Bogus Numbers

Investors today have a right to be confused. A cadre of investment strategists tell them that stocks are cheap, authoritatively declaring that the price-earnings ratio of the S&P 500 index is much lower than the historic average. Yet, another crowd of analysts claim that the market is overvalued, quoting different price-earnings numbers. Who is right?

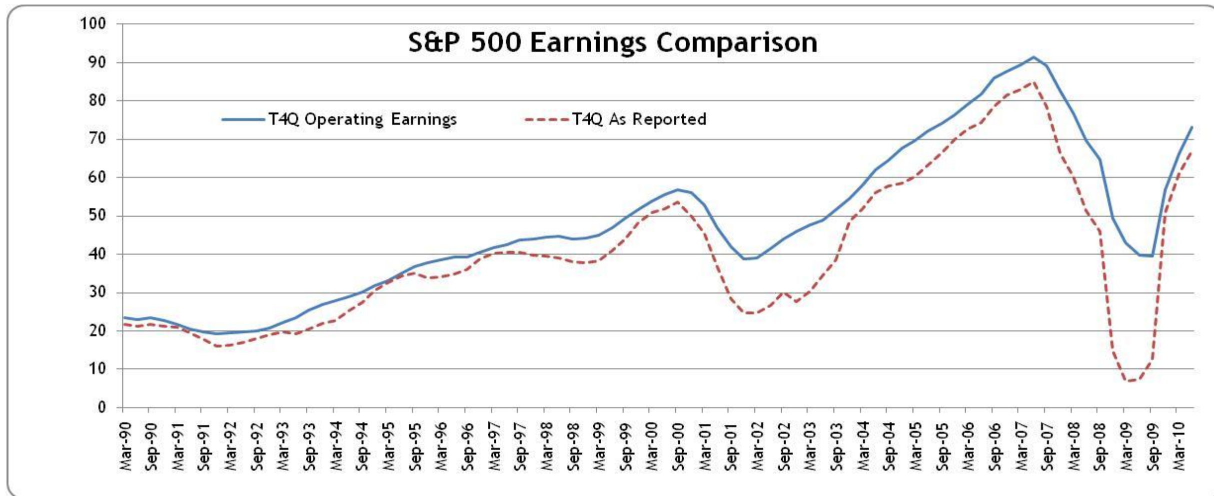
This is a critical issue. Although market valuations have virtually no relationship to short-term returns, they clearly impact long-term returns. Investors who stampeded into the market during the tech mania learned the hard way that expensive entries into an asset class do not pay off in the long-term. The S&P 500 price index today is at a level that was first achieved in 1998.

The crux of the difference between the “cheap” and “overvalued” views lies in the selection of earnings numbers, of which there are two basic sets. The broadest traditional measure is “as reported” earnings which includes all charges except the cumulative impact of accounting changes, discontinued operations and extraordinary items. All of these exclusions are defined by Generally Accepted Accounting Principles (“GAAP”).

The second set is “operating earnings” which is “as reported” earnings less a number of additional exclusions such as restructuring charges, asset sale gains and losses, major litigation charges, goodwill write-downs, inventory and other write-offs. There is no GAAP definition of “operating earnings” and hence, management has latitude in how it is calculated. Analysts also often adopt unique calculation methods.

In fact, the original intent behind “operating earnings” was to create a measurement of a firm’s earnings from its core operations that could be compared across time periods. It was never intended as a valuation measure.

In theory, the difference between the two earnings numbers should be modest. In fact, from 1970 to 1990, “as reported” earnings averaged only 2% less than “operating earnings”.[i] However, since then the average difference has skyrocketed to 17%.[ii] This is evidenced in the following graph which compares the trailing four-quarter “operating earnings” for the S&P 500 (in blue) to the “as reported earnings” (in red).



In retrospect, it is clear that during the tech boom of the late 1990's and the financial boom of the last decade, companies either overpaid for acquisitions or booked illusory profits that resulted in massive write-offs in the subsequent recessions. The enormous profits booked by AIG from its Financial Products subsidiary's issuance of ill-conceived and mispriced credit default swaps, which effectively bankrupted the entire company in 2008, exemplifies this behaviour.

