Why earnings matter

Reaffirming the philosophy that underpins our investment process

A research update from Rosenberg Equities

Rosenberg Equities' core investment belief is that earnings matter. Why? Because we believe that future earnings and fundamentals ultimately drive share prices. We seek to capitalise on this by building what we define as an 'earnings advantage' into every portfolio. This earnings advantage should be a combination of better quality earnings, better growth in earnings and better capture of undervalued earnings (higher earnings yield).

It is important for us to periodically validate these ideas to ensure that our investment premise remains sound. We recently re-validated our assumption that stocks with superior earnings yield, on average, have higher stock returns. In other words, that there is a strong positive relationship between earnings delivered and stock performance.

Methodology

To effectively understand this relationship we measured the realised earnings yield (1-year forward earnings per share / today's price) and the total return for each company in the universe over a one-year horizon. The universe used in this analysis is the largest 3,000 companies in the US market. When we sort the universe from the lowest to highest realised earnings yield we found that, on average, the low realised earnings-yield companies had lower stock returns while companies with high realised earnings-yield also had higher stock returns. Of course, we observe this relationship only in perfect foresight, but the fact that it exists underpins our efforts to identify those stocks with the highest realised earnings yield, which we believe should ultimately lead to outperformance for our clients.

Analysis

In Exhibit 1, below, we sorted the universe into realised earnings yield deciles from lowest (red) to highest (blue) and then plotted their 1-year performance. The bar chart shows the long-term average from 31 December 1989 through 31 January 2019.

Exhibit 1: Decile performance – realised earnings yield

Source: AXA IM, Rosenberg Equities. Data based on the largest 3,000 companies in Rosenberg Equities' internal US equity universe. Company weights are based on square root of market cap and exclude companies whose stock price was less than $5 per share or whose market capitalisation was less than $200 million. Timeframe shown: 31 December 1989 through 31 January 2019.

On average, the top decile of stocks gained 24% annually while the bottom decile lost 12%. In other words, an investor would have been rewarded handsomely for buying stocks with the highest earnings yield (low price/earnings) and avoiding those with low earnings yield (high price/earnings), validating our view that earnings matter.

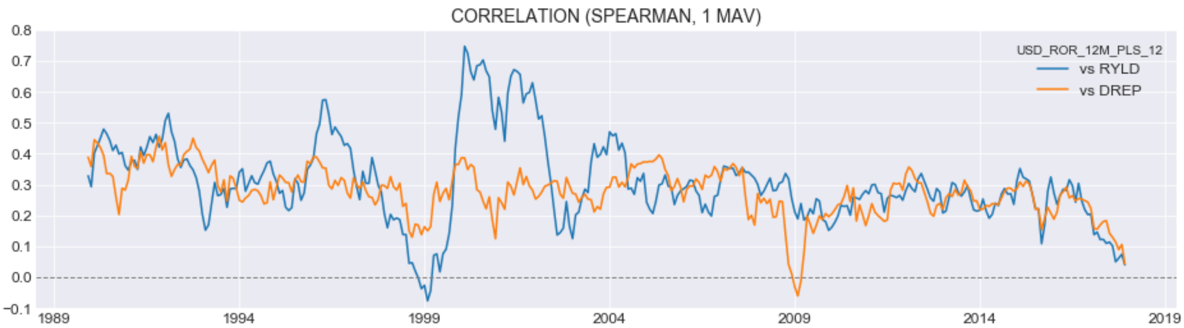
We also observe that it's not just the level of earnings that matter, but how these change. Our preferred metric for assessing growth is the difference between forward and trailing earnings yield, and our analysis below (Exhibit 2) shows that this growth metric has historically exhibited a similar performance as described above: higher earnings growth coincided with higher stock returns and vice versa.

Exhibit 2: Decile performance – change in 1yr forward earnings yield

Source: AXA IM, Rosenberg Equities. Data based on the largest 3,000 companies in Rosenberg Equities' internal US equity universe. Company weights are based on square root of market cap and exclude companies whose stock price was less than $5 per share or whose market capitalisation was less than $200 million. Timeframe shown: 31 December 1989 through 31 January 2019.

While this relationship holds true on average and over time, if you squint hard enough at the charts above you'll notice there are times when the decile performances are not well ordered. Another way of looking at this is to plot the correlation of stock performance and our two measures – realised earnings yield and change in forward earnings yield – over the same time period.

