S&P 500 Companies That Overstated EPS by Over 75% in 3Q21

Misleading earnings outperformance continued in 3Q21, increasing downside risk for the S&P 500. Operating Earnings from S&P Global (SPGI) exaggerated the drop in 2020 and have overstated the rebound in S&P 500 earnings through 3Q21. The same is true for Zacks Earnings (referred to in this report as Street Earnings), which are adjusted to remove non-recurring items using standardized assumptions from the sell-side.

This report shows:

- The prevalence and magnitude of overstated Street Earnings in the S&P 500
- Why Street Earnings (and GAAP earnings) are flawed
- Five S&P 500 companies with overstated Street Earnings and a Very Unattractive Stock Rating
- How Core Earnings[1] and our Earnings Distortion factor provide a new source of alpha

Nearly 200 S&P 500 Firms Overstate EPS by More than 10%

For 360 companies in the S&P 500, Street Earnings overstated Core Earnings[2] for the trailing-twelve-months (TTM) ended calendar 3Q21. When Street Earnings overstate Core Earnings, they do so by an average of 19% per company, per Figure 1. The overstatement was more than 10% of Street Earnings for 39% of companies.

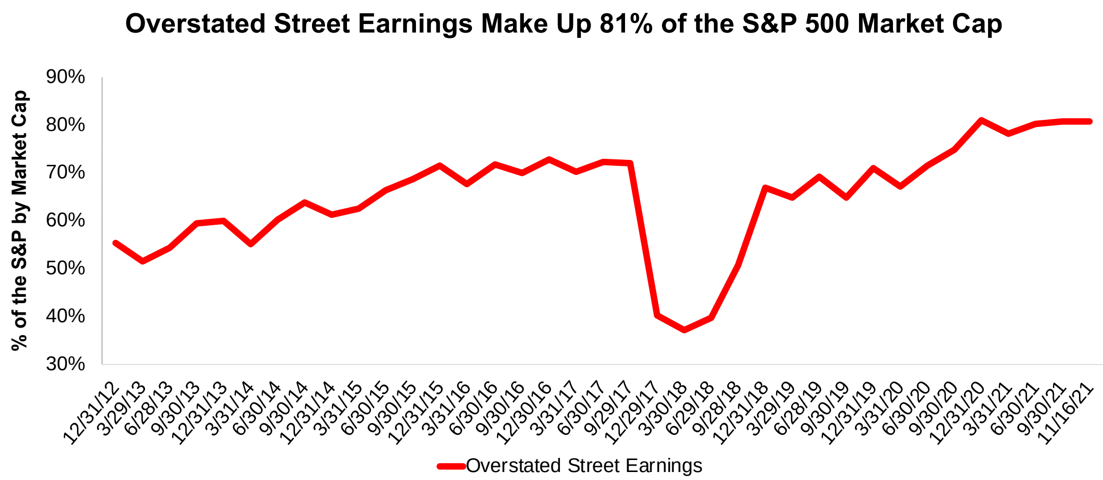
Figure 1: Street Earnings Overstated by 19% on Average Through 3Q21

Overstated Street Earnings	Overstated by >10%	Average Overstated %[3]
360 companies	197 companies	19%

Sources: New Constructs, LLC and company filings.

The 360 companies with overstated Street Earnings make up 81% of the market cap of the S&P 500, which is the highest percent since 2012 (earliest data available). See Figure 2.

Figure 2: Overstated Street Earnings as % of Market Cap: 2012 through 11/16/21



Sources: New Constructs, LLC and company filings.

[1] Only Core Earnings enable investors to overcome the flaws in legacy fundamental data and research, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan for The Journal of Financial Economics.
[2] Our Core Earnings research is based on the latest audited financial data, which is the calendar 3Q21 10-Q in most cases
[3] Average overstated % is calculated as Street Distortion, which is the difference between Street Earnings and Core Earnings.

