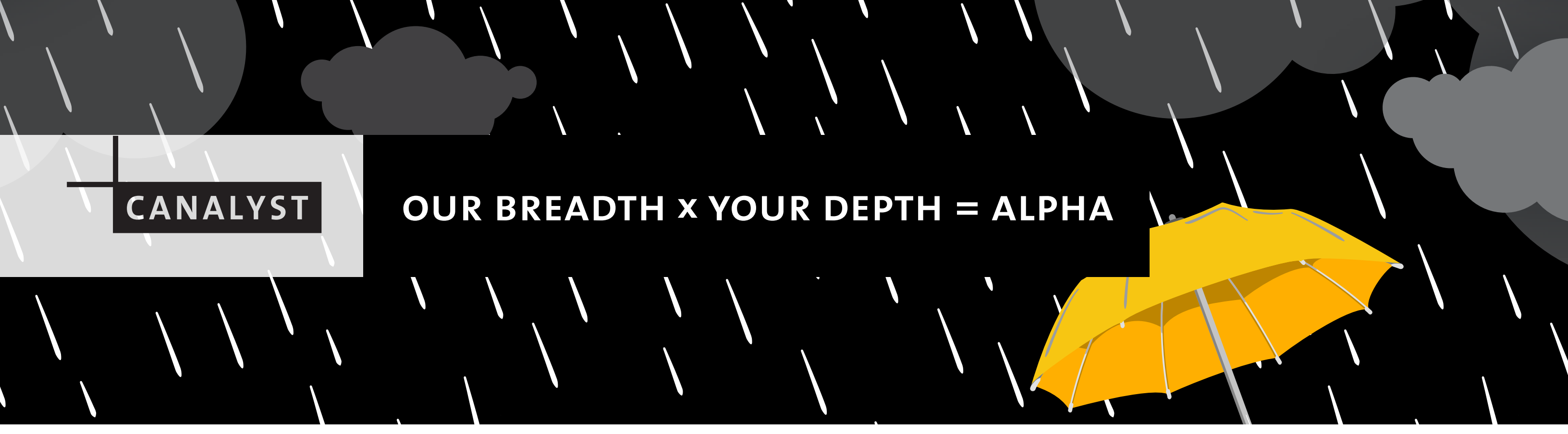

CANALYST NEWSLETTER: FINDING ALPHA IN EARNINGS SEASON'S RUBBLE

In this edition, we bid adieu to 2018 with a look back at the last quarter and what we learned from market volatility. Also, product news and how to better weather stormy earnings in the future, plus the Canalyst Holiday Quiz. Here's to a fresh start in 2019 and a Happy New Year to all our readers!

LOOKING BACK AT A VOLATILE QUARTER

The market was angry this quarterly earnings season, my friends. Like an old man trying to send back soup at a deli. When market volatility increases and investors become more skittish, earnings season takes on even greater importance. With almost all major markets in the midst of corrections, the usual weighing and sorting of quarterly results becomes a downright vicious process. Anecdotally, it is easy to express feelings like "in this market, you better not miss," and "even for winners, it's a reminder or excuse to sell," but we thought we'd take a quick look at how this played out quantitatively.

NOVEMBER EARNINGS SEASON		
% CHANGE	# OF CO.	% OF TOTAL
Up >20%	75	2%
Up 10-20%	253	8%
Up 3-10%	626	20%
Flat (± 3%)	1024	33%
Down 3-10%	672	22%
Down 10-20%	307	10%
Down >20%	127	4%

AUGUST EARNINGS SEASON		
% CHANGE	# OF CO.	% OF TOTAL
Up >20%	100	3%
Up 10-20%	256	8%
Up 3-10%	670	22%
Flat (± 3%)	1064	35%
Down 3-10%	651	21%
Down 10-20%	264	9%
Down >20%	77	2%

Source: Thomson. Returns are market relative from T-3 to T+3 of earnings.

As shown above, there was significantly more negative skew this earnings season vs. last. The sum of the three negative probabilities was 36% this earnings season vs. 32% in August, and most notably doubling the number of most severe occurrences (4% chance of >20% vs. 2% in August).

