



S&P 500 Peaks As Earnings Trough

COVID-19 has wreaked havoc on economies across the globe and resulted in [record asset write-downs](#). Meanwhile, the S&P 500 races to new all-time highs as most investors are already looking past the COVID-induced decline in earnings, just as we recommended in our [See Through the Dip](#) series of [Long Ideas](#).

Now is the time for investors, especially fiduciaries, to reduce risk in equity portfolios.

Learn more about the best fundamental research

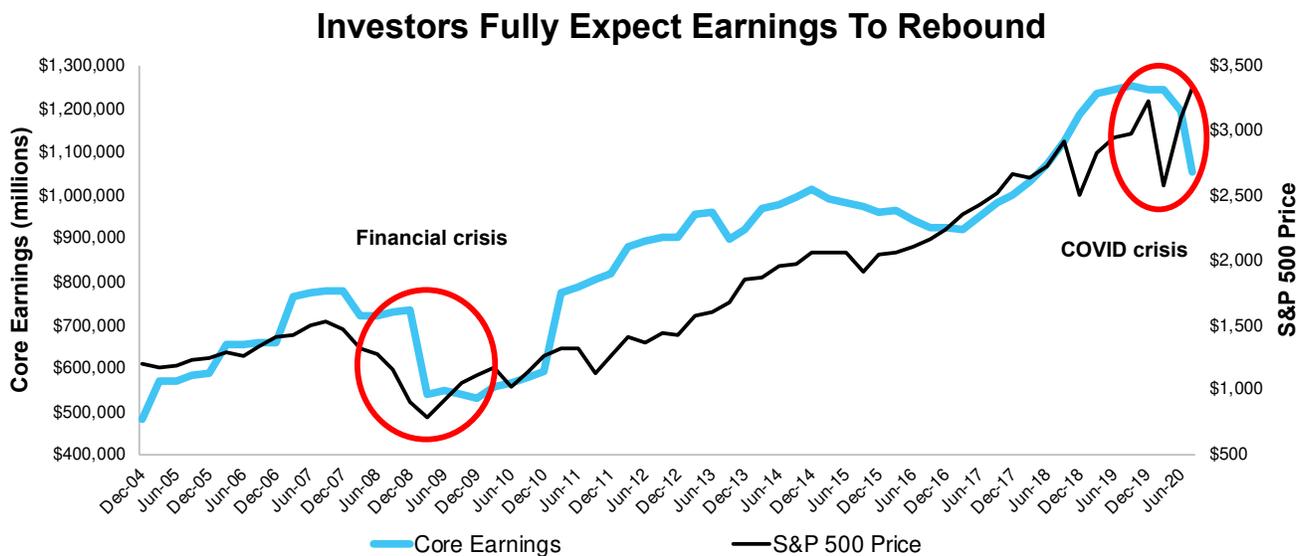
S&P 500 Pricing In a Major Earnings Recovery – Already

In our last update, [The Market Is Right & Consensus Earnings Are Wrong](#), we called a market bottom in March. We're calling a market top in this quarter's review of the S&P 500's true [Core Earnings](#) and valuation. Figure 1 shows how the bottoming out of Core Earnings during the Financial Crisis presaged the market rebound in 2009.

Currently, Figure 1 shows that the market is anticipating a strong rebound in earnings even sooner, relative to the trend in Core Earnings, than during the Financial Crisis. Consequently, with expectations already so high, any setbacks to the recovery will hit the large cap heavy weight stocks driving the S&P 500 hard.

While [retail and momentum investors](#) may push markets higher, those with fiduciary duties should consider pumping the brakes and lowering the risk in their portfolios by selling stocks with abnormally high valuations (we provide a list below).

Figure 1: Core Earnings vs. S&P 500 Price: 2004 to Present



Sources: New Constructs, LLC, company filings, and [S&P Global](#) (SPGI).

Our Core Earnings analysis is based on aggregated TTM data for the S&P 500 constituents in each measurement period.

