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## The Earnings Operation

Once upon a time, equities were priced based on the dividends they paid. While this sounds like a hopelessly antiquated notion, there was a reason for it. Dividends, after all, are cash payments, and a company was unlikely to pay out a dividend that they could not afford, if management's basic goal was to remain in business. Dividends, therefore, told you a fair bit about the ongoing profitability of a corporation. Eighty years ago there were no standard accounting rules specifying what counted as earnings, and during the Depression investors were rather shocked and horrified to find that companies that had been claiming to be very profitable were anything but. This lack of clarity eventually got on investors' nerves, so much so that in the 1930s America's accountants got together to decide on a set of standards for auditing the results of public corporations. Why it took them until 1939 to come up with those standards is a bit of a puzzler, but a mere 450 or so years after the invention of double entry bookkeeping, U.S. accounting standards were worthy of the term 'standards.'

For the next 50 years or so, 'net' or 'GAAP' (Generally Agreed Accounting Principles) earnings were the standard earnings figures that investors were given by corporations and their auditors. These earnings were not perfect, so a group called the Financial Accounting Standards Board was set up in the 1970s to continually update the standards to accommodate changing circumstances. The basic meaning of earnings never changed, however, being something along the lines of 'the part of a company's revenues that remains after subtracting all expenses and taxes.' Still, GAAP earnings were never perfect. One of their particular weaknesses is that they are not necessarily a wonderful starting point for analysts who are trying to predict *future* earnings because they include a number of items that would not necessarily be expected to recur in the future. This problem led to the creation of operating earnings, which attempt to strip out the 'non-recurring' stuff.

### What Are Operating Earnings?

While there is no universally agreed on definition of operating earnings, the concept is fairly simple. Some of what winds up in net earnings is legitimately not representative of the ongoing earnings power of the company. The sale of a division, in many cases, is a truly one-off event, so investors would be well served to adjust their forecast for future earnings for the fact that any profit on the sale will not recur and the profits or losses generated previously from that division will no longer affect the company. Generally, operating earnings differ from net earnings in that operating earnings exclude discontinued operations, extraordinary items, and the cumulative effect of accounting changes. By 1988, the use of this version of earnings was sufficiently widespread that Standard & Poor's began calculating operating earnings along with net earnings for the S&P 500 index.

When the adjustments to earnings are being done by well-intentioned investors and analysts, operating earnings is a perfectly decent measure. Since investors are a forward looking group, operating earnings should, in principle, be a better guide to future profits than GAAP earnings. However, many ideas that are lovely in principle turn out to be much less so in practice. It was not long before companies got into the act of telling investors what they felt their operating earnings were, and as soon as they did, the opportunity existed for them to manipulate the categorization of gains and losses to make their operating earnings look artificially good. And there is little question they have jumped on the opportunity, although it took them some time to perfect their technique.

### Historical Data on Operating Earnings

In principle, one-off events are about as likely to be positive as negative for a company, and operating earnings would be as likely as not to be less than net earnings. However, this is not what history has shown us.

Chart 1 shows the percentage of quarters in which net earnings for the S&P 500 were higher than operating earnings.

In the first year Standard & Poor's compiled the data, net earnings were higher than operating earnings in three out of the four quarters. Over the next three and a half years, net earnings were higher just over a third of the time, and in the next four and a half years, there was exactly one quarter in which net earnings were higher than operating earnings (March 1995). Since March 1995, there have been precisely *zero* quarters in which net earnings were higher than operating earnings.

If there truly was a 50/50 chance of net earnings being higher than operating earnings, the odds of a run of 44 quarters in a row of operating earnings being higher than net would be 18 trillion to 1 against. It is probably pretty safe to assume that this was not a random event.

And there is more evidence that something fishy is going on. Perhaps more important than the frequency of events in which net earnings are higher than operating earnings is the average amount by which operating earnings overstate net earnings, since in the end it is price/earnings ratios that are affected by the issue. Chart 2 shows the

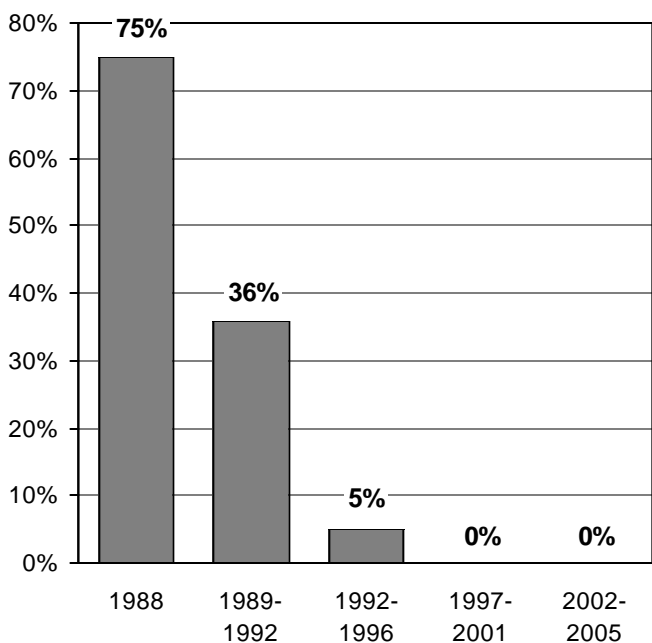
average amount by which operating earnings are higher than net in the same five time periods.

