Earnings Distortion Scorecard: Week of 1/6/20-1/10/20

For the week of 1/6/20-1/10/20, we focus on the Earnings Distortion scores for three companies.

We measure earnings distortion using a proprietary human-assisted ML methodology featured in a recent paper from Harvard Business School (HBS) and MIT Sloan. This paper empirically shows that street earnings estimates are incomplete and less accurate since they do not consistently and accurately adjust for unusual gains/losses buried in footnotes.

As corporate managers bury key data in footnotes to manipulate earnings, and investors miss them, investment opportunities arise because stock prices tend to be driven by core earnings power.

Our Earnings Distortion Scores[1] empower investors to combat management efforts to obfuscate financial performance. The aggregate level of distortion recently reached levels not seen since right before the tech bubble and the financial crisis.

Weekly Earnings Distortion Insights

Figure 1 contains the S&P 500 companies, plus those with market caps greater than $10 billion, that report earnings the week of January 6, 2020.

Figure 1: Earnings Distortion Scorecard: Week of 1/6/20-1/10/20

Company	Ticker	EPS Estimate	Earnings Date	Earnings Distortion Score
Lennar Corp	LEN	$1.89	1/7/20	Miss
Constellation Brands Inc	STZ	$1.88	1/8/20	Strong Miss
Walgreens Boots Alliance Inc.	WBA	$1.41	1/8/20	Inline

Sources: New Constructs, LLC and company filings

Details: WBA's Earnings Distortion

In fiscal 2019, WBA had $601 million in net earnings distortion that cause earnings to be understated. Notable unusual expenses found in the firm's 2019 10-K include:

- $477 million in transformational cost management expenses primarily recorded in SG&A – Page 47
- $303 million in acquisition-related costs – Page 47
- $196 million in store optimization costs primarily recorded in SG&A – Page 47
- $73 million in impairment charges on its pharmacy licenses primarily recorded in SG&A – Page 80

The transformational cost management expenses are part of WBA's Transformational Cost Management Program, which aims to deliver over $1.8 billion in costs savings by fiscal 2022. Similarly, the store optimization costs are part of WBA's Store Optimization Program, which aims to close around 750 stores in the company's Retail Pharmacy USA segment.

In total, we identified $0.65/share in net unusual expenses in WBA's 2019 results. After removing this earnings distortion from GAAP net income, we see that WBA's 2019 core earnings of $4.96/share are down just 8% year-over-year (YoY). Meanwhile, GAAP net income paints a much worse picture, as it is down almost double, or 15% YoY.

[1] Note that Earnings Distortion scores will be added to our website via a new column on the Screeners and Portfolios page in January 2020.

How to Make Money with Earnings Distortion Data

"Trading strategies that exploit {adjustments provided by New Constructs} produce abnormal returns of 7-to-10% per year." – Page 1 in Core Earnings: New Data & Evidence

In Section 4.3 of Core Earnings: New Data and Evidence, professors from HBS & MIT Sloan present a long/short strategy that holds the stocks with the most understated EPS and shorts the stocks with the most overstated earnings. Positions are opened in the month each 10-K is filed and held until the next 10-K is filed, or about a year.

This simple, low turnover strategy produced abnormal returns of 7-to-10% a year. These abnormal returns show that the market misses important data in the footnotes and that investors who adjust for unusual items can make more money. Click here for more details on our data offerings.

For more on how to use core earnings and earnings distortion to pick better stocks, click here.

This article originally published on December 30, 2019.

Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, sector, style, or theme.

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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