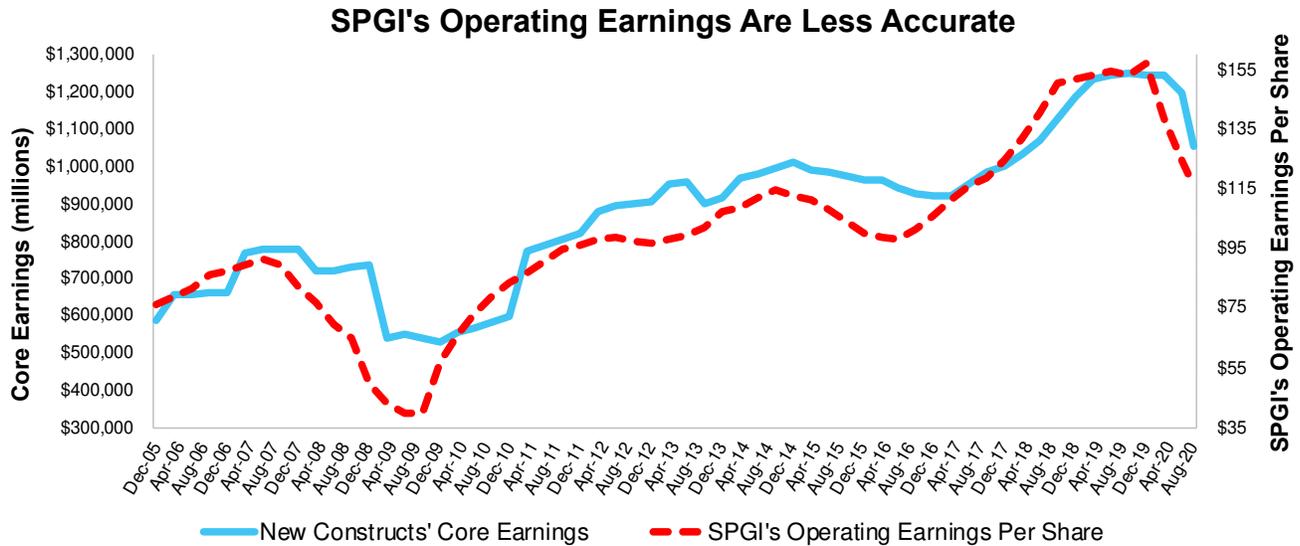
The Right Measure of Earnings Matters – Especially for Fiduciaries

Figure 2 highlights how different our measure of Core Earnings is from S&P Global's (SPGI) Operating Earnings. The differences are due to SPGI's [data systems](#) not capturing the full impact of unusual gains/losses buried in footnotes [as shown by this Harvard Business School & MIT Sloan study](#). Missing these unusual gains and losses causes earnings to be [unreliable and subject to management manipulation](#).



Relying on this legacy provider's data can put investors at risk of not understanding the true trajectory of earnings and, consequently, at risk of holding the wrong stocks.