Once again, the discrepancy has grown over time. In 1988, operating and net earnings were almost the same. Over each proceeding period, the gap has grown, and in the past four years operating earnings have averaged a full 20% higher than net.

**Why it Matters**

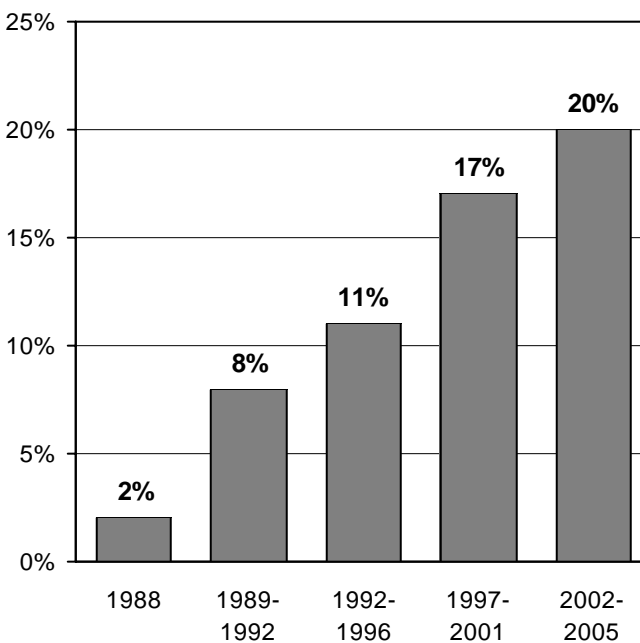
Given that corporations are also providing net earnings, one could argue that this overstatement doesn't matter. Investors have access to all of the data and can either ignore the operating figures entirely or make up their own version of earnings that takes into account exactly those items they care about. However, it is clear that in practice the operating figures are taken more or less at face value. Almost every strategist on Wall Street uses operating figures when calculating the P/E ratio of the S&P 500. This would be a problem even if they only compared today's operating P/E to that of the last 17 years, when we have had operating earnings to compare, since the extent of the gap between operating and net has grown, and the 'quality' of today's operating earnings figures is far below what it was in the early years.

**Chart 1**  
**Percent of Quarters Net Earnings Higher than Operating Earnings**



Source: Standard & Poor's, GMO

**Chart 2**  
**Average Amount by which Operating Is Higher than Net**



Source: Standard & Poor's, GMO

But Wall Street does investors an even worse disservice by comparing today's operating P/Es to historical *net* P/Es, as if the two figures were the same. If operating earnings today are 20% higher than net, the resulting P/E is almost 20% lower than the equivalent P/E on net earnings. This gap is enough to make a P/E within the worst quartile of history appear to be just about median. Since markets with P/Es in the worst quartile have delivered a return of 0% real in the next year versus a long-term average of 7% real, this gap matters immensely.

And for times when even that amount of overstatement of earnings isn't enough, Wall Street has another trick up its sleeve: valuing the market on *next year's* forecast operating earnings. On average, forecast earnings overstate what eventual operating earnings will be by about 10%, and they are *always* higher than trailing operating earnings, let alone trailing net earnings. Ten percent overstatement may not sound like much, but given that the average operating earnings growth since 1988 has been 3.5% real, and the average forecast operating earnings growth has been over 13% real, it means that the forecast has overstated actual real growth by a factor of over 3.5 times on average. A P/E on next year's operating earnings would therefore be using an earnings figure likely to be at least 30% higher than the trailing net earnings, which is the *only* long-term earnings series available for the S&P 500. This magnitude of adjustment is enough to move from the 85<sup>th</sup> percentile on P/E down to the median, which is to say moving from an expected return that is negative in real terms up to the 7% real long-term average.

### What to Do about it

In the short term, there isn't much that consumers of data can do about the quality of the data received. It would be nice to say that if we all agreed to stop looking at operating earnings, corporations and Wall Street would stop trying to foist them upon us. But the game of investing is such that all too many investors don't care about reality, but only what they think other investors are thinking. And short of FASB or Congress demanding that corporations improve the quality of the data we are getting, there is very little incentive for corporate executives, or the analysts who follow them, to do anything about the problem.

As consumers of data, it is incumbent upon us to be *smart* consumers. If someone says the P/E of the S&P 500 is 16 and that is about average, make sure to ask what those earnings are – net earnings? Operating earnings? Forecast earnings? If the figure is 'average' or 'above average' or 'below average,' what kind of an average are we talking about? Are historical net earnings being compared to forecast operating earnings? If you do not know the answers to such questions, it would be wise to be very cautious when drawing conclusions on the valuation of the market or, indeed, an individual stock. And if the analyst quoting you the data cannot answer such questions or claims the questions are irrelevant, you can be fairly confident that he is simply showing the version of earnings that puts his argument in the best possible light.

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