S&P 500 & Sectors: GAAP Earnings' Misleading Trend Continues In 2Q23 (Free, Abridged)

Seeing GAAP earnings move in the opposite direction of Core Earnings raises red flags about the quality of reported earnings while also raising the risk of earnings misses in subsequent quarters. In other words, 3Q23 and 4Q23 earnings seasons could be ugly. These results also underscore the more stable nature of Core Earnings. Because we remove unusual gains and losses, Core Earnings are not prone to the large swings seen in GAAP Earnings.

This report is an abridged and free version of S&P 500 & Sectors: GAAP Earnings' Misleading Rise Continued In 2Q23, one of our quarterly series of reports on fundamental market and sector trends. The full reports are available to Professional and Institutional members.

The full version of the report analyzes Core Earnings[1,2] and GAAP earnings for the S&P 500 and each of its sectors (last quarter's analysis is here) from 2004 to present.

This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior[3] fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

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GAAP Earnings Rise Is Again Misleading in 2Q23

Our superior fundamental data protects investors from being misled by false trends in un-scrubbed GAAP Earnings. The recent rise in GAAP Earnings, which we first highlighted in 1Q23, explains part of Wall Street's recent bullishness and our bearishness on certain stocks. Looking beyond the headlines reveals that the recent rise in GAAP Earnings may be an illusion for three reasons:

1. Understated GAAP earnings in prior quarters set up easy comps. The kitchen sink effect in in full effect.
2. Unusual gains are artificially elevating GAAP Earnings and cannot persist forever.
3. Core Earnings heading lower suggests GAAP Earnings will normalize and do the same soon.

If the rise in GAAP Earnings proves to be an illusion, investors could be in for a rude awakening in the second half of 2023, especially if they've been investing in expensive stocks. See Figure 1 in the full report.

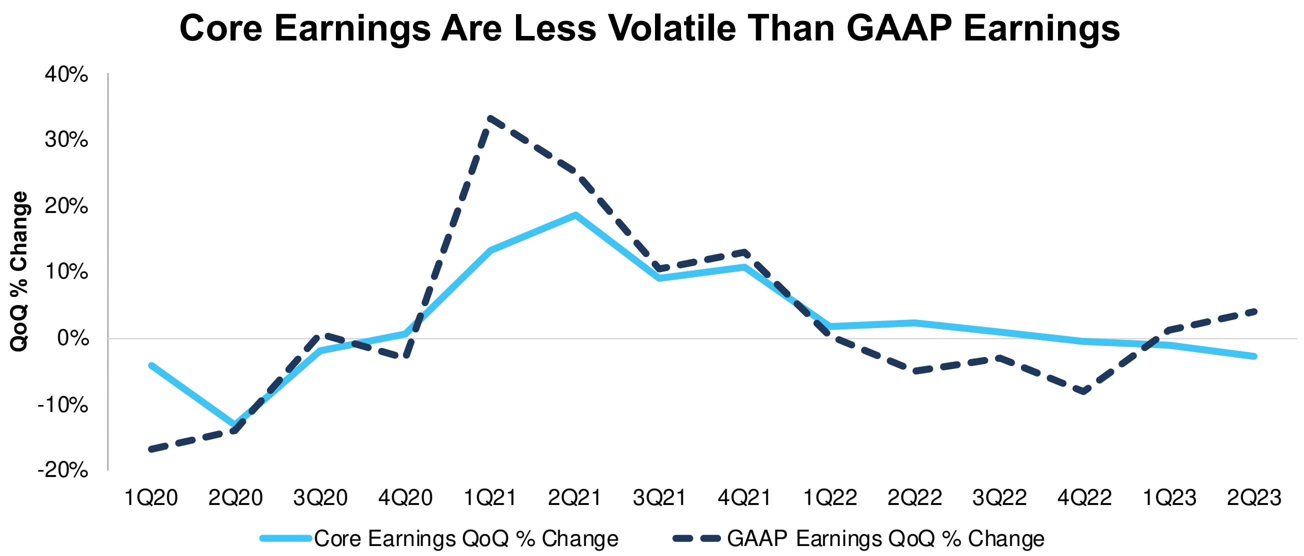
Generally Accepted Accounting Distortions