Figure 2: Core Earnings vs. SPGI's Operating Earnings: 2005 – Present

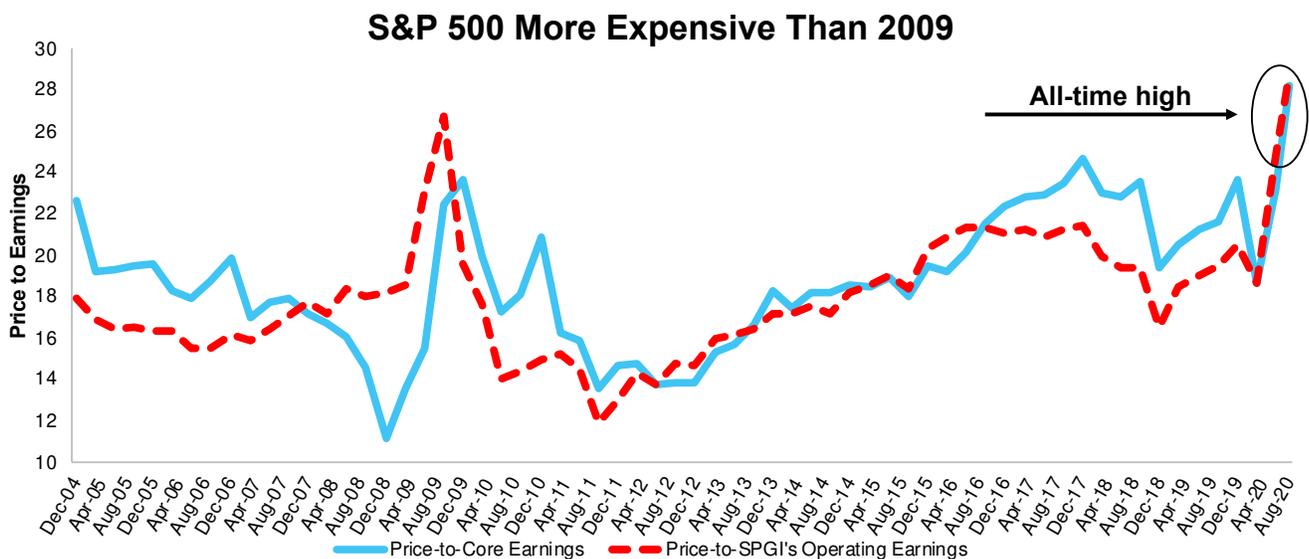


Sources: New Constructs, LLC, company filings, and S&P Global. Note: the most recent periods' data for SPGI's Operating Earnings is based on consensus. Our Core Earnings analysis is based on aggregated TTM data through 9/30/13, and aggregated quarterly data thereafter for the S&P 500 constituents in each measurement period. More details in Appendix I.

Figure 3 shows how much the P/E ratio based on SPGI's Operating Earnings differed from the P/E based on our Core Earnings during the Financial Crisis. While our P/E signaled a buy in December 2008, SPGI's P/E signaled sell. Currently, our P/E's agree that the market is fully valuing a significant recovery in earnings.

As mentioned above, anything that threatens that recovery will hit stocks hard. All the more reason for fiduciaries to be diligent about analyzing earnings accurately at both the market level and for individual stocks.

Figure 3: Price-to-Core vs. Price-to-SPGI's Operating Earnings: TTM 12/31/04 – Present



Sources: New Constructs, LLC, company filings, and S&P Global. Note that the Core Earnings P/E ratio is aggregating the TTM results for constituents in each period. SPGI P/E is based on four quarters of aggregated S&P 500 results in each period. More details in Appendix II.



COVID-19 Erased Years of Earnings, But It's Not as Bad as You Think

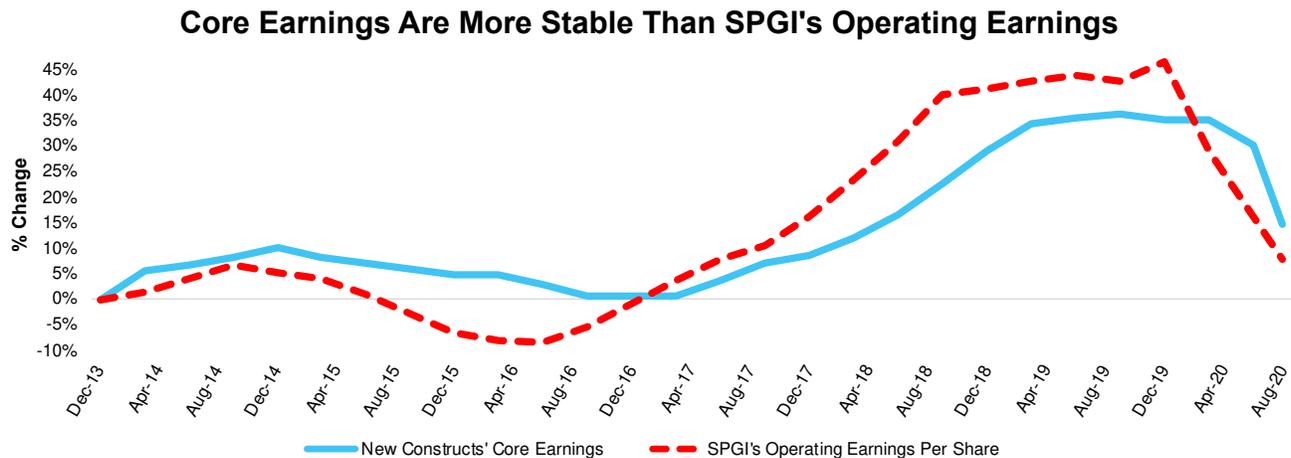
As we showed [last quarter](#), a differentiated view on earnings can lead to a differentiated view on valuation. Our measure of Core Earnings leverages [cutting-edge technology](#) to provide clients with a [cleaner and more comprehensive](#) view of earnings¹, which shows that earnings, while at multi-year lows, aren't as bad as Wall Street would have you believe.

