What Corporate Profits Are Telling Us

Stock market *value* is ultimately determined by one thing: corporate profits. Politics and historical events only impact stock values if they impact the cash that corporations generate for shareholders. We believe the vast majority of reasons given for daily stock market *price* fluctuations, from government shutdowns to foreign wars, have little lasting effect on true stock market value. Factors such as products, markets, management, demand, supply, and competitive dynamics are the real determinants of corporate profits and stock market value in the long term.

Corporate profits take on even greater importance when one considers that the stock market is like an economic EKG. A sustained rise in stock prices has a decidedly positive impact on the public mood, just as a sharp decline spooks everyone. The prevailing mood then feeds into the rest of the economy, from consumer spending to real estate activity, which in circular form feeds back into corporate profits and stock values. In short, as corporate profits go, so goes the stock market, and so goes the economy.

Certain credit markets also have a significant influence on investors and the public, but no market is more visible than the stock market. It is nearly impossible for a day to go by without hearing what the Dow did. Additionally, most credit markets are ultimately backed by corporate enterprise values, and therefore corporate profits.

With all this in mind, it is worthwhile to take a closer look at what corporate profits are telling us; not only about stock market value, but about the health of the economy.

Corporate profits are difficult to assess. At first glance, measuring profits would seem simple – they are the main line item found in corporate income statements. Many market pundits accept reported profits from the most recent income statement at face value, and then simplistically apply a “multiple” to this figure to determine the value of a company or the stock market.

We believe it would be a mistake to apply a multiple to current corporate profits to derive stock market value. The problem is corporate profit myopia – a short-sighted focus on the most recent years reported profits. Intrinsic business value is determined by the future course of cash profits, not reported profits in one year. Reported profits in any one year may be inflated or deflated by a variety of factors.

ACR adjusts reported profits for every company that we evaluate. Adjustments are made for items such as anticipated tax rates, normalized interest rates, non-cash charges, non-reported cash expenses, special non-recurring charges, pension plan assumptions, maintenance capital expenditures, and in-process research and development expenses.

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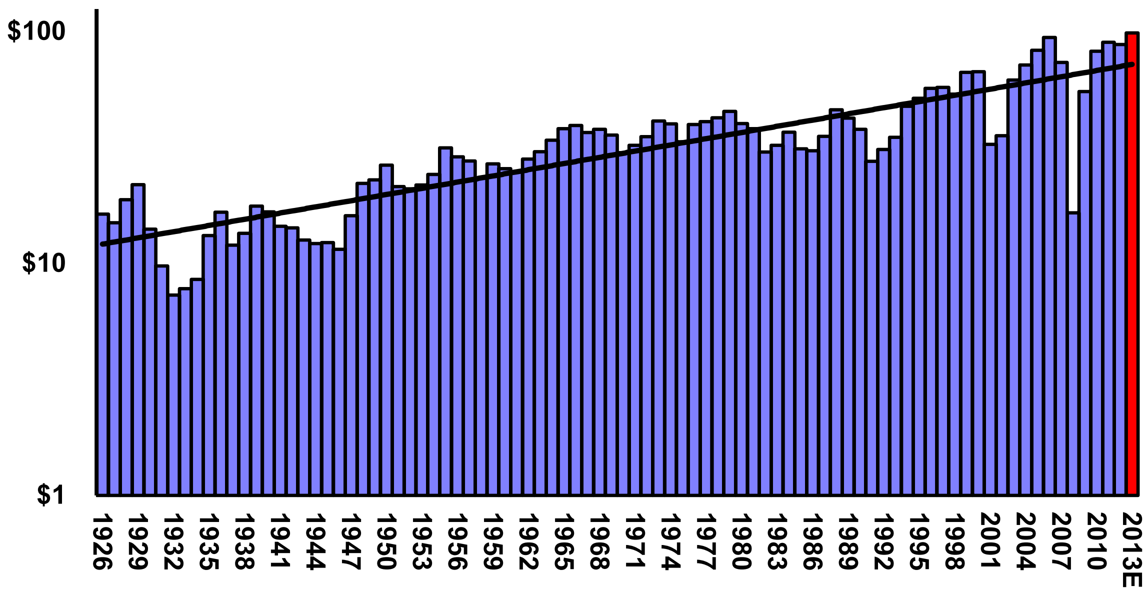
One of the most significant profit adjustments for many companies is for the economic cycle. The chart below is familiar to ACR investors. It shows historical corporate profits (as measured by S&P 500 earnings per share) with a trend line to adjust profits for economic cycles.