So, what to do about this? When markets approach these highly bearish levels of sentiment, the fundamental analyst or portfolio manager's instinct is to concentrate on his or her highest conviction names. This is a rational practice, as these tickers are the ones where they most likely have an edge, and can lead to significant outperformance when sanity returns. Still, there's a limiting factor to this practice. Maybe your 3% weights become 4%, or 4% becomes 5%, but what about the rest of your portfolio?

In these times, the increased value of having a sizable watchlist or shadow-coverage universe is apparent. First, with more of those >20% blowups occurring, there's more alpha to find when sifting through this earning season's rubble. Moreover, there's a good quantitative reminder that these times call for more stocks in your portfolio, not fewer. When macro fears rule markets like today (trade war turmoil, inverted yield curve fears, peak profit perils, etc.), the common complaint is "all stocks move together." The euro-crises of the early 2010s gave us a name for this; "risk-on risk-off," but it's more accurately described as greater pairwise stock correlations.

Dusting off our CFA portfolio math, we show the following simple example:

ASSET	A	B
Weight ($ or %)	50	50
Standard Deviation	10	10
Correlation of A-B	0.6	
Portfolio SD %	8.94	

Source: xplaind.com/268982/portfolio-standard-deviation

ASSET	A	B	C
Weight ($ or %)	33	33	33
Standard Deviation	10	10	10
Correlation of A-B	0.7		
Correlation of B-C		0.7	
Correlation of C-A			0.7
Portfolio SD %	8.94		

Here, we assume that that stock correlations rise from 0.6 to 0.7, but show that you can combat this by adding more names to your portfolio, resulting in the same standard deviation.

Bottom line, apart from your handful of monster bets that you can add weight to, make it your upcoming New Year's Resolution to add more breadth to your portfolio. So, finish your tax loss trims, make the necessary rounds at the in-laws holiday parties, then pour yourself a tall glass of eggnog and fire up the Canalyst portal. Our model database of 4,000+ companies has you covered for 2019.

LOOKING FORWARD TO NEXT EARNINGS

Updating models < Time to think

Regardless of market conditions, updating models has never been an analyst's most valuable use of time. Saving our clients time by keeping our model database updated was a good start, but we heard from our clients that they wanted to carry updates through to their own customized models. So we built new software, and call it the Canalyst Updater. Now, you can customize any Canalyst model and then automatically import the latest reported financial results during earnings season while maintaining your own customizations and forecasts. Plus, you can now generate a comparison report which shows your forecasted numbers vs. actual reported numbers. Our latest version – easy to use and lightning fast – is being rolled out in January as a part of a suite of new tools. Ask your rep about implementing it into your process, or [request a demo] today, and see for how much better next earnings can be.

HOLIDAY QUIZ

In early December we launched the inaugural Canalyst Holiday Quiz, and had a ton of fun challenging our friends in the financial community to 18 brain teasers for 2018. While the prizes have already been awarded, see how you compare to some of the smartest minds in the industry. (Because bragging rights really is the top prize.) [Take the quiz].

WE'RE HIRING

As Canalyst continues to grow, we're looking for bright talent. If you know anyone who is passionate about stocks or technology – or both, please send them to the Canalyst careers page for [current job openings]. Midtown uniform optional.

James Rife
Canalyst, Head of Equities

Prior to founding Canalyst, James had 10 years' experience in equity research and portfolio management. He started his career in equity research with Fidelity Canada's investment team, covering sectors including Utilities, Forestry, Technology, and Energy from 2006 to 2010. After Fidelity, he took a role as Portfolio Manager at a Boston-based $1B long/short fund, rounding out his experience across most other sectors in the process.

James holds a Bachelor of Commerce from the University of British Columbia and is a recipient of a Leslie Wong Fellowship from UBC's Portfolio Management Foundation, and is a CFA Charterholder.

Interested in learning more about how you can uncover more investment opportunities with Canalyst financial models?
[Click here for a free trial].