Trailing-twelve month (TTM) Core Earnings for the S&P 500 have fallen 15% since the end of 2019 while consensus TTM S&P Global Operating Earnings per share² for the S&P 500 have fallen 26%. The COVID-19-induced economic downturn wiped out eight quarters worth of Core Earnings growth in just two quarters.

Figure 4 charts the percentage change in our Core Earnings and SPGI's operating earnings, and more clearly illustrates that our Core Earnings are less volatile and present a better measure of the normalized performance of businesses. Appendix I provides percentage changes in Core Earnings and SPGI's Operating Earnings since 2005.

These differences at the aggregate level come from even larger differences at the individual company level. In other words, investors armed with our measure of Core Earnings have a differentiated and more informed view of the fundamentals of companies.

Figure 4: Core vs. SPGI's Operating Earnings for the S&P 500 – % Change: TTM 12/31/13 – 8/11/20



Sources: New Constructs, LLC, company filings, and S&P Global (SPGI). Note: the most recent periods' data for SPGI's Operating Earnings is based on consensus. Our Core Earnings analysis is based on aggregated quarterly data for the S&P 500 constituents in each measurement period.

Lower Risk – Sell the Riskiest Stocks

Below are some of the stocks that we think present abnormally high risk. Selling these stocks would provide most investors with more than healthy gains. Nevertheless, this strategy is directed more to fiduciaries than traders, who see the recent price performance as reason for holding these positions. Fiduciaries need more than price momentum to justify investing in a given stock.

1. Wayfair (W) – [This Online Retailer is Furnishing Investors With Risk](#)
2. Tesla (TSLA) – [Tesla: The Most Dangerous Stock for Fiduciaries](#)
3. Uber (UBER) – [The Emperor Has No Clothes – Uber's Business Model Is Broken](#)
4. Carvana (CVNA) – [You Won't Find a Bargain With This Car Dealer](#)
5. Beyond Meat (BYND) – [Competition Will Eat This Firm Alive](#)

¹ For 3rd-party reviews on the benefits of adjusted Core Earnings, historically and prospectively, across all stocks, click [here](#) and [here](#).

² We think SPGI's Operating Earnings provide the best comparison to how we calculate Core Earnings.

**Stocks to Own Instead**

Since mid-April, we've identified [several companies](#) with strong underlying Core Earnings and valuations implying profits would never recover from COVID-induced lows. These stocks have not seen huge increases in their prices even though their cash flows are far superior to the companies above.

Our "[See Through the Dip](#)" thesis acknowledges that most of these firms' profits are on the [decline in the short term](#), however, their fundamentals, along with ample liquidity, will enable them not just to survive the economic downturn, but also thrive in a recovery. These stocks should be held through the market turmoil as we expect them to outperform the [crowded passive strategies](#) over the long term.

Figure 5: See Through the Dip Stocks Vs. S&P 500 – Prices through September 2, 2020