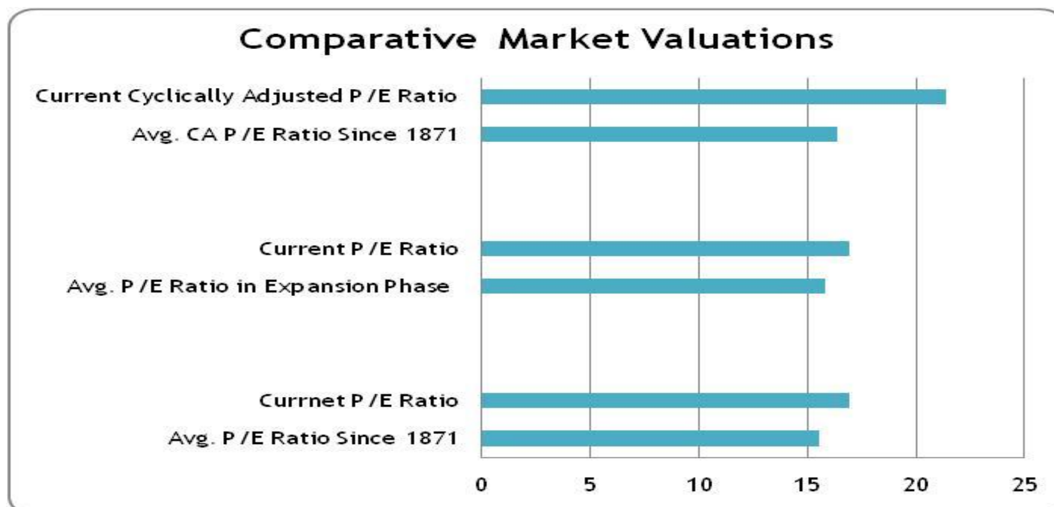
"Operating earnings" have clearly become "earnings before a lot of bad stuff". Since they do not measure the economic performance of companies, their use as a valuation tool is entirely inappropriate. Yet, time and again, many investment strategists use these numbers to trumpet that the market is cheap.

An example is in order. "Operating earnings" for the S&P 500 for the twelve months ended September 2010 are expected to be in the order of $79 per share. With an S&P 500 index of 1180, this translates into a price earnings ratio ("P/E") of 14.9. In contrast, the lower "as reported" earnings of $70[iii] results in a higher P/E ratio of 16.9, comparatively a market that is 13% more expensive.

However, the faulty logic of the "inexpensive" market advocates doesn't stop at the use of inappropriate historic "operating earnings" number. They use projected "operating earnings", a number that swells during the optimism of recoveries. Today, for example, the top-down forecast of "operating earnings" for the S&P 500[iv] for 2011 is $87 translating into a P/E ratio of 13.6. Never mind that the earnings have yet to materialize and a severe slowdown would chop them.

Then, in a final sleight of hand, this number is compared against the historic, "as reported" P/E ratio of 15.5[v]. This is a bogus comparison. You can't use forecast earnings in one ratio calculation and historic in another; earnings grow on average about 6% a year so the projected P/E is automatically biased to look cheaper. And you certainly can't compare P/E's based on "operating earnings" to the much lower "as reported" numbers.

Using "as reported" earnings as of September 30, 2010[vi], a more appropriate measure of economic profits, the following graph compares three different historic P/E measures since 1871[vii] against their current counterparts. The first is the cyclically-adjusted, real 10-year average P/E ratio that balances out the distortive impacts of both the business cycle and inflation on profits. The second is the average P/E ratio since 1871 during the expansion phase of every business cycle while the third is simply the long-term average incorporating all years.



Every "as reported" price-earnings measure shows that the market is overvalued relative to historic norms. There is a wide variation ranging from 7% to 30% so there is room to debate the degree of overvaluation, but the verdict is clear. The market is not cheap. The "overvaluation" advocates have it right. We wish it were otherwise.

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[i] Jeremy J. Siegel, *Stocks for the Long Run*, 4th Ed. (New York: McGraw Hill, 2008) 103.

[ii] Based on quarterly earnings. Data from Standard & Poor's at http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--.

[iii] Data from Standard & Poor's at http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l-- with September 30, 2010 quarterly profits based on prior estimates by Standard & Poor's.

[iv] Data from http://www.standardandpoors.com/indices/sp-500/en/us/?indexId=spusa-500-usduf--p-us-l--.

[v] Based on Robert Shiller's data at http://www.irrationalexuberance.com/index.htm.

[vi] Data from Standard & Poor's as previously noted.

[vii] Based on Robert Shiller's data at http://www.irrationalexuberance.com/index.htm and Business Cycle dates from http://www.nber.org/cycles/cyclesmain.html.