Exhibit 3: Correlation between earnings and performance



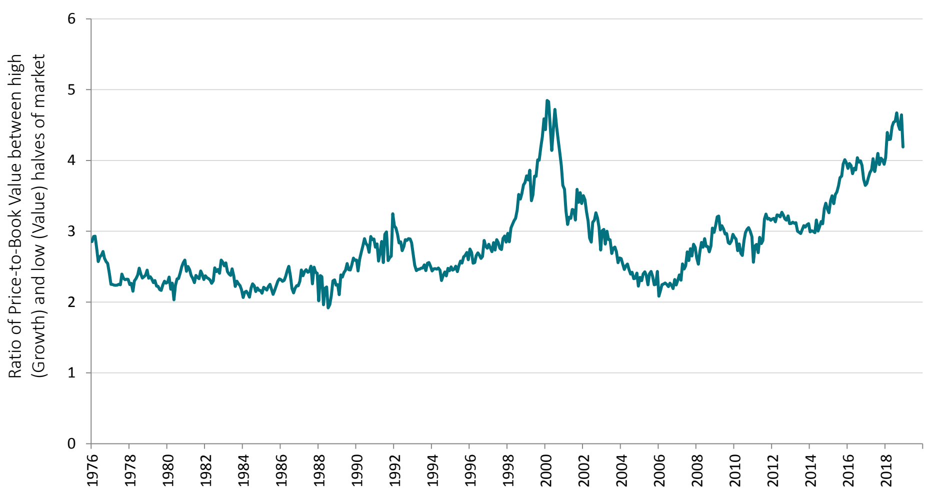
Source: AXA IM, Rosenberg Equities. Data based on the largest 3,000 companies in Rosenberg Equities' internal US equity universe. Timeframe shown: 31 December 1989 through 31 January 2019.

The correlations at the beginning of the time period were between 0.40 and 0.45 for both measures. However, by the end of January 2019 the correlations had fallen to below 0.10 for each. That there was a sharp disconnect between earnings and stock prices at the peak of the technology bubble is well known, and is evident in the chart when realised earnings yield's correlation with performance (blue) turned negative.

Similarly in 2009 amid the aftermath of the global financial crisis, year-on-year earnings growth was very strong on the back of negative earnings in 2008 and market sentiment that rebounded sharply and propelled a junk rally. Accordingly we saw another disconnect between earnings and prices and the correlation of change in earnings growth and performance fell below zero.

The last two years of the series points to another fairly sharp disconnect between earnings delivered and concurrent stock performance, which has coincided with performance that at times has disappointed. We think that this is an abnormal market environment. The post-financial crisis equity market has been fuelled by ultra low interest rates and excess liquidity that has seen the premium paid for growth rise to a level not seen since the technology bubble, as shown in Exhibit 4.

Exhibit 4: Premium paid for growth stocks, S&P 500



Source: AXA IM, Rosenberg Equities, Standard & Poor's. Universe is S&P 500. Data to 31 Dec 2018.

Another unwelcome outcome of ultra-low interest rates is the ability of companies to manage debt that would otherwise be unsustainable in times of normalised interest rates, allowing loss-making firms to continue operations based on an expectation that they will generate earnings at some point in the future rather than delivering earnings today. According to the Bank for International Settlements, these so-called zombie companies are on the rise, with some 12% of global companies falling under this definition, up from just 2% in the late 1980s[1].

Conclusion

Despite the near-term low correlation of realised earnings yield and change in earnings yield with stock price, we remain confident in our assertion that earnings matter and ultimately drive stock prices. Prior periods of disconnect were directly linked with market extremes such as the technology bubble and global financial crisis. The current period of disconnection closely aligns with one of abnormal monetary policy that cannot persist in the long run. As we revert to more normal interest rates and lower levels of liquidity, this should be the catalyst for the long-term relationship of earnings and prices to be normalised. We believe earnings matter, even if they have been overlooked recently. We retain our conviction that identifying undervalued companies with superior earnings should be a strategy that will be rewarded over the market cycle.

[1] BIS Quarterly Review, September 2018, 'The rise of zombie firms: causes and consequences', www.bis.org/publ/qtrpdf/r_qt1809g.pdf

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