Company	Ticker	Publish Date	Return Since Publish Date	Performance vs. S&P 500
SYSCO Corporation	SYY	4/15/20	32%	3%
Simon Property Group	SPG	4/20/20	26%	-1%
Darden Restaurants	DRI	4/22/20	32%	4%
D.R. Horton	DHI	4/27/20	73%	49%
Cracker Barrel Old Country Store	CBRL	4/29/20	34%	12%
Southwest Airlines	LUV	5/4/20	42%	16%
Omnicom Group	OMC	5/6/20	-1%	-26%
Hyatt Hotels	H	5/14/20	23%	-3%
Allstate Corp	ALL	5/18/20	-4%	-26%
JPMorgan Chase & Company	JPM	5/21/20	13%	-9%
Caterpillar	CAT	5/27/20	22%	4%
PVH Corp	PVH	6/10/20	0%	-12%
MasTec Inc.	MTZ	6/10/20	13%	1%
Allison Transmission Holdings	ALSN	6/15/20	-1%	-18%
Standard Motor Products	SMP	6/17/20	19%	4%
HCA Healthcare	HCA	6/22/20	41%	26%
Bloomin' Brands Inc.	BLMN	6/24/20	58%	41%
Meritage Homes	MTH	6/29/20	35%	18%
HollyFrontier Corp	HFC	7/8/20	-15%	-28%
John B. Sanfilippo & Son, Inc.	JBSS	7/13/20	-8%	-22%
General Motors Co.	GM	7/15/20	15%	4%
PACCAR Inc.	PCAR	7/20/20	10%	0%
Universal Health Services, Inc.	UHS	7/22/20	6%	-3%
Phillips 66	PSX	7/29/20	-8%	-18%
Intel Corporation	INTC	8/6/20	8%	1%
The Hershey Company	HSY	8/12/20	2%	-4%
Equal Weighted Portfolio Return			18%	
Average Outperformance vs S&P 500			1%	

Sources: New Constructs, LLC and company filings.

This article originally published on [September 3, 2020](#).

Disclosure: David Trainer owns SYY, DHI, H, JPM, SPG, and LUV. David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

Follow us on [Twitter](#), [Facebook](#), [LinkedIn](#), and [StockTwits](#) for real-time alerts on all our research.



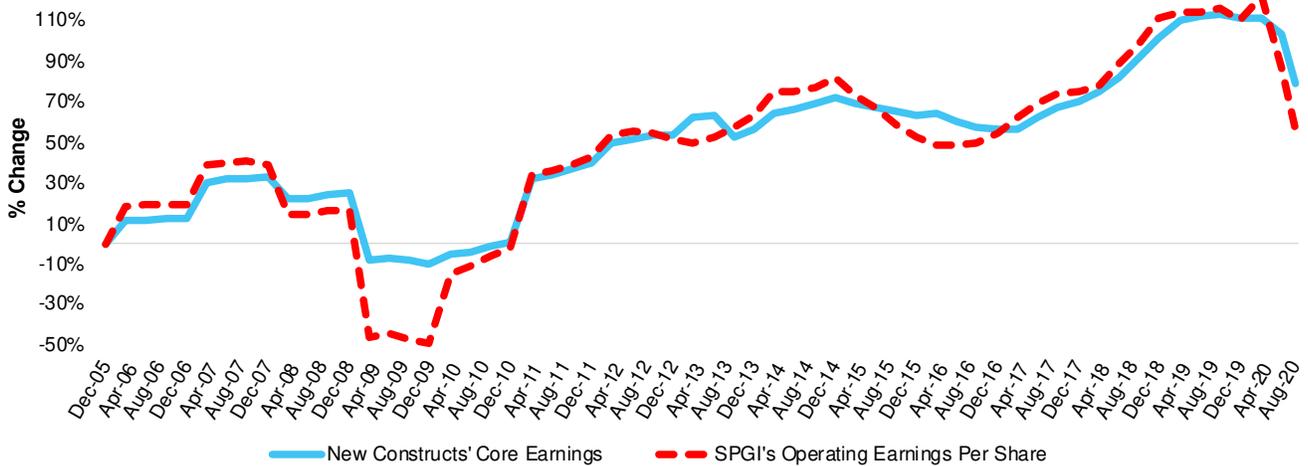
Appendix I: Core Earnings Methodology & Historical Analysis

Figure I shows the percentage change in Core Earnings and S&P Operating Earnings per share dating back to 2005. Note the severity of the decline brought on by the COVID-19 pandemic. Core Earnings have declined 15% since March 2020, which is around the time the U.S. economy entered a recession. For reference, during the Great Recession, Core Earnings bottomed in December 2009, which was two years after the U.S. economy entered the recession, and fell 32% during that time.