Corporate Profits – S&P 500 Earnings per Share Adjusted for Inflation



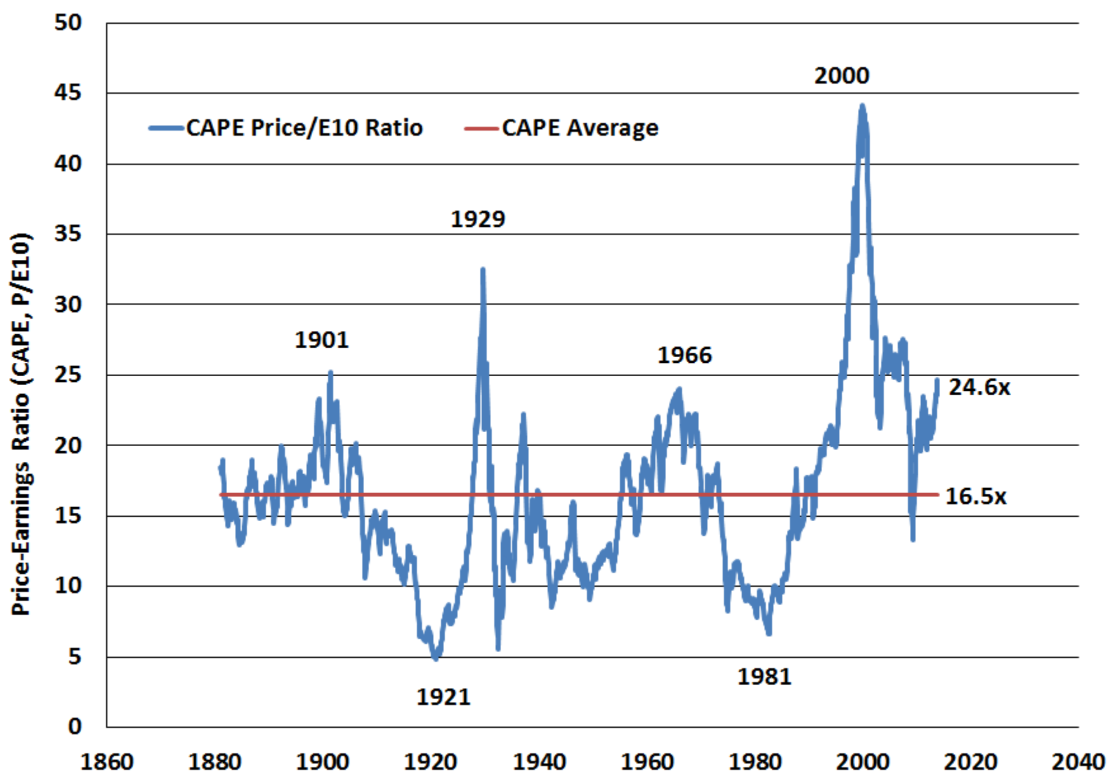
Sources: S&P Statistical Service; S&P Index Services
2013 Estimated as of 10/24/2013

Logic and data are enough to conclude that the more correct figure is closer to the trend line than current profits. Why? Economic cycles which include periods of expansion and recession have been a fixture of economic history since the advent of free enterprise systems. Ignoring these fluctuations would be to ignore all of economic history. An average or trend line serves to smooth the fluctuations and thereby normalize or cyclically adjust current profits.

Benjamin Graham, the father of value investing and Warren Buffett's mentor, advocated a ten year average of earnings for this purpose. Robert Shiller, the celebrated economist and recent Nobel laureate, adjusted the ten year average for inflation to produce the well-known Cyclically Adjusted Price-to-Earnings ratio (CAPE).

ACR employs an inflation-adjusted trend line (using the least-squares method) to account for the fact that earnings grow. Shiller's 10 year average P/E is potentially skewed higher (earnings are skewed lower) due to earnings growth. The ACR trend-line P/E does not suffer from this relatively minor flaw. Despite this difference, both Shiller's P/E and ACR's P/E reveal that corporate profits and P/Es are 49% and 53% higher, respectively, than historical averages. See the following two charts.

