How to Trade off Earnings Reports

Public companies must announce four times a year how they are performing. The best way to make money in the stock market is to own the companies that surprise Wall Street in a positive way, generally on both a top-line (revenue) and bottom-line (earnings per share) basis. It's difficult to mistake a positive reaction from Wall Street because when a company outperforms its expectations, it's usually rewarded in terms of a higher stock price. And in order to see "accumulation" by Wall Street's big money firms, you must see a significant increase in volume in terms of the number of shares that the company trades.

I find it difficult to track every single earnings report that is released on a daily basis. Therefore, I let the StockCharts scan engine do all the work for me. I set up certain volume parameters to identify stocks trading with extremely high volume each day during earnings season. I first make sure that the stocks identified are "liquid" stocks, meaning that they generally trade more than 250,000-300,000 shares daily over say a 90 day period. I want to make sure I won't have any problems exiting a position later if I so desire.

Companies whose stock price spikes suddenly on large volume due to the release of an earnings report provides you an opportunity to trade a stock perceived by Wall Street to be a winner. While we never have any guarantees in the stock market, I do find that these types of companies tend to outperform over the next several weeks, months and quarters.

Once I find the companies that I believe are poised to outperform the market (my quarterly "Diamond picks"), I further break them down into the following categories:

Bottoming Stocks

This group tends to include companies that have been underperforming the market for a period of time, but are showing technical signs of bottoming PRIOR to a key earnings report that CONFIRMS the bottom. The technical indicators alert me to the fact that a company may have reached or may be reaching an important bottom and this signal is followed up (and confirmed) by a fundamental earnings report that blows away Wall Street expectations. This can be an excellent trading candidate for the next few weeks, possibly quite a bit longer.

Illustration:

Celestica (CLS) fit the bottoming formation as a series of highs over an eleven month period is shown below with the red line. After earnings were reported, CLS advanced on very heavy volume, clearing this downtrend line and suggesting that the nearly year-long downtrend was over. CLS appeared to be a high reward, low risk long trading candidate on a pullback near its 20 day EMA. Note that CLS continued to push higher off of that bottom nearly 25% before printing an ominous long-term negative divergence that marked the subsequent top.


CLS (Celestica, Inc.) NYSE
© StockCharts.com
4-May-2012
Open 8.45 High 8.49 Low 8.27 Close 8.32 Volume 809.0K Chg -0.22 (-2.58%)
MACD(12,26,9) -0.183, -0.159, -0.024
L/T Neg Divergence
CLS (Daily) 8.32
MA(50) 9.33
MA(200) 8.41
EMA(20) 8.90
CLS - Example of Bottoming Stock
Breakout
BUY
Breakout occurred after earnings were released on January 26th, 0.33 actual EPS vs. 0.26 consensus estimates. We liked entry on a pullback near the 20 day EMA, which occurred the very next week. From the lows in early February to the March high, CLS gained just under 25%. At that point, a long-term negative divergence printed and squashed the upward momentum.
Volume 809,023
RSI(14) 34.35
Full STO %K(14,3) %D(3) 26.29, 46.93
Oct Nov Dec 2011 Feb Mar Apr May Jun Jul Aug Sep Oct Nov Dec 2012 Feb Mar Apr May

Trending Stocks

This group includes companies that have moved higher after solid earnings reports, but were already in nice technical patterns before the current earnings report was released. Many times I'll see a bullish continuation gap that suggests a further climb is likely in the near-term. These types of stocks can represent excellent swing trading candidates.

Illustration:

Interactive Brokers Group (IBKR) began trending higher off of its August 2011 low and was in a bullish ascending triangle pattern when it reported earnings that blew away estimates. Earnings per share came in at $.30 vs. an estimate of just $.23 and that ignited the breakout in mid-January 2012. The pullback to its 50 day SMA created a high reward to risk trade on the long side. From the early February low where we identified IBKR as a solid trading candidate to the early April high, when a long-term negative divergence printed, IBKR rose a very healthy 16.7% in just 7 weeks.


IBKR (Interactive Brokers Group, Inc.) Nasdaq GS
© StockCharts.com
4-May-2012
Open 14.79 High 14.83 Low 14.54 Close 14.54 Volume 415.2K Chg -0.26 (-1.76%)
MACD(12,26,9) -0.504, -0.376, -0.128
L/T Neg Divergence
IBKR (Daily) 14.54
MA(50) 16.32
MA(200) 15.08
EMA(20) 15.60
IBKR - Example of Upwardly Trending Stock
Breakout
50 day SMA test
Ascending triangle
Double Bottom
Volume 415,218
RSI(14) 26.84
Full STO %K(14,3) %D(3) 3.17, 6.33
Jun Jul Aug Sep Oct Nov Dec 2012 Feb Mar Apr May

Aggressive Stocks

We recognize that many traders really like to trade more aggressively so we search for candidates that meet criteria in that regard. Generally, the stocks in this category are either small cap stocks or micro cap stocks, but still with average daily volume significant enough so that we don't have to worry about liquidity. Many stocks in this category fall into the pharmaceutical or biopharma space and could be moving on high volume for reasons unrelated to earnings.

Illustration:

Extreme Networks (EXTR) posted what seemed to be just ordinary quarterly earnings in late January, but the market's reaction to the report was more significant. Check out the volume that accompanied the late January breakout above $3.10 price resistance. That led to some outsized gains over the next 2-3 months. From the $3.10 breakout to the move just above $4.40 in mid-April, EXTR gained more than 40% while the overall market languished.