S&P Global's Earnings Rebound Is Misleading

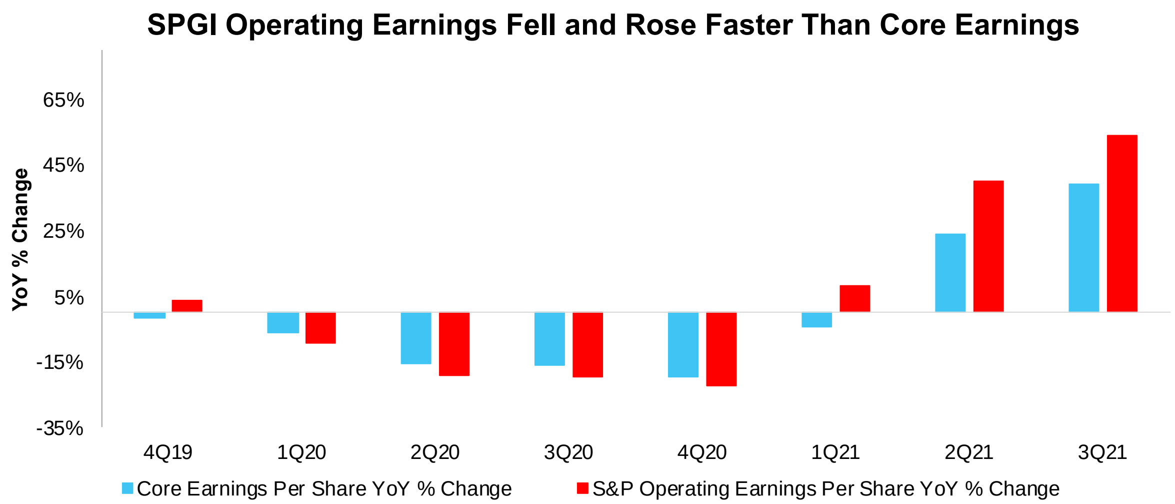
In theory, equity analysts create adjusted earnings measures like Street Earnings and Operating Earnings to exclude unusual gains and losses. In reality, these adjusted earnings measures rarely, if ever, fully capture unusual items that have a material impact on results.

Per Figure 3 (from our report Overstated Operating Earnings Increase Downside Risk for the S&P 500), the rebound in earnings is not as robust as SPGI's Operating Earnings suggest. Year-over-year (YoY):

- SPGI's Operating Earnings improved from $123.37/share to $189.88/share, or 54%
- Core Earnings improved from $129.35/share to $180.31/share, or 39%

SPGI's Operating Earnings for the S&P 500 were 5% below Core Earnings in 3Q20 and were 5% higher in 3Q21. Unusual losses included in SPGI's Operating Earnings drive the exaggerated declines while unusual gains lead to the exaggerated rebounds.

Figure 3: Core Earnings vs. SPGI Operating Earnings: 4Q19 – 3Q21[4]



Sources: New Constructs, LLC, company filings, and S&P Global (SPGI). Note: the most recent period's data for SPGI's Operating Earnings is based on consensus estimates for companies with a non-standard fiscal year.
Our Core Earnings analysis is based on aggregated TTM data through 6/30/13 and aggregated quarterly data thereafter for the S&P 500 constituents in each measurement period.

The Five Worst Offenders in the S&P 500

Figure 4 shows the S&P 500 stocks with a Very Unattractive Stock Rating and the most overstated Street Earnings (Street Distortion as a % of Street Earnings per share) over the TTM through 3Q21. "Street Distortion" equals the difference between Core Earnings per share and Street Earnings per share. Investors using Street Earnings miss the true profitability, *or lack thereof*, of these businesses.

Figure 4: S&P 500 Companies with Most Overstated Street Earnings: TTM as of 3Q21

Ticker	Name	Street EPS	Core EPS	Overstated %*	Stock Rating
			Most Overstated Street Earnings		
ALK	Alaska Air Group	($4.89)	($9.92)	103%	Very Unattractive
ILMN	Illumina Inc.	$6.43	($0.14)	102%	Very Unattractive
DXC	DXC Technology Company	$3.32	$0.07	98%	Very Unattractive
FTV	Fortive Corporation	$2.65	$0.56	79%	Very Unattractive
EQR	Equity Residential	$2.82	$0.65	77%	Very Unattractive

Sources: New Constructs, LLC and company filings.
*Measured as Street Distortion as a percent of Street EPS

[4] November 16, 2021, is the earliest date for which all the calendar 3Q21 10-Qs for the S&P 500 constituents were available.

In the section below, we detail the hidden and reported unusual items that distort GAAP Earnings for Equity Residential (EQR), one of the stocks in December's Most Dangerous Stocks Model Portfolio. All of these unusual items are removed from Core Earnings.

Equity Residential's (EQR) TTM 3Q21 Street Earnings Overstated by $2.17/share

The difference between Equity Residential's Street Earnings ($2.82/share) and Core Earnings ($0.65/share) is $2.17/share, per Figure 5. That difference is the Street Distortion, which for Equity Residential is seventy seven percent of Street Earnings.

Equity Residential's GAAP Earnings overstate Core Earnings by $2.08/share. Street Earnings are more distorted by unusual items than GAAP earnings for Equity Residential.

Figure 5: Comparing Equity Residential's GAAP, Street, and Core Earnings: TTM as of 3Q21

Sources: New Constructs, LLC and company filings.

