



Fisher Funds

Investor Education Centre

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Reporting season – a chance to look under the hood

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We are heading into reporting season again. This is a great time of year for investors because we get to lift the hood and find out what our companies have been up to, and what they are expecting for the next six months.

This reporting season will be even more interesting than usual, and hopefully, more lucrative for astute investors. At the early stages of any economic recovery there tend to be clear winners and losers as some companies emerge faster or in better shape than others. We've already seen evidence of divergent performances in the retail sector, with Michael Hill and Kathmandu announcing earnings upgrades following better-than-expected Christmas sales; while Hallenstein Glassons and The Warehouse announced earnings downgrades. The share prices of each of these companies reacted accordingly.

One of the key things to look at in this season's profit results will be the sales trend. Usually I prefer to focus on profitability because I've seen investors get excited before about increases in sales that never quite made it to the bottom line. But sales increases at this stage in the cycle will be an important indicator of future profitability.

The profit growth that we've seen from businesses since the financial crisis has generally come from productivity growth. Most of that productivity growth is the result of cost-cutting. Scared for their jobs during the crisis, employees worked harder for no more money, but that can't go on forever. While markets have applauded cost-cutting to date, there will come a point where investors realise that companies are paring muscle as well as fat.

Last week Pfizer, a research-based drug firm, announced increased profits and a hefty cut in its research and development budget. Profit performance is good now, but how will the company fare in three years without a good pipeline of ideas coming from the R&D department?

Thankfully there are signs, at least from recent US profit results, that sales are at last starting to pick up. In the first week of the earnings season, the number of US companies reporting better-than-expected sales outstripped the number of companies reporting better-than-expected profits. Thanks to the productivity improvements of recent years, companies should be well placed to turn higher sales into higher profits. These higher profits will be added to the piles of cash that have built up in recent years to provide a safety net in case of another financial disaster. With the likelihood of another disaster diminishing, we could easily see companies start to put their cash to work.

Already this year we've seen an increase in merger and acquisition activity. Investors can enjoy the benefits on both sides of an M&A deal. If we own a company that is being acquired, we will likely be paid a premium to sell. If we own a company that is acquiring, we will enjoy the future profit growth that comes as a result of the acquisition.

Reporting season can give us a hint of what lies ahead for our companies, and right now, that's pretty exciting.

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