EXTR (Extreme Networks, Inc.) Nasdaq GM
©StockCharts.com
4-May-2012
Open 3.76 High 3.92 Low 3.69 Close 3.90 Volume 1.7M Chg +0.11 (+2.90%)
MACD(12,26,9) -0.013, 0.018, -0.031
EXTR (Daily) 3.90
MA(50) 3.87
MA(200) 3.20
EMA(20) 3.91
EXTR - Example of Aggressive Stock
Breakout
EXTR reacted quite favorably to its earnings report in January. Sometimes it's not about the numbers, but the reaction to the numbers.
Jun Jul Aug Sep Oct Nov Dec 2012 Feb Mar Apr May
Volume 1,663,546
Sudden increase in volume suggests accumulation
RSI(14) 50.00
Full STO %K(14,3) %D(3) 30.59, 27.97

Low Beta Stocks

While many traders may enjoy taking big risks in exchange for the opportunity to capture large gains, others simply want to be able to trade and still sleep at night. In an effort to appease our more risk-averse client base, we provide a list of lower risk stocks to be considered for trading. You can find some low risk trades amongst the Dow Jones components. Other areas where lower risk candidates can be found included consumer staples and utilities sectors. Some energy and healthcare names could also be found in this group.

Illustration:

Sara Lee (SLE) reported its results in early February 2012 and Wall Street liked what it saw. Earnings per share came in at $.27, besting $.25 consensus estimates. Those results sent the stock rising and the bullish momentum continued for the next few months. At the time of the report, SLE was trading near the $19.00 level, but just one month later SLE touched $22.00. That 15%+ gain in one month was spurred by a solid reaction to earnings where prior resistance was cleared. So even though SLE had traded in a very narrow four dollar range ($15.50-$19.50) during the nine months leading up to the report, the solid earnings announcement provided risk-averse traders an opportunity to capitalize in a meaningful way without having to risk too much in terms of downside action.


SLE (Sara Lee Corp.) NYSE
© StockCharts.com
4-May-2012
Open 21.84 High 22.02 Low 21.79 Close 21.96 Volume 10.5M Chg -0.16 (-0.72%)
MACD(12,26,9) 0.215, 0.196, 0.018
SLE (Daily) 21.96
MA(50) 21.45
MA(200) 18.97
EMA(20) 21.80
SLE - Example of Lower Risk Trade
Breakout
Resistance
SLE posted better-than-expected earnings and Wall Street reacted favorably. That set up additional gains over the next three months as accumulation in the shares took place.
Volume 10,472,991
Heavy volume to confirm breakout
RSI(14) 56.98
Full STO %K(14,3) %D(3) 80.83, 87.79
Jun Jul Aug Sep Oct Nov Dec 2012 Feb Mar Apr May

Diamond Picks

This is simply our term for the stocks that we believe present the greatest reward to risk based on strong volume trends during earnings season. They may represent aggressive trades or low risk trades, but the fundamental reasons for inclusion are obvious. Normally, these stocks will represent companies that not only have walloped revenue and/or earnings per share estimates, but they also will many times have raised guidance in future periods. Momentum begets more momentum. That's the theory, and for traders looking for quick returns on their trading dollars, our Diamond picks are the way to turn.

Illustration:

In mid-January 2012, Tractor Supply Company (TSCO) upped its earnings forecast from a range of \$2.85-\$2.89 to a higher range of \$2.97-\$2.99. That may not seem like much, but raised guidance provides investors confidence in the company's management and ability to execute its business plan. That alone will send shares higher. But in a more basic, fundamental sense, the higher earnings helps drive the price higher given a stock's current PE multiple. In addition, because earnings are being revised higher, that increases the growth of the company and gives it reason to trade at a higher multiple. All of this usually translates into an upwardly-trending stock that you want to be part of as a trader.


TSCO (Tractor Supply Co.) Nasdaq GS
4-May-2012
©StockCharts.com
Open 98.50 High 98.76 Low 95.55 Close 96.48 Volume 1.1M Chg -2.50 (-2.53%)
MACD(12,26,9) 1.915, 2.366, -0.452
TSCO (Daily) 96.48
MA(50) 92.00
MA(200) 75.54
EMA(20) 96.93
TSCO - Example of Diamond Pick
Breakout on Raised Guidance
Resistance
After raising guidance, TSCO prints a continuation gap higher on very heavy volume - a bullish combination. TSCO proceeds to push higher throughout the next 3-4 months on continuing bullish volume trends. This is the hallmark of a Diamond Pick.
Jun Jul Aug Sep Oct Nov Dec 2012 Feb Mar Apr May
Volume 1,111,478
Confirming Volume
RSI(14) 52.10
Full STO %K(14,3) %D(3) 49.07, 61.06

Our philosophy is to trade into or out of stocks solely based on technical indicators. We do use quarterly earnings reports, however, to identify stocks with strengthening fundamental characteristics. **By combining strong fundamentals and healthy technicals, we're able to uncover high reward to risk trades.** As we often say, it's not always about being right and making money on a trade. It's about managing risk.

Utilizing both a fundamental and technical approach helps us to do just that.

Each quarter I provide our Diamond club members with a selection of stocks that I think are good near term trade opportunities based on that combination of technical and fundamental analysis. These are the Diamond Picks that I mentioned above. If you'd like more information on our next Diamond Picks session you can click here to find out how to attend totally **RISK FREE** with our seven day 100% money back Guarantee.