CAPE P/E10 Ratio



Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, updated
Robert J. Shiller

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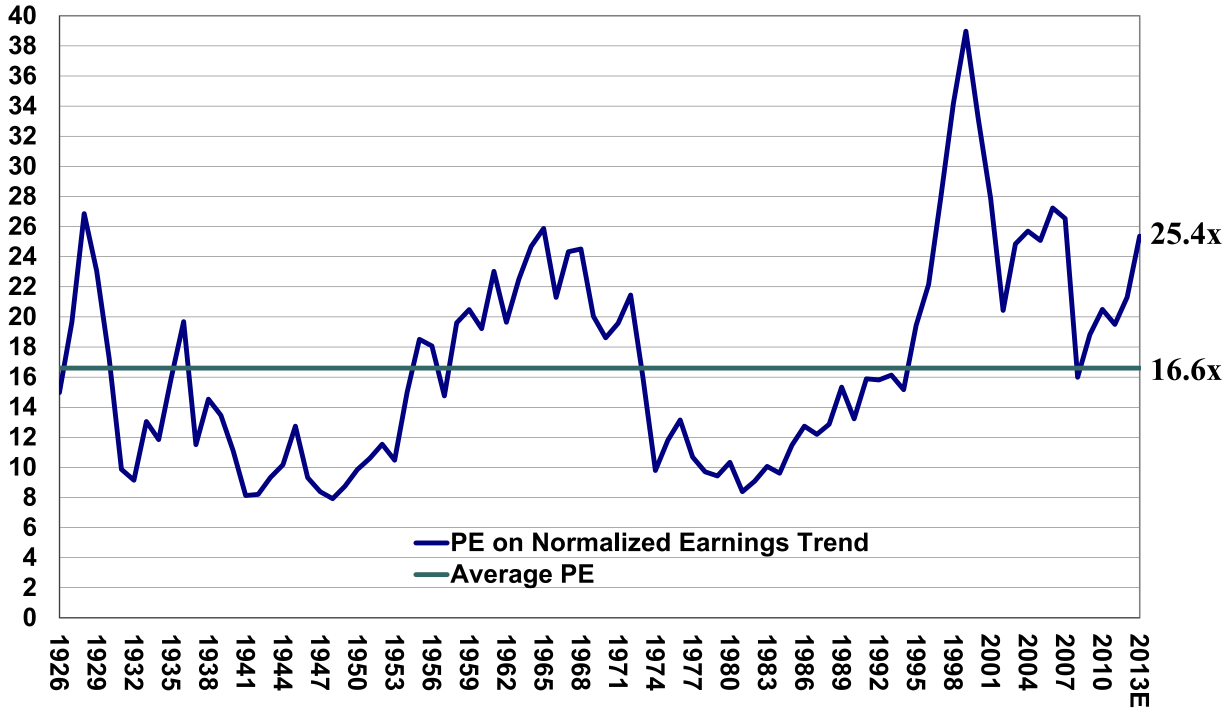
S&P 500 Historical Price-to-Earnings Ratio



Sources: S&P Statistical Service; S&P Index Services; ACR Analysis
2013 Estimated as of 10/24/2013

Current profits appear "inflated" today based on cyclical adjustments such as these. But why would profits be inflated? Answering this question at the aggregate profit level requires a different way of thinking. The ACR investment team spends the vast majority of its time studying and valuing individual companies. The potential mistake that stock investors make is treating aggregate data like company data.

To see the problem of applying company analysis to aggregate data, consider the following paradox. If a company cuts wages while holding revenue constant, it will increase profit by an amount equal to the wage cut. However, the wage cut potentially reduces the revenue and profit of other companies, since workers no longer have these wages to spend on goods and services. In this scenario, a wage cut produces a decline in revenue and profit at the aggregate level which offsets the initial rise in profits (at least to the extent that workers do not deplete their savings, which is unlikely to be sustainable anyway).

