Session 25

Information Trading: Public Information – Earnings Reports

Test

1. A company that reports lower earnings should see its stock price go down.
    a. True
    b. False
2. Studies of earnings reports look at the market reaction to earnings surprises, i.e., the difference between the actual earnings and the expected earnings. Which of the following statements best summarizes what these studies have found for <u>positive earnings surprises</u>?
    a. Prices start to drift up before the announcement, jump further up on the announcement and continue to drift up after the announcement.
    b. Prices are flat before the announcement, jump up on the announcement and are flat after the announcement.
    c. Prices are flat before the announcement, jump up on the announcement and continue to drift up after the announcement.
    d. Prices start to drift up before the announcement, jump further up on the announcement and are flat after the announcement.
    e. Prices start to drift up before the announcement, jump further up on the announcement but drift down after the announcement.
    f. Prices are unaffected by earnings surprises.
3. Assume that you are investor who wants to exploit the market reaction to earnings surprises, but you want to invest before the earnings are announced. Which of the following strategies would you adopt?
    a. Buy companies that have had positive earnings surprises in the past.
    b. Buy companies that have had negative earnings surprises in the past.
    c. Buy companies where expected earnings growth is highest.
    d. Buy companies where expected earnings growth is lowest.
    e. None of the above.
    Explain why.
4. Companies sometimes delay reporting earnings to the market. When earnings reports are delayed, relative to the expected announcement date, which of the following would you expect the report to contain?
    a. A positive earnings surprise, i.e., higher earnings than expected.
    b. A neutral earnings report, i.e., earnings are close to expected.
    c. A negative earnings surprise, i.e., lower earnings than expected.
5. When the earnings are reported, there is a price reaction on the date of the report, with prices going up for positive surprises and down for negative surprises. Which of the following statements best summarizes the nature of the intraday reaction?
    a. The price reaction occurs over gradually over the course of the day.
    b. Most of the price reaction occurs in the first hour after the announcement, with a faster response for positive than for negative surprises.

c. Most of the price reaction occurs in the first hour after the announcement, with a slower response for positive than for negative surprises.

Solution

1. A company that reports lower earnings should see its stock price go down.
    a. True
    b. False

Explanation: It is not the earnings per se that matters, but how it measures up to expectations. Thus, if a company reports lower earnings, but not as low as expected, it may be a positive surprise.

2. Studies of earnings reports look at the market reaction to earnings surprises, i.e., the difference between the actual earnings and the expected earnings. Which of the following statements best summarizes what these studies have found for <u>positive earnings surprises</u>?
    a. Prices start to drift up before the announcement, jump further up on the announcement and continue to drift up after the announcement.
    b. Prices are flat before the announcement, jump up on the announcement and are flat after the announcement.
    c. Prices are flat before the announcement, jump up on the announcement and continue to drift up after the announcement.
    d. Prices start to drift up before the announcement, jump further up on the announcement and are flat after the announcement.
    e. Prices start to drift up before the announcement, jump further up on the announcement but drift down after the announcement.
    f. Prices are unaffected by earnings surprises.

Explanation: With positive earnings surprises, it looks like the price starts to drift up in the days before the announcement (reflecting insider trading), jump on the announcement and continue to drift up in the days after.

3. Assume that you are investor who wants to exploit the market reaction to earnings surprises, but you want to invest before the earnings are announced. Which of the following strategies would you adopt?
    a. Buy companies that have had positive earnings surprises in the past.
    b. Buy companies that have had negative earnings surprises in the past.
    c. Buy companies where expected earnings growth is highest.
    d. Buy companies where expected earnings growth is lowest.
    e. Any of the above as long as ________________.
    Explain why.

Explanation: The key is to be able to predict which companies are most likely to have positive earnings surprises. A story can be said about each of the choices here working as a predictor but the evidence has to be collected to back it up.

4. Companies sometimes delay reporting earnings to the market. When earnings reports are delayed, relative to the expected announcement date, which of the following would you expect the report to contain?
    a. A positive earnings surprise, i.e., higher earnings than expected.

   b. A neutral earnings report, i.e., earnings are close to expected.
   c. **A negative earnings surprise, i.e., lower earnings than expected.**

Explanation: Delayed earnings reports are more likely to contain bad news than good news.

5. When the earnings are reported, there is a price reaction on the date of the report, with prices going up for positive surprises and down for negative surprises. Which of the following statements best summarizes the nature of the intraday reaction?
   a. The price reaction occurs over gradually over the course of the day.
   b. Most of the price reaction occurs in the first hour after the announcement, with a faster response for positive than for negative surprises.
   c. **Most of the price reaction occurs in the first hour after the announcement, with a slower response for positive than for negative surprises.**

   Explanation: The studies that have looked at intraday price reaction find a quick reaction almost instantaneously and a mild drift over the rest of the day, with the reaction being quicker for negative surprises.