Markets

Earnings shenanigans underpin Wall Street record

Return on invested capital paints much less flattering picture of company valuations

Smart Money

YESTERDAY by: Miles Johnson

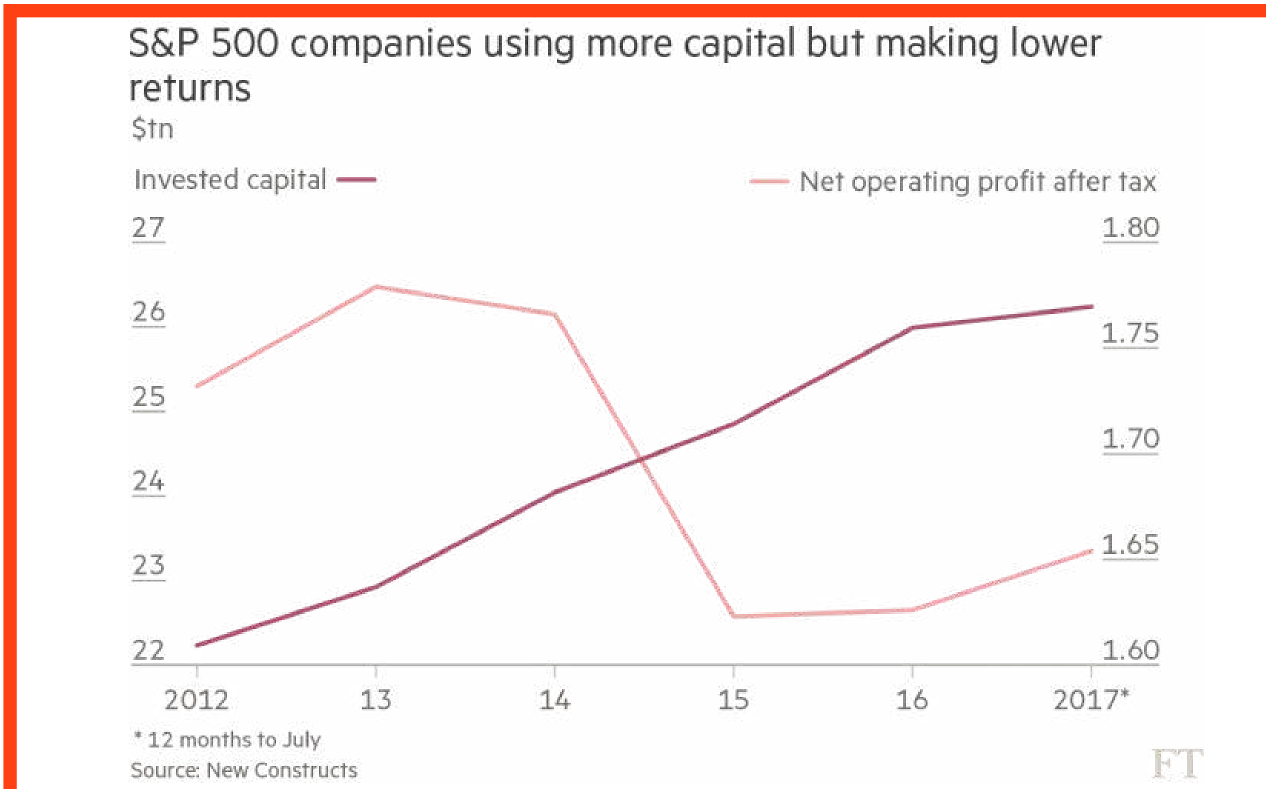
With earnings season under way in the US, investors have been able to judge whether company profits are good enough to justify an S&P 500 index which has repeatedly hit new all-time highs this year.

Last year bearish commentators pointed out that lofty valuations mean optimistic expectations for earnings need at the very least to be matched to avoid a major market tantrum. Superficially, at least, it appears high hopes have been met. The FT reported last week that with almost half the companies in the S&P 500 having reported second-quarter earnings, 73 per cent have beaten analyst expectations, the highest level since FactSet began tracking such data in late 2008.

That will embolden optimists to point to a sustained US earnings recovery that has unfolded since 2016. Don't expect this to reassure those who have sounded warnings about over exuberance in the US equity markets for years. They will note that the S&P 500 is trading at a multiple of earnings near to the highest in its history, on both a forward and cyclically adjusted basis. Based on the logic of mean reversion they argue a sharp correction is likely.