Note: In Figure 2 above and I below, for analysis post 9/30/13, we use aggregated quarterly data for the companies in the S&P 500. For values prior to 9/30/13, we use aggregated annual data for every company in the S&P 500. While we prefer aggregated quarterly numbers, we have examined the potential impacts of the two methodologies and have found no material differences.

Figure I: Core vs. SPGI's Operating Earnings for the S&P 500 – % Change: 12/30/05 – 8/11/20

SPGI's Operating Earnings are Noisier Than Core Earnings



Sources: New Constructs, LLC, company filings, and S&P Global (SPGI).
Note: the most recent periods' data for SPGI's Operating Earnings is based on consensus.



Appendix II: P/E Ratio Methodology for Core & SPGI's Operating Earnings

In Figure 3 above, we calculate the price-to-Core Earnings ratio as follows:

1. Calculate a TTM earnings yield for every S&P 500 constituent
2. Weight the earnings yields by each stock's respective S&P 500 weight
3. Sum the weighted earnings yields and take the inverse (1/Earnings Yield)

We use the earnings yield methodology because P/E ratios don't follow a linear trend. A P/E ratio of 1 is "better" than a P/E ratio of 30, but a P/E ratio of 30 is "better" than a P/E ratio of -15. In other words, aggregating P/E ratios can result in a low multiple due the inclusion of just a few stocks with negative P/Es.

Using earnings yields solves this problem because a high earnings yield is always "better" than a low earnings yield. There is no conceptual difference when flipping from positive to negative earnings yields as there is with traditional P/E ratios.

For all periods in Figure 3, we calculate the price-to-SPGI's Operating Earnings ratio by summing the preceding 4 quarters of Operating Earnings per share and, then, dividing by the S&P 500 price at the end of each measurement period.

Figures II and III show the price-to-Core Earnings ratio using quarterly data for the companies in the S&P 500 (which we have back to December 2012).

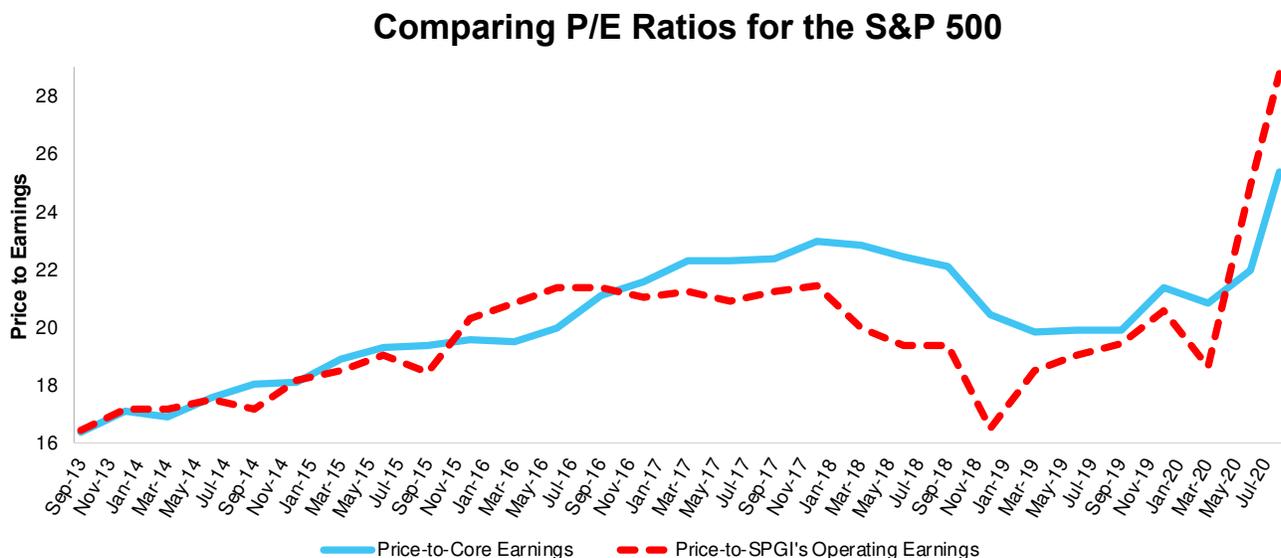
In these Figures, we calculate the price-to-Core Earnings ratio as follows:

1. Calculate a trailing four quarters earnings yield for every S&P 500 constituent
2. Weight the earnings yield by each stock's respective S&P 500 weight
3. Sum the weighted earnings yields and take the inverse (1/Earnings Yield)

This method allows us to capture the impact of changes to S&P 500 constituents on a quarterly basis. For example, a company could be a constituent in 2Q18, but not in 3Q18. This method captures the continuously changing nature of the S&P 500 constituency.