Below, we detail the differences between Core Earnings and GAAP Earnings so readers can audit our research. We would be happy to reconcile our Core Earnings with Street Earnings but cannot because we do not have the details on how analysts calculate their Street Earnings.

Equity Residential's Earnings Distortion Score is Strong Miss and its Stock Rating is Very Unattractive. As noted above, Equity Residential is in December's Most Dangerous Stocks Model Portfolio due to its overstated earnings and expensive valuation. Despite trading at $86/share, EQR has an economic book value (EBV), or no growth value, of just $10/share.

Figure 6 details the differences between Equity Residential's Core Earnings and GAAP Earnings.

Figure 6: Equity Residential's GAAP Earnings to Core Earnings Reconciliation: 3Q21

	TTM ($ per share)
GAAP Net Income	$2.73
– Hidden Unusual Gains, Net	$0.01
– Reported Unusual Gains Pre-Tax, Net	$1.98
– Tax Distortion	<-$0.01
– Reported Unusual Gains After-Tax, Net	$0.09
= Core Earnings	**$0.65**

Sources: New Constructs, LLC and company filings.

More details:

Total Street Distortion of $2.08/share is comprised of the following:

Hidden Unusual Gains, Net = $0.01/per share, which equals $5 million and is comprised of

- $5 million in gains in 4Q20 to offset write-offs reported in prior 10-Qs but no longer disclosed separately in the 10-K

Reported Unusual Gains Pre-Tax, Net = $1.98/per share, which equals $766 million and is comprised of

- $767 million in gains on the sale of real estate properties in the TTM period based on
  - $364 million gain in 3Q21
  - $224 million gain in 2Q21
  - -$43 thousand loss in 1Q21
  - $180 million gain in 4Q20
- $27 million in interest and other income in the TTM period based on
  - $1 million in 3Q21
  - $24 million in 2Q21
  - $216 thousand in 1Q21
  - $2 million in 4Q20
- -$9 million in amortization of deferred financing costs in the TTM period based on
  - -$2 million in 3Q21
  - -$2 million in 2Q21
  - -$2 million in 1Q21
  - -$3 million in 4Q20
- -$20 million in "other expenses" in the TTM period based on
  - -$3 million in 3Q21
  - -$3 million in 2Q21
  - -$4 million in 1Q21
  - -$9 million in 4Q20

Tax Distortion = <-0.01/per share, which equals -$831 thousand

- We remove the tax impact of unusual items on reported taxes when we calculate Core Earnings. It is important that taxes get adjusted so they are appropriate for adjusted pre-tax earnings.

Reported Unusual Gains After-Tax, Net = $0.09/per share, which equals $34 million and is comprised of

- $34 million in gains in the TTM based on $34 million gain on the sales of land parcels in 2020

Given the similarities between Street Earnings for Equity Residential and GAAP Earnings, our research shows both Street and GAAP earnings fail to capture significant unusual items reported directly on Equity Residential's income statement.

How to Make Money with Core Earnings & Earnings Distortion

As demonstrated above, Core Earnings do a better job of excluding unusual gains and losses and provide a more reliable earnings measure. All Core Earnings adjustments are 100% transparent; so users can audit and trust the research.

To enable you to easily monetize our new Earnings Distortion factor we present multiple trading strategies that drive alpha. Learn more below.

- ExtractAlpha presents a long/short market-neutral strategy that generates 9.3% annualized return net of Fama-French 5 factors, momentum, short-term reversal, and 12 sectors. More details here.
- CloudQuant presents two strategies to monetize the alpha in Earnings Distortion:
  - the long-only portfolio outperformed the S&P 500 by an average of 4% per annum over 10 years
  - the dollar-neutral long-short portfolio returned 60% over 10 years with a Sharpe Ratio of ~1 over the last five years. More details here.
- AltHub presents three strategies to monetize the alpha in Earnings Distortion:
  - Earnings Distortion S&P 500 Smart Beta Portfolio: 10-yr annualized return of 13.9% vs 12.1% for the S&P 500 with a Sharpe Ratio of 0.97.
  - Earnings Distortion ML Model S&P 500 Smart Beta Portfolio: 3-yr annualized return of 18.2% vs 13.7% for the S&P 500 with a Sharpe Ratio of 0.82.
  - Truth Stocks (Companies without Earnings Distortion) Portfolios:

    - S&P 500 Universe: 10-yr annualized return of 16.8% vs 12.8% for the S&P 500 with a Sharpe Ratio of 0.7.
    - Russell 3000 Universe: 9.5-yr annualized return of 28.4% vs 12.6% for the S&P 500 with a Sharpe Ratio of 1.
  - More details here.

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

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Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

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