GRANT'S
INTEREST RATE OBSERVER®

Vol. 38, No. 2 | 233 Broadway, New York, New York 10279 • www.grantspub.com | JANUARY 24, 2020

'Low growth at a huge multiple'

The quoted words above refer not to some overhyped common stock but to the majestic S&P 500 itself. We write to call attention to the underside of the passive-investing boom. In preview, what the indexed investor sees is not always what the indexed investor gets.

Theorists agree that a common stock derives its value from the present value of the earnings or dividends of the company that prints the share certificates (or lends its name to the digital representation of those formerly engraved pieces of paper). Does it follow, then, that if the market is up, it was earnings that put it there?

Certainly, not now. In the five years through 2018, economy-wide business profits were essentially flat, according to the Bureau of Economic Analysis of the Department of Commerce, slightly down on a pretax basis, up a bit after tax. Over the same half-decade, the S&P 500 produced compound annual returns of 6.3%.

While BEA profit data for 2019 are not yet available, nine months of 2019 S&P 500 earnings data are already in the can. They're not much to look at—year-over-year, the 500-odd hand-curated component companies delivered an earnings decline of 6.5%. Yet, from the fourth quarter of 2018 until the present moment, the blue chips have surged by 32.6%, thanks to a trailing p/e ratio that shot to 22 from 16.

"Don't look for the needle in the haystack," index proponents admonish the dwindling remnant of stock-pickers, "just buy the haystack." Patrick J. English, chairman, CEO and chief investment officer of Fiduciary Management, Inc., Milwaukee (and, to declare an interest, paid-up subscriber to *Grant's* and a personal friend of the editor's), retorts that there's a problem with that very mound of corporate alfalfa. The reported S&P 500 p/e ratio is too low, he contends. As value-deprived as the stock market may seem, it is substantively more deprived and, of course, riskier, than people know.

Every trainee is aware that the S&P 500 is a capitalization-weighted index, with price movements of Apple, Inc. and Microsoft Corp., for instance, counting for proportionally more (on account of their stock-market value) than those of, say, News Corp and Coty, Inc. But as to earnings, democracy rules. To calculate the denominator of the p/e ratio, the S&P index makers combine the results for all 500 member companies. So while the numerator—price—is cap-weighted, the denominator—earnings—is an average (both market cap and earnings are adjusted for free float).

"When you buy an index fund," says English, whose firm manages $23.5 billion of nonindexed assets, "you're buying Apple's weighting times Apple's p/e,

and you're buying GE's weighting times GE's p/e. You're buying each company's weighting times its actual p/e." And because the biggest, fastest-appreciating stocks tend to be the most highly valued, the true, functional p/e quickly becomes detached from the figure quoted in *The Wall Street Journal*.

If you cap-weight earnings, as English does, the S&P is selling not at 22 times year-ago net income but at 31.5 times. "That is the most accurate gauge of where earnings are today," he says—convincingly, enough, in our opinion.

Of course, the trouble with earnings goes deeper than the index makers' M.O. Almost two-fifths of listed American companies showed GAAP losses over the past 12 months, the *Journal* reported on Jan. 9, the highest such proportion in a non-recession year since the dotcom era. If this striking fact has made fewer waves than you'd expect, it's because GAAP is fast-becoming a dead language, like Latin. Between 1996 and 2016, according to a 2018 report by Audit Analytics, the share of S&P 500 companies reporting non-GAAP metrics rose to 96% from 59%. Over the same span, the average number of non-GAAP metrics per filing climbed to 7.45 from 2.35. Years ago, the late, great technician Richard Russell coined the phrase, "Markets make opinions." In a bubble, markets make facts, too.

"What we've noticed," says English, "is that in the past five years there's been a dramatic deterioration in earnings quality. There is something amiss when you look at the BEA numbers that show that actual earnings peaked in 2014. The S&P is a significant percentage of corporations. To have the sum total of all corporations show down earnings [on a pretax basis] and the S&P

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500 show earnings per share up 31% over the past five years is remarkable. Part of it is that larger companies have been able to beat the tax bogeyman better than small companies have. There are more tax breaks for the large guys than the little guys. If you look at the S&P 500 on a pre-tax basis over the past five years, it hasn't grown much at all, which is this unknown story out there.

"It is easy to run the actual S&P revenue growth over the last decade," English goes on. "It is 2.9%. It is hard to believe, unless you have perpetual margin expansion, how your actual earnings are going to be able to grow much [faster] than your revenue growth. We went through a large expansion period, but margins have been shrinking the last several years. I think part of that is that labor is generally about 60% of cost-of-goods-sold, and margins are getting squeezed by higher wages."

An active—or, as Benjamin Graham styled the type, "enterprising"—investor, English speaks from interest as well as conviction: "We're feeling the negative impacts of people saying, 'I'm just going to index this. Why should I pay a fee to somebody when I could just index this whole value-core, value-growth space.' It is a phenomenon that seems unstoppable right now. People have lost their minds. We just say, 'If someone asked you, would you buy a stock that traded at 31.5 times trailing earnings...that has low single-digit growth and in fact had negative growth last year? Everyone would just look at you and go, 'You're out of your mind.' Yet, that is what these people are doing, hand over fist. To me, it is one of the biggest bubbles that we have ever seen.

"People have no idea what they're buying. They are buying low growth at a huge multiple."

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