Figure 1 in the full report shows GAAP Earnings for the S&P 500 meaningfully differ from Core Earnings for the fifth consecutive quarter. Corporate profits, as measured by Core Earnings, have been much less volatile than GAAP earnings suggest, especially since 1Q20. For example, per Figure 2, in the TTM ended:

- 1Q21, GAAP earnings trend differs from Core Earnings by 20%.
- 2Q22, GAAP earnings trend differs from Core Earnings by 7%.
- 3Q22, GAAP earnings trend differs from Core Earnings by 4%.
- 4Q22, GAAP earnings trend differs from Core Earnings by 7%.
- 1Q23, GAAP earnings trend differs from Core Earnings by 2%.
- 2Q23, GAAP earnings trend differs from Core Earnings by 7%.

[1] The Journal of Financial Economics features the superiority of our Core Earnings in Core Earnings: New Data & Evidence.
[2] Based on the latest audited financial data, which is the calendar 2Q23 10-Q in most cases. Price data as of 8/15/23.
[3] Our research utilizes our Core Earnings, a more reliable measure of profits, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan and published in The Journal of Financial Economics.

Figure 1: S&P 500 Core Earnings Vs. GAAP Earnings QoQ Percent Change: 1Q20 – 2Q23



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.
The August 15, 2023 measurement period incorporates the financial data from calendar 2Q23 10-Qs, as this is the earliest date for which all the calendar 2Q23 10-Qs for the S&P 500 constituents were available.

GAAP Earnings[4] Understate Core Earnings for Nearly Two-Thirds the S&P 500 (by Market Cap)

64% of the companies in the S&P 500 reported GAAP Earnings that are lower than Core Earnings for the TTM ended 2Q23.

When GAAP Earnings understate Core Earnings, they do so by an average of 57%, per Figure 2. GAAP Earnings understated Core Earnings for 320 companies in 2Q23, compared to 335 in the TTM ended 1Q23.

Figure 2: S&P 500 GAAP Earnings Understated by 57% On Average

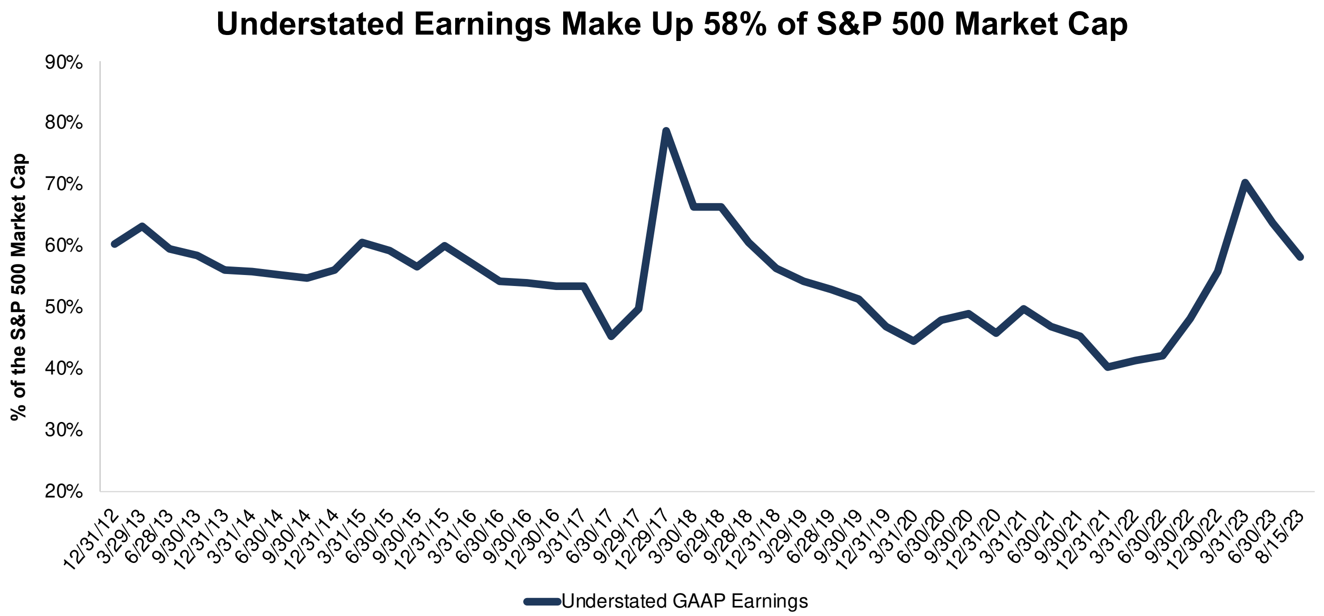
Understated GAAP Earnings	Understated by >10%	Average Understatement %
320 companies	163 companies	57%

