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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

According to Zacks Investment Research, revenues of S&P 500 companies are projected to increase 4.95% this year relative to 2009

The Texas state budget deficit as a percentage of its general fund stands at 9.5%. California's is 56.2%.

Corporate Earnings and the Recession

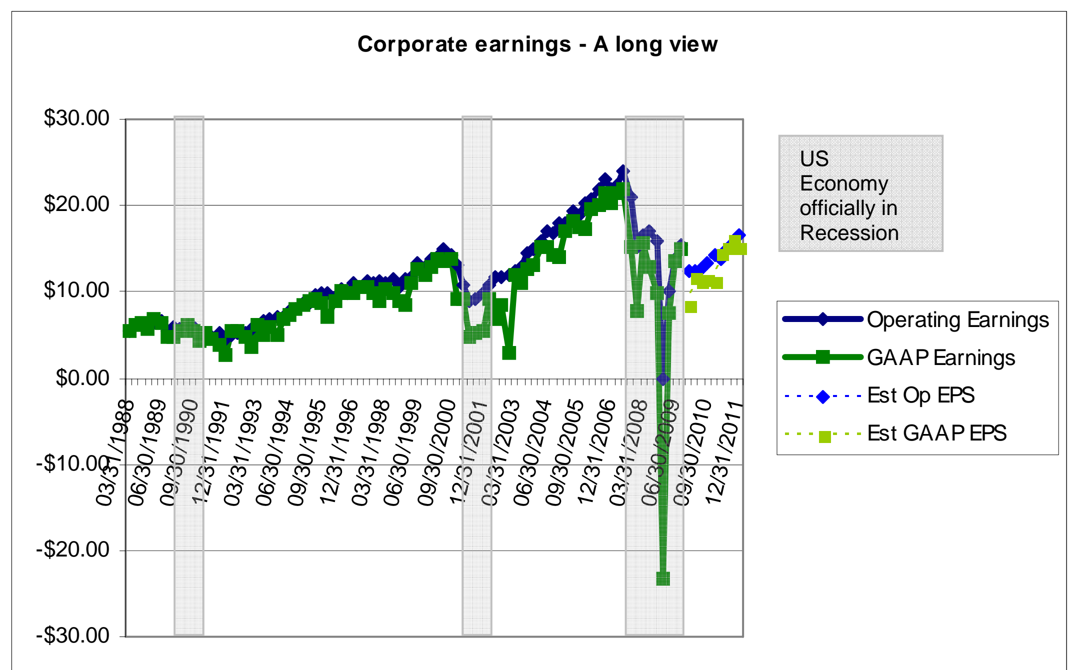
Several years ago, *Intelligent Money* undertook a review of corporate earnings using source data compiled by Standard & Poors. We focused then on trends in the quality of earnings. This article updates the data since 2003 and reviews similar topics in the aftermath of the global economic crisis.

The chart below graphically depicts actual and forecast quarterly earnings looking back to 1988 and forward to 2011. There are two key measures of earnings that are represented below: as reported or GAAP earnings and operating earnings. The former describes the weighted net income per share of all the companies in the S&P 500. Operating earnings exclude a wide range of events such as the expensing of options, legal settlements, gains or losses from the sale of assets, restructuring severance costs, and asset write downs. Operating earnings are most often referenced by analysts in their forecasts. Consequently, they are the currency of discussion in the financial press such as Bloomberg and CNBC.

Recent studies of earnings reporting have shown that the divergence of reported and operating earnings increases dramatically when firms report negative results. In adverse circumstances companies will more aggressively segregate negative events so that their operating earnings can be positive. In the fourth quarter of 2008, many financial firms decided to exclude the substantial write down of loans from their reportage of operating income. That explains the large disparity between operating and as reported earnings in the 4th quarter of 2008.

Some argue that actual operating earnings and forecasts are the best metric to use to value stocks. Operating results tend to fluctuate less. After all, stock prices should reflect future profitability and not be weighed down by one time write offs. A problem with that view is that operating earnings are consistently higher than GAAP earnings. These *one time* negative events occur over and over again.

