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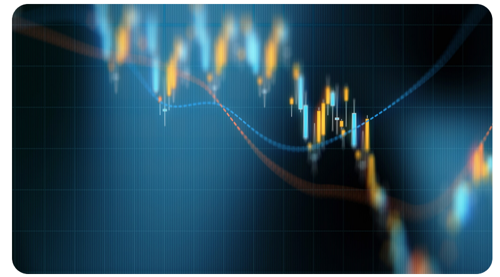
Price-to-Fantasy Ratio: Self-Deception with Forward Operating Earnings

January 2023



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A common error of earnings[1] aggregation from stocks to the market persists. The aggregation fallacy is at its most extreme during recessions. Consider AIG. During the market lows of 2009, the share price fell briefly below $6 and GAAP (Generally Accepted Accounting Principles) reported earnings were a loss of $90.48. Neither an owner of AIG stock nor an owner of an index fund was on the hook for the $90 loss—their remaining downside risk was not even $6—yet aggregate earnings for the S&P 500 Index were reduced by the entire $90 per-share loss.

We magnify this error if we use forward estimates of earnings rather than trailing earnings, and if we rely on operating earnings rather than reported earnings.

Forecasts of future operating earnings for the market aggregates begin with two sensible assumptions:

1. Market prices of stocks are based on discounted future earnings, not past reported earnings.

2. Operating earnings *should* measure earnings from ongoing operations, excluding nonrecurring extraordinary items and discontinued lines—whether positive or negative—that will not be part of future earnings.

Many analysts will therefore analyze a stock's price-to-earnings (P/E) ratio, or the P/E for the aggregate market, using forward earnings for the next quarter or next year, which are built on a foundation of recent past operating earnings.

So, what's wrong with this approach?

These assumptions introduce a large bias into aggregate market earnings, hence, into aggregate market P/E ratios. In practice, companies choose to exclude far more negative extraordinary items than positive, which has led some analysts to whimsically describe operating earnings as "earnings before whatever went wrong." Analysts know that every year some companies will disclose truly awful losses, depressing those companies' reported earnings. They cannot know, however, *which* companies may do so in any given year. This means that forward earnings, built on a foundation of recent operating earnings, will tacitly assume no future drag from the inevitable extraordinary items that overwhelmingly tend to be negative.

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As a result, estimates of individual companies' future reported earnings—when aggregated across the full market—will reliably overstate aggregate future market earnings and understate the aggregate market P/E ratio. Over the last 34 years, data provided by S&P show that aggregate S&P 500 reported earnings have been an average 5% lower than prior-year operating earnings, despite powerful growth in both reported and operating earnings over the same span. The same-year comparison is even larger: concurrent reported earnings are lower than operating earnings by 13%. As noted earlier, this gap between operating earnings and reported earnings becomes more extreme in recessions. In 2001 and 2002, in the same period aggregate operating earnings exceeded reported earnings by 57% and 70%, respectively. In 2008, aggregate operating earnings exceeded reported earnings by 233%. In 2020, aggregate operating earnings exceeded reported earnings by 30%.

Sometime near the middle of 2023, all companies in the S&P 500 will have published their 2022 reported earnings and operating earnings. Aggregate earnings for the S&P 500 for 2020 were a deeply depressed $94, rebounding in 2021 to $198, per S&P 500 "share." Aggregate earnings for 2022 (which tend to be relatively reliable by now, once the year is over) are estimated at $181 per "share," a 9% drop from 2021.

How does this look from the perspective of operating earnings? Operating earnings—not surprisingly—exceeded reported earnings for these years, coming in 30% high in 2020 and 5% high in 2021 and likely will be high by 10% or more in 2022. That is a three-year average of about 15% higher than reported earnings, slightly below the 34-year historical norm.

When the numbers are final, sometime in the middle of 2023, this number will likely have declined further, but will go unnoticed as the press and strategists will already be focusing on expectations for 2023 and 2024. Of course, analysts are already forecasting earnings for 2023. Adding a presumed 13% growth rate on top of expected 2022 operating earnings of $200 leads to a consensus forecast of $226 for 2023 aggregate reported earnings. In order for aggregate earnings to finish the year at the projected $226, we would need to see a whopping 25% growth in earnings this year.

Conversely, if we have a recession in 2023 as many expect, history suggests that reported earnings will be below 2022 reported earnings of $181 (give or take some typically-modest changes in the weeks ahead), perhaps by a wide margin. Yet, the press and strategists are discussing a current market multiple of 17 based on the ratio of *today's* S&P 500 Index price level divided by *projected 2023* earnings of $226, which in turn are built on a foundation of already-elevated estimates for 2022 operating earnings.

If reported earnings next year merely match the likely final 2022 level of $181, then the current price-to-forward earnings (P/F) ratio is 21. In 2023, if earnings tumble just 20% from 2022 levels, then the correct current P/F ratio is 26, hardly a bargain.

It is easy to see why we occasionally refer to the P/F ratio as the Price/Fantasy ratio.

Endnotes

1. As is common in Wall Street reports and forecasts, we use the term *earnings* for earnings per share, or EPS.

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