Sources: New Constructs, LLC and company filings.
We use Funds from Operations (FFO) for Real Estate companies rather than GAAP Earnings.

The 320 companies with understated GAAP Earnings make up 58% of the market cap of the S&P 500 as of August 15, 2023. Companies with understated GAAP earnings made up 64% of the S&P 500 market cap in 1Q23 and 48% of the S&P 500 market cap in 2Q22.

[4] Overstated companies include all companies with Earnings Distortion >0.1% of GAAP earnings.

Figure 3: Understated Earnings as % of Market Cap: 2012 through 8/15/23



Sources: New Constructs, LLC and company filings.

Key Details on Select S&P 500 Sectors

Six of eleven sectors saw a QoQ rise in Core Earnings through the TTM ended 2Q23, which was up from just four sectors in 1Q23.

The Consumer Cyclicals sector saw the largest QoQ improvement in Core Earnings, which rose from $163.9 billion in 1Q23 to $170.1 billion in 2Q23, or 4%.

At $447.5 billion, the Technology sector generates the most Core Earnings and saw Core Earnings rise 2% QoQ in 2Q23. On the flip side, the Real Estate sector has the lowest Core Earnings at $23.5 billion. The Energy sector had the largest QoQ decline in 2Q23 at -16%.

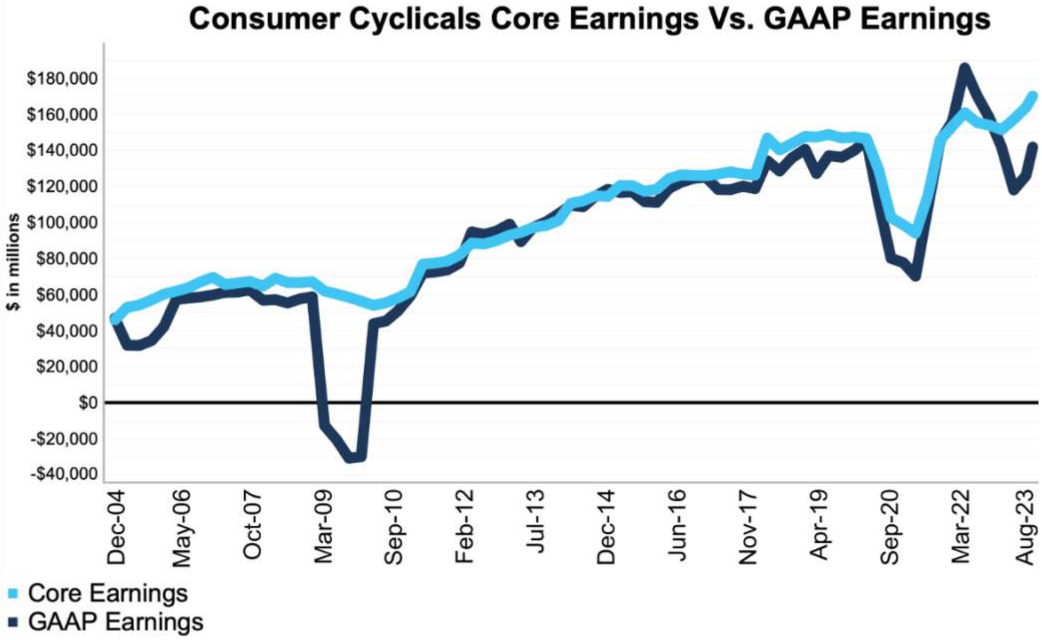
Below we highlight the Consumer Cyclicals sector and a stock with some of the most negative Earnings Distortion (i.e. understated GAAP earnings) in the sector.