Of course, the events that are typically excluded to produce operating earnings are adverse items. Since the turn of the decade the disparity between operating and reported earnings has grown considerably. Total reported earnings were 90% of operating earnings in the 90s while they were only 80% in the 00s. The largest divergence tends to occur during recessions. This is not a surprising



observation as firms aggressively attempt to "manage" reported earnings when they are in the process of falling precipitously.

The implications for valuation are significant. The Price/Earnings ratio of the S&P 500 is a long standing measure of valuation for the stock market. The price of the market is known with certainty at any particular time. The denominator, earnings, is a far more subjective value. Do we use operating earnings, GAAP earnings, trailing earnings or prospective earnings? One should also be mindful that there are numerous sources of earnings estimates and that they can vary significantly based on who is compiling them. The chart below illustrates the differences using data provided by Standard and Poors:

"During 2009, two thirds of earnings surprises among the USA's 1000 largest companies were positive"

P/E Computation under different EPS measures

2/1/2010 S&P 500: 1089.18	Trailing 12 months	Forward 12 Months
Operating EPS	21.08	20.75
GAAP EPS	24.48	23.94

With these varying interpretations of corporate profitability, it is difficult to point to reliable measures of fair value. However, there are some relative value indicators that have trended in the past. Earnings surprises and earnings revisions are catalogued by financial information venders such as First Call and Zacks.

Stock analysts typically estimate operating earnings and revenues for the companies they follow. The predictions include the next reporting period and often the next fiscal year as well. First Call and Zacks aggregate these predictions to establish a consensus expectation of future results for just about every major company. Changes to this consensus that are driven by updates in analysis opinion are known as *earnings revisions*. *Earnings surprises* are deviations in actual operating results from this analyst consensus. Both measures trend as positive surprises and revisions tend to reinforce one another.

As corporate financial officers often understate expected results, surprises tend to be positive. During 2009, for example, two thirds of earnings surprises among the USA's 1000 largest companies were positive.

Earnings revisions are a bit different. A revision reflects a change in the *expected* operating result of a company. Since companies like to manage expectations downward just prior to an announcement, aggregate earnings revisions across the S&P 500 composite tend to be neutral or negative.

Despite these biases, the recent history of both earnings revisions and earnings surprises demonstrate a positive outlook in corporate health. Note that this is not a "buy" signal on stocks but rather an observation of changing economic fortune. So far, positive earnings surprises outnumber negative surprises fivefold in the 4th quarter 2009 reporting season.

Over the past 4 weeks, the number of positive earnings revisions among S&P 500 companies has outnumbered negative changes by 1908 to 1069. That, too, is high by historical standards. The stock market may not cooperate but guidance from companies is improving.

Next Year's Income Taxes

"President Obama submitted his budget to congress this past Monday. He proposes to keep in place today's tax rates in 2011 for those earning less than $250,000 annually."

The Bush tax cuts of 2001 and 2003 are scheduled to expire at the end of this year unless congress takes pre-emptive action. When originally passed, the measures lacked supermajority support and therefore had a limited duration. A return to the tax schedule that prevailed prior to 2001 would increase marginal tax rates by 3 to 5 points across the board. Most taxpayers would therefore see their overall tax liability increase by more than 10%.

The method of tax computation will become less favorable. The capital gains tax rate for most investors will increase by a third from 15% to 20%. Dividends will once again be taxed at ordinary income tax rates after this year. The standard deduction for joint filers and the child care tax credit are due for a substantial decrease. These reversions will increase tax liability.

President Obama submitted his budget to congress this past Monday. He proposes to keep in place today's tax rates in 2011 for those earning less than $250,000 annually ($200,000 if single). The budget also calls for diminished effect of itemized deductions for higher income individuals. Needless to say these proposals will be reshaped as they make their way through the legislative process.

There are implications for the average taxpayer. Many should consider recognizing ordinary income and capital gains in 2010. The tax environment will be getting more hostile next year so it might be better to pay now.