The Right Way to Handle a Surprise
Why a one-penny shortfall in a stock's earnings makes Wall Street go crazy, and how to keep yourself sane

Research in Motion, which makes the BlackBerry wireless device, announced on April 11 that net income was up from a year earlier thanks to a 66% increase in sales. How did the stock react? It fell 8%. Why? Mainly because Wall Street had expected RIM to raise forecasts for the next quarter, but the company left them unchanged.

Welcome to the wacky world of "earnings surprises," in which what matters isn't whether a business performs well over the long haul, but how quarterly profits stack up against the average forecast of Wall Street's "experts." A positive surprise will make a stock rise a bit. But a negative one can lead to a crash—even if the company just made a ton of money.

To understand—and profit from—this foolishness, we need to delve into the human mind. A special area of the brain, the anterior cingulate cortex or ACC, matches what you get against what you expected. When what you get is better, the ACC responds mildly. But when what you get is worse, these brain cells fire three times more intensely, in as little as three-tenths of a second—sounding an unmistakable alarm to other areas of the brain where anger, fear, pain and disgust are generated. Originally, the ACC responded to the difference between experience and expectation of ancient risks and rewards like predators, food and sex. In modern times, it reacts the same way when it comes to money.

Thus as soon as a company earns less than analysts expect, panic sets in. In 2005 companies came up a penny a share short of expectations more than 1,250 times, and their shares promptly lost an average of 2%. And the hotter a stock is, the harder it falls. Yahoo shares sank 12% on April 18, for example, after the company announced it missed earnings forecasts by a penny.

But will advertisers spend less with Yahoo because it earned 10¢ a share instead of 11¢? In 2012, will anyone care about a one-penny shortfall in mid-2007?

Of course not. So today's angst can create opportunity for smart buyers and patient holders of a stock. Here's how to be on the right side of a surprise.

> STEER CLEAR The U.S. Chamber of Commerce is calling for companies to halt "earnings guidance," or coaching analysts, toward a precise target for quarterly profit. "The incentive to meet that number is an incentive to manipulate," says Robert Pozen, head of the MFS mutual funds. The negative surprise comes in the end: Remember Enron. Roughly a quarter of the companies in the S&P 500 have stopped giving guidance (or never started), including Berkshire Hathaway, Coca-Cola and Google. Check the investor-relations area of a company's website to see whether it plays what David Hirschmann of the Chamber of Commerce calls the "fool's game" of earnings guidance.

> BE PREPARED Because a negative surprise can turn a decent stock into a bargain, keep a watch list of companies you'd like to own if they got cheap enough. That way when Wall Street is panic-selling, you'll be ready to buy.

> STEP LIGHTLY Stocks that have been on a tear are booby-trapped. Stay away from them and the mutual funds that focus on them. Opt for index funds, or pick "value" funds that buy low-priced stocks, and let somebody else be surprised.

ADDITIONAL REPORTING BY ASA FITCH
E-mail Jason Zweig at investor@moneymail.com.