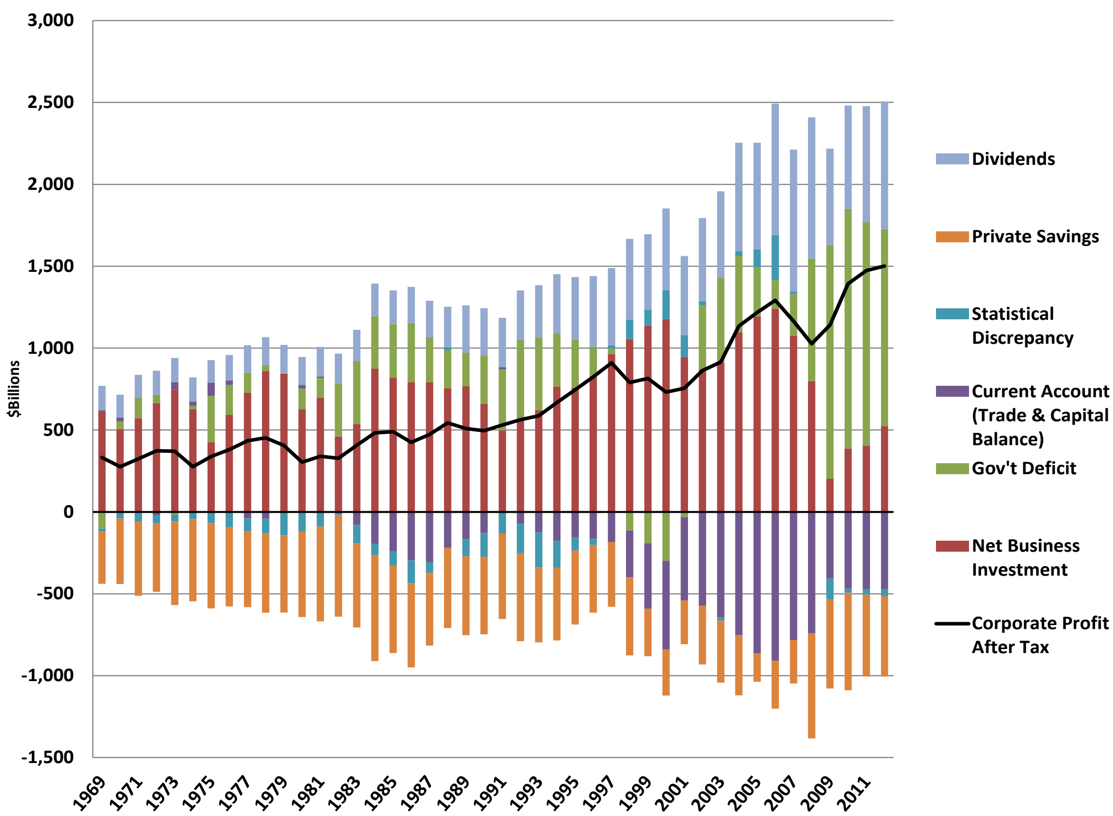
One method for assessing aggregate corporate profits with these issues in mind is to employ the basic macroeconomic equations for Gross Domestic Product and Gross Domestic Income.

In simplified terms:

GDP = Consumption + Investment + Government Spending + Net Exports
GDI = Wages + Profits + Taxes
GDP = GDI

Using algebra, we are able to solve for profits. The identities in the profits equation, derived with a few additional adjustments, are shown on the following chart.

Macroeconomic Components of Profits (1969-2012)



Data source: U.S. Department of Commerce Bureau of Economic Analysis; ACR Analysis

The most striking figure in our opinion is the government deficit (green bars), which counter-intuitively, but unquestionably, feeds into corporate profits. The government deficit essentially consists of government spending less tax revenue. Current corporate profit estimates for 2013 are $1.669 trillion, of which amount the government deficit contributes over $858 billion. Fiscal policy, at least in this simple accounting sense, appears to be having a major impact on profits and the economy; even as the Fed's low interest rate monetary policy captures most of the headlines regarding the impact of public sector economic policy.

Not a single legitimate economist would disagree with the basic identities and equations used to construct this chart. Economists would seriously disagree, however, on how these identities impact corporate profits, what causes them to increase or decrease, and the way in which they interact with each other. Therefore, we remain cautious as we explore this data further, especially as we are still in the early stages of this research project with ACR's macroeconomic advisor, Steve Fazzari, and analyst, Zach Kahn. Nevertheless, we find the data intriguing and worthy of introduction.

Our current takeaway is that corporate profits from 2005-07 were likely inflated by the final phase of the housing bubble, and corporate profits today may be inflated by US government fiscal policy. We do not expect a catastrophic collapse in profits as the government deficit declines. A potential offsetting factor is a deficit decline due to stronger economic growth. In this case, we would expect a rise in tax revenues (without a tax rate increase) and a rise in private investment, both of which would offset the current deficit as a source of profits. Nonetheless, we do anticipate that the apparent dependence of aggregate profits on high government deficits, along with the plans in Washington to reduce this deficit, creates a corporate profit headwind which supports our conservative estimates.

The bottom line is that a potentially inflated level of corporate profits is sending us a caution signal. The timing of any headwind and return to more normal profit levels is, in our opinion, impossible to predict. Profits may continue to grow in the short term. Whether the headwind develops over the next several years or takes the form of a more immediate recession, we simply do not know.

Either way, by valuing companies today using a more prudent and accurate profit yardstick, we are confident of being able to protect client capital and produce satisfactory long term investment returns. Conversely, investors who extrapolate normal growth rates from current profits to value stocks may someday find those corporate profits, and the stock values that they support, far lower than they had originally imagined.

We could always be wrong. If so, our conservatism could take the form of a somewhat lower future investment return than we could have otherwise earned. Given our core objective of preserving capital, we would rather reduce what we hope is still a satisfactory return than incur a permanent and significant loss.

Nick Tompras
Chief Investment Officer
October 2013

As of November 4, 2022, we have provided this supplement to accompany the commentary and satisfy changing regulations: https://acr-invest.com/commentary-supplement/

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