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CAMBRIDGE ASSOCIATES LLC

INVESTMENT PUBLICATIONS HIGHLIGHTS

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"Optimistic Analyst Earnings Projections Amidst a Slowdown in Growth and Diminished Fiscal Support" by Bob Prince and Jason Rotenberg, Bridgewater Daily Observations, July 27, 2010

Amid concerns about European deficits, the sustainability of Chinese growth, continued weakness in consumer confidence, and other macro issues plaguing the global economy, it is likely that current earnings forecasts are overly optimistic. Additionally, as the end of fiscal easing and potential start of fiscal tightening loom, the threat of projections surprising on the downside is becoming increasingly likely.

With about 50% of companies having reported, earnings at nonfinancial companies have been better than expected across most sectors. This is the sixth consecutive quarter of positive earnings surprises from nonfinancial companies. Despite recent momentum, analyst projections that earnings will continue their strong rate of growth throughout the remainder of 2010 look vulnerable on several fronts. The rise in earnings is expected to come equally from revenue growth and margin expansion, both of which face headwinds. Given current pricing, the markets are taking these optimistic forecasts with a grain of salt. However, should earnings miss expectations, there are still downside risks.

Analysts tend to be overly optimistic about earnings growth when margins are low and overly pessimistic when margins are elevated. On average, analysts tend to predict a rate of earnings (20%) that is nearly three times that which actually occurs (7%). Adjusting for current margins, which are very high, the rate of earnings growth predicted by analysts is extremely high, ranking in the upper 15% of their previous forecasts.

Half of this earnings growth is expected to come from top-line revenue growth. Sales numbers, while still at depressed levels, are coming in better than anticipated for most sectors, except for non-cyclical goods. However, current revenue forecasts imply roughly 4% to 5% nominal GDP growth, based on previous linkages between GDP growth and business revenues. Given the economic slack in today's economy, this type of nominal growth will be difficult to achieve. In addition, the drivers of first half growth appear to be fading or reversing; it is possible that a slowdown is already developing.

The other half of the boost to future earnings is expected to come from margin expansion, which would bring margins near or to record-high levels across all sectors, save cyclical consumer goods. The optimistic sentiment may be driven by the fact that when labor markets are weak, as they currently are, companies tend to keep more of the gains from productivity rather than pass them on to workers. However, there are downside risks to margins that may reverse these gains. In earlier stages of the economic recovery, companies were more easily able to cut labor expenses without pressuring profits because personal income levels were somewhat supported by government transfer payments, funded by borrowing. As the government cuts back on spending, and people have lower incomes as a result, it is likely that corporate profits will be negatively impacted. In order to offset this effect, more household borrowing or an improvement in the trade balance would have to occur, although given the economic outlook, both remain unlikely.

Comments by corporate managers during recent earnings calls reinforce these conclusions. In citing concerns such as deficit worries in Europe, downward revisions to Chinese growth, and continued weakness in consumer confidence, among other factors, managers suggest that optimistic forecasts may be difficult to achieve.

"Valuing the S&P 500 Using Forward Operating Earnings" by John Hussman, Hussman Funds, August 2, 2010

Valuation arguments referring to forward operating earnings estimates often incorporate flawed assumptions. However, once these issues have been addressed, investors can infer useful implications about market valuations from these data. Currently, the S&P 500 Index is most likely priced to deliver a ten-year total return of roughly 5.5%. Historically, investors have not generally tolerated implied low- or mid-single-digit equity returns for long, raising the risk of a market pullback in the near or intermediate term. Put simply, forward operating earnings suggest that stocks are unquestionably not cheap on a historical basis.

Stocks are claims to a long-term stream of cash flows that will be distributed to investors over time. These cash flows (and thus the value of the stock market) cannot be estimated from a single year's forecasted earnings, as profit margins vary over the business cycle, and tend to revert to the mean over the long term. Some recent "valuation" arguments, however, treat future estimated operating earnings as if they were an immediately distributable dividend that will grow indefinitely without the need for capital investment, while sustaining current record profit margins in perpetuity.

Such assumptions are dangerous and need to be met with a healthy dose of skepticism. Forward operating earnings are *not* distributable cash flows. Operating earnings exclude charges that may not occur on an annual basis, but are legitimate costs and losses incurred as part of the ordinary course of business. Meanwhile, operating earnings often include a benefit from those very same "extraordinary" sources, *provided* they make positive contributions (e.g., major banks saw a large boost to their operating earnings this past quarter from a reduction in reserves for future loan losses). *Forward* operating earnings, meanwhile, take these hypothetical earnings to the next level, and are based on the year-ahead *forecasts* of Wall Street analysts.

There are two main failures of standard forward operating earnings analysis. First, analysts incorrectly assume that the long-term average price-earnings (P/E) ratio for trailing net earnings represents a fair value multiple that can be applied to forward operating earnings, which are invariably higher. How much higher? We cannot be certain given the short history of operating earnings, a metric that was created in the early 1980s. Thus, the valuation bubble between the late 1990s and 2007 represents a significant chunk of the observable record. Second, analysts fail to model the variation in prospective earnings growth induced by changes in the level of profit margins, and therefore wildly over- or underestimate long-term cash flows that are relevant to proper valuation.

Still, given the increasingly common use of this earnings measure, investors should attempt to deal with it constructively. For instance, the lack of history prior to 1980 is not particularly difficult to overcome. Indeed, it is possible to explain the relationship between forward operating earnings and standard earnings measures using variables that have been observable throughout history, and to form good estimates prior to 1980 on that basis. By addressing the two main failures directly, investors can infer useful implications about market valuation and subsequent market returns from these data.

The long-term annual return for an equity market over any horizon is its annualized capital gain in addition to its dividend yield over the holding period. In order to generate an accurate return forecast, one has to get two things right: the "normal" future P/E and the prospective long-term earnings growth rate. Standard forward operating earnings analysis misses on both counts. Over a seven- to ten-year horizon, the proper historical norm for the price-to–forward operating earnings ratio is approximately 12.7. Moreover, one cannot simply apply the historical operating earnings growth rate of 6.3%. Rather, growth estimates should reflect the level of profit margins at any point in time, since the current P/E multiple may reflect either depressed or elevated earnings. Given the tendency of profit margins to revert to the mean, earnings growth tends to be above average for the seven- to ten-year period following depressed earnings associated with compressed profit margins. In contrast, earnings that reflect elevated profit margins are strongly associated with poor rates of subsequent growth. For a ten-year investment horizon, the proper growth rate estimate should take into account the gradual normalization of margins.

During the past half century, the correspondence between projected (using estimated forward operating earnings and a margin-adjusted earnings growth rate) and actual ten-year market returns for the S&P 500 has been very close. The only notable exceptions were the 1988–91 projections, which ultimately underestimated the market's subsequent ten-year total return, and excessive valuations between 1998 and 2001, which represented the opposite extreme. At the 2009 low, the market was moderately undervalued, but far from the low valuations seen at points in 1950, 1974, and 1982.

Currently, the market is near the same level of overvaluation seen at the 1972 and 1987 market peaks. Indeed, the aforementioned methodology suggests that the S&P 500 is most likely priced to deliver a ten-year total return of roughly 5.5%. Historically, investors have not usually tolerated low- or mid-single-digit implied equity returns for long. Thus, lower projected returns are also associated with a dramatically higher risk of intermediate-term loss. Put simply, forward operating earnings would suggest that stocks are unquestionably not cheap on a historical basis. ■