But as the debate rages on whether earnings will justify current valuations, a critical point is lost: the accounting earnings which are used to construct the widely cited p/e multiples that each camp employs fail to tell the whole story. There are reasons to be sceptical about the apparent current earnings recovery, but not for the reasons that many bulls or bears believe.

Great attention is lavished on the earnings each company releases. Yet published accounting earnings — used by the majority of the market to make their investment decisions — can do a poor job of reflecting the true economic earnings power of a business.



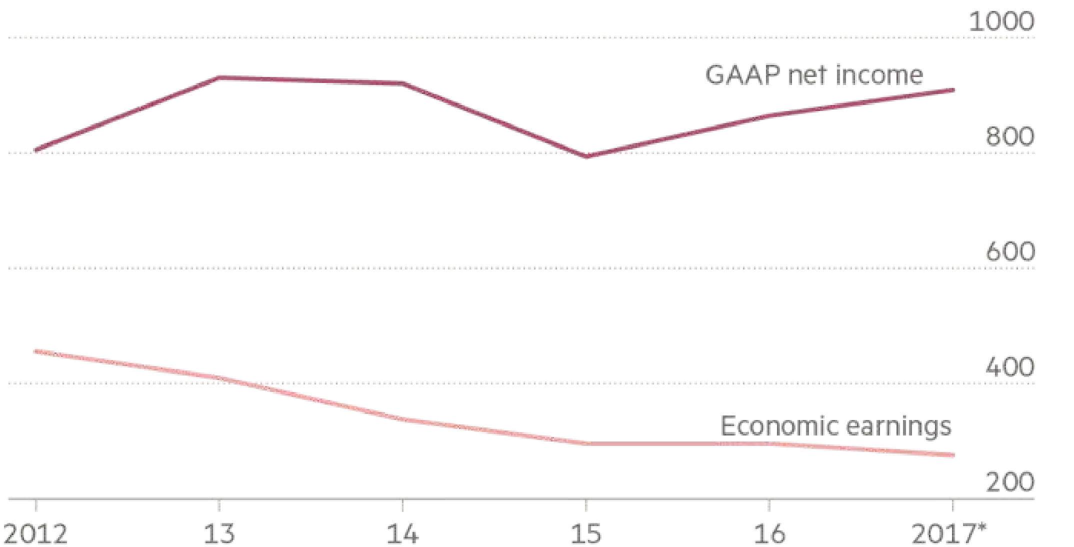
Many highly respected investors instead argue that the returns a company makes on its invested capital are the single most important factor dictating the performance of its shares. As Charlie Munger of Berkshire Hathaway has put it, “Over the long term, it’s hard for a stock to earn much better than the business which underlies it earns.”

Return on invested capital measures the profit a company is generating on every dollar of capital ever invested in its business, and is far trickier to calculate than simple published accounting earnings. It requires trawling back through hundreds of pages of footnotes in annual reports to adjust back all the capital ever invested into a business. New Constructs, an investment research company, bases its entire practice on the superiority of ROIC over the frequent shenanigans found in GAAP earnings. Not only do accounting rules change over time, rendering crude historical comparisons inaccurate, there are multiple ways large US-listed companies can use adjustments and other tricks to massage their quarterly numbers.

Instead of relying on accounting earnings, New Constructs instead calculates the return on invested capital of each S&P 500 member company to gain an accurate assessment of their true economic earnings. Their research shows that the apparent earnings recovery of large US listed companies in recent years that is used to justify the stock market rally may have been something of a mirage.

According to New Constructs, since 2015 reported annual GAAP net earnings for the S&P 500 have increased by 14.6 per cent from $794bn to $910bn. At the same time, its calculation of true economic earnings, which are derived from returns on invested capital, have actually fallen by 5 per cent. What is driving this discrepancy and what does it mean?

GAAP earnings up and economic earnings decline for S&P 500



* 12 months to July
Source: New Constructs

Crucially, over this period of earnings recovery from 2015 onwards, there has been a 5 per cent increase in the total amount of capital invested by S&P 500 companies, but net operating profits after tax have only edged 1.9 per cent higher. Over a slightly longer period, from 2012 to now, net operating profits for the index are actually down by 4.5 per cent while total invested capital has increased by 18 per cent.

These are far from reassuring numbers. The picture they reinforce is that US large companies have been able to grow accounting earnings through financial engineering even though their cash flows are actually flat, or even declining.

This raises troubling questions about the sustainability of the current rally for the majority of US companies. Rather than place all their faith in popular, but flawed, price to earnings ratios, investors and commenters on both sides of the valuation debate would do far better to start focusing more closely on returns on capital.

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