Sample Sector Analysis[5]: Consumer Cyclicals Sector

Figure 4 shows Core Earnings for the Consumer Cyclicals sector, at $170.1 billion, rose 4% QoQ in 2Q23, while GAAP earnings, at $141.8 billion, rose 12% over the same time.

[5] The full version of this report provides analysis for all eleven sectors.

Figure 4: Consumer Cyclicals Core Earnings Vs. GAAP: 2004 – 2Q23



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.
The August 15, 2023 measurement period incorporates the financial data from calendar 2Q23 10-Qs, as this is the earliest date for which all the calendar 2Q23 10-Qs for the S&P 500 constituents were available.

GAAP Earnings Understatement Details: General Motors (GM)

Below, we detail the hidden and reported unusual items overlooked in GAAP Earnings and captured in Core Earnings for General Motors (GM). After adjusting for unusual items, we find that General Motors' Core Earnings of $12.0 billion, or $8.43/share are much higher than reported GAAP Earnings of $10.2 billion, or $7.17/share.

General Motor's Stock Rating is Very Attractive, in part due to its positive economic earnings, high free cash flow yield, and low price-to-economic book value (PEBV) ratio of 0.3. We made General Motors a Long Idea in March 2018. and while the stock has underperformed, it remains highly undervalued. See all our research on General Motors here.

Below, we detail the differences between Core Earnings and GAAP Earnings so readers can audit our research.

Figure 5: General Motors' GAAP Earnings to Core Earnings Reconciliation: TTM through 2Q23

	TTM ($ per share)
GAAP Net Income	$7.17
– Hidden Unusual Expenses, Net	($1.36)
– Reported Unusual Expenses Pre-Tax, Net	($0.06)
– Tax Distortion	$0.16
= Core Earnings	**$8.43**

Sources: New Constructs, LLC and company filings.

More details:

Total Earnings Distortion of -$1.26/share, which equals -$1.8 billion, is comprised of the following:

Hidden Unusual Expenses Pre-Tax, Net = -$1.36/per share, which equals -$1.9 billion and is comprised of:

- -$1.5 billion in hidden restructuring expenses in the TTM period based on
  - -$246 million in Buick dealer strategy charges on page 29 in 2Q23 10-Q
  - -$875 million in voluntary separation program charges on page 26 in 1Q23 10-Q
  - -$99 million in Buick dealer strategy charges on page 26 in 1Q23 10-Q

    - -$256 million in restructuring and other initiatives in the TTM based on $511 million charge on page 90 in the 2022 10-K
    - -$1 million impairment charges in 4Q22 based on -$12 million impairment charge on page 72 in 2022 10-K
- -$529 million in cruise compensation modifications based on -$1.1 billion charge on page 27 in the 2022 10-K
- $76 million benefit from GM Korea wage litigation no page 29 in the 2Q23 10-Q

Reported Unusual Expenses Pre-Tax, Net = -$0.06/per share, which equals $79 million and is comprised of:

- -$542 million in other expenses in the 2022 10-K
- $1.5 billion in interest and other non-operating income in the TTM period based on
    - $358 million in 2Q23
    - $409 million in 1Q23
    - $102 million in 4Q22
    - $598 million in 3Q22
- $238 million in licensing agreements income in 2022 10-K
- -$236 million in revaluation of investments in 2022 10-K
- $1.0 billion contra adjustment for recurring pension costs. These recurring expenses are reported in non-recurring line items, so we add them back and exclude them from Earnings Distortion.

Tax Distortion = $0.16/per share, which equals $225 million.

This article was originally published on August 25, 2023.

Disclosure: David Trainer, Kyle Guske II, Italo Mendonça, and Hakan Salt receive no compensation to write about any specific stock, style, or theme.

Questions on this report or others? Join our Society of Intelligent Investors and connect with us directly.

Appendix: Calculation Methodology

We derive the Core Earnings and GAAP Earnings metrics above by summing the Trailing Twelve Month individual S&P 500 constituent values for Core Earnings and GAAP Earnings in each sector for each measurement period. We call this approach the "Aggregate" methodology.

The Aggregate methodology provides a straightforward look at the entire sector, regardless of market cap or index weighting and matches how S&P Global (SPGI) calculates metrics for the S&P 500.

It's Official: We Offer the Best Fundamental Data in the World

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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