams issue to investors during the call.
 - To help combat this, we also focus on relative stock performance on the day of the earnings call; if the stock performs poorly relative to the market on the day of earnings, one of a number of things probably happened -- earnings and/or operating metrics (regardless of whether a preannouncement existed) were below current expectations, guidance was below expectations, or some combination of the two. As fiduciaries, the cause matters less than the result -- a “cockroach” stock that's likely to underperform, precisely the type of company we are looking to identify ahead of time in order to risk manage.
 - Therefore, we eliminated stocks from our “avoid” list whose share prices relative to the S&P 500 responded positively to the last earnings report, regardless of where EPS came in relative to consensus expectations. This is due not only to our belief that positive reactions to terrible news can often be a sign of a stock that's valued too pessimistically by the market (i.e., the stock's price level and/or forward guidance already reflects extremely depressed expectations -- see “So Bad, They're Good” stocks bullet above), but also to help account for stocks for which a pre-announcement or guidance was a main driver of stock price performance.

Based on our screens, we believe the following stocks look attractive heading into earnings season (estimated earnings date included where possible -- these dates are mostly unconfirmed and should be double-checked closer to the listed date)

- Fluor Corp (FLR-N-\$51.29) – 8/10
- IBM (IBM-N-\$104.42)¹ – 7/16
- Colgate-Palmolive (CL-N-\$70.74) – 7/30
- Apple Inc (AAPL-NasdaqGS-\$142.43)¹ – 7/22
- Dollar Tree (DLTR-NasdaqGS-\$42.10) – 8/27
- Express Scripts (ESRX-NasdaqGS-\$68.75) – 7/29
- Verizon (VZ-N-\$30.73) – 7/27
- Hudson City Bancorp (HCBK-NasdaqGS-\$13.29) – 7/20
- Aflac (AFL-N-\$31.09) – 7/29
- Teradata (TDC-N-\$23.43)¹ – 8/7

Based on our screens, here are some names we would avoid heading into earnings season:

- Zions Bancorp (ZION-NasdaqGS-\$12.85) – estimated earnings date: 7/20
- RPM International (RPM-N-\$14.04) – 7/27
- Molex Inc (MOLX-NasdaqGS-\$15.55)¹ – 8/4
- Washington Post (WPO-N-\$352.18) – 7/31
- United States Steel (X-N-\$35.74) – 7/28
- NVIDIA Corp (NVDA-NasdaqGS-\$11.29)¹ – 8/12
- Applied Materials (AMAT-NasdaqGS-\$11.01)¹ – 8/11
- SunTrust Banks (STI-N-\$17.27) – 7/20
- Reynolds American (RAI-N-\$38.62) – 7/27
- Archer Daniels Midland (ADM-N-\$26.77) – 8/10

1. Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Note: *Many of the companies listed above report quarterly earnings in the next 2-6 weeks...stocks generally tend to be highly volatile around earnings season, so we would suggest apportioning risk appropriately based on an investor's risk tolerance*

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Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 75% of the total US equities market.

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