Through this analysis, we see that the market trades at the highest P/E since at least 2013 based on our Core Earnings, but well below the P/E based on SPGI's Operating Earnings.

Figure II: Price-to-Core vs. Price-to-SPGI's Operating Earnings: Quarterly 9/30/13 – Present

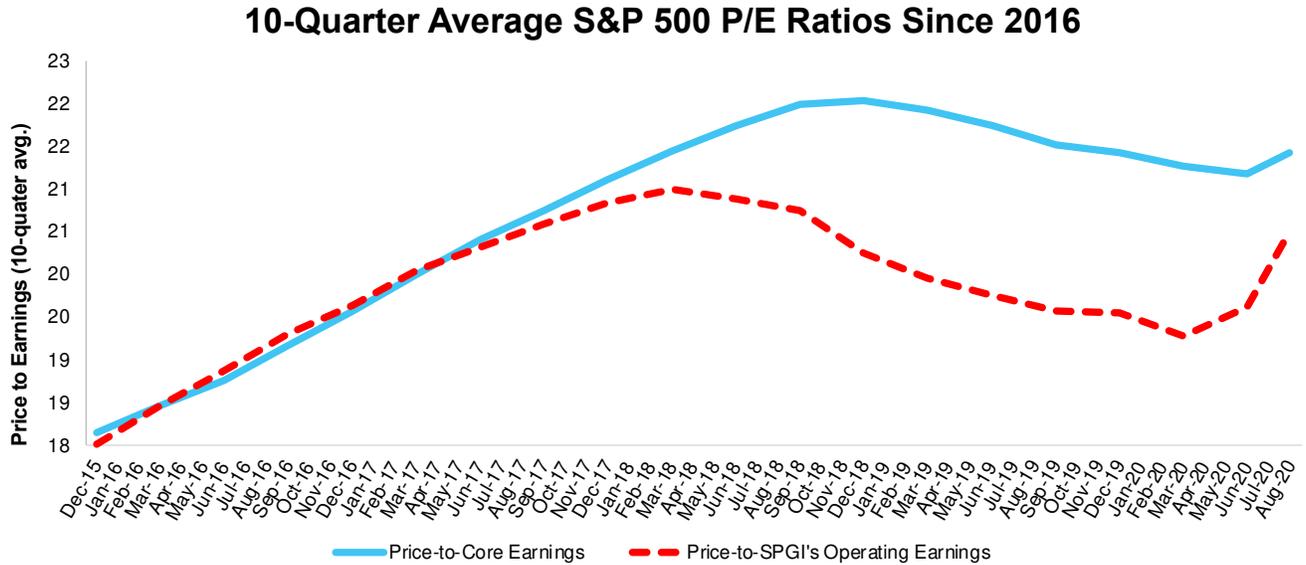


Sources: New Constructs, LLC, company filings, and S&P Global. P/E ratios are based on four quarters of aggregated S&P 500 constituent results in each period.



Figure III shows that our price-to-Core Earnings ratio provides a much more normalized measure of the S&P 500's valuation, compared to the price-to-SPGI's Operating Earnings ratio, which jumped significantly since March 2020 as Operating Earnings have plummeted (per Figure 2 above).

Figure III: Price-to-Core vs. Price-to-SPGI's Operating Earnings: Quarterly 10 Quarter Average



Sources: New Constructs, LLC, company filings, and S&P Global.

P/E ratios are based on four quarters of aggregated S&P 500 constituent results in each period.



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



DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs. Copyright New Constructs, LLC 2003 through the present date. All rights reserved.