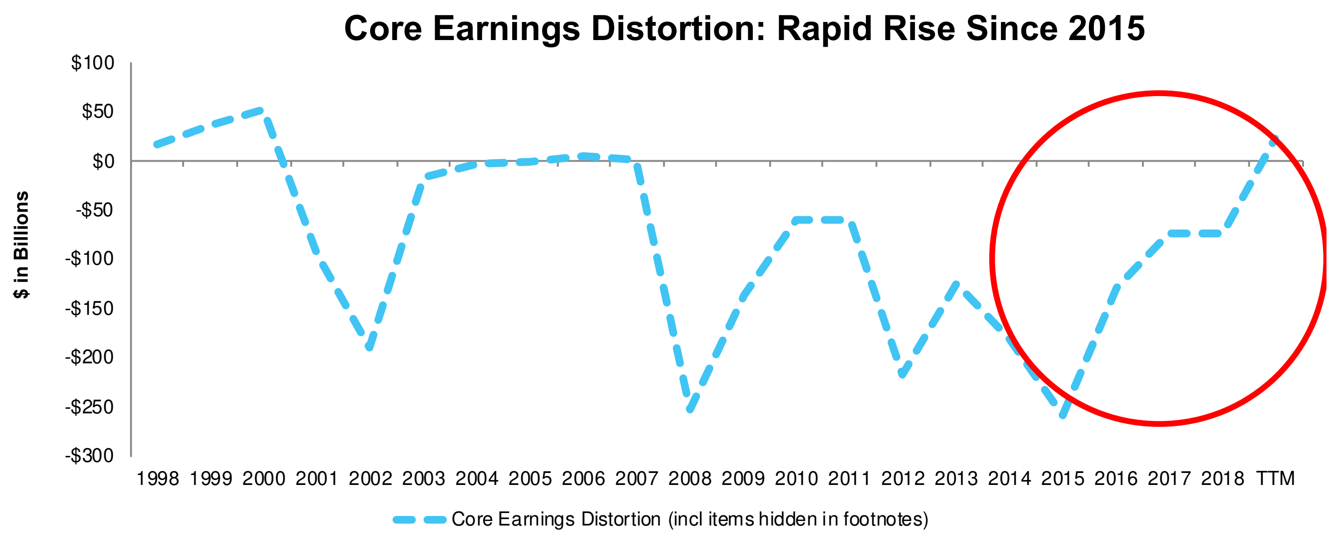
Earnings Distortion Costs You: TD Ameritrade Network

We joined TDA Network's Morning Trade Live on Wednesday, November 27 to show how Wall Street and companies use earnings distortion to fool investors.

Watch the TD Ameritrade Network Interview

Over the trailing twelve months, GAAP earnings fell 1% while adjusted core earnings fell 6%[1]. Most investors know that GAAP earnings are prone to distortion because they include lots of non-recurring or unusual items. Most investors are not aware that the core earnings (from CompuStat or Wall Street analysts) are also distorted by unusual items. In fact, earnings for the S&P 500 were distorted by 22% on average in 2018.

Figure 1: Core Earnings Distortion[2]: Worst Since 2000



Sources: New Constructs, LLC and company filings.

The rapid rise in earnings distortion since 2015 means that an increasing amount of corporate income is coming from unusual or one-time gains, which is not apparent to investors analyzing press releases or income statements. Corporate managers hide the one-time nature of these gains by only disclosing them in the fine print. In other words, managers are dressing up the numbers in an increasingly aggressive manner over the last few years.

Notably, earnings distortion is now positive for the first time since 2007, and the highest it's been since 2000. Soon after earnings distortion broke into positive territory, in 2006-07 and 1998-2000, the market crashed.

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Disclosure: David Trainer, Sam McBride, and Kyle Guske II receive no compensation to write about any specific stock, sector, style, or theme.

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[1] This analysis is based on the top 1,000 companies by market cap in each measurement period.
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Footnotes adjustments matter. We are the ONLY source.

We provide ratings, models, reports & screeners on U.S. 3,000 stocks, 700 ETFs and 7,000 mutual funds.

HBS & MIT Sloan research reveals that:

- **Markets are inefficiently assessing earnings because no one reads the footnotes.**
- **Corporate managers hide gains/losses in footnotes to manage earnings.**
- **Our technology brings the material footnotes data to market for the first time ever.**

Combining human expertise with NLP/ML/AI technologies (featured by Harvard Business School), we shine a light in the dark corners (e.g. footnotes) of hundreds of thousands of financial filings to unearth critical details.

The HBS & MIT Sloan paper, Core Earnings: New Data and Evidence, shows how our superior data drives uniquely comprehensive and independent debt and equity research.

This paper compares our analytics on a mega cap company to other major providers. The Appendix details exactly how we stack up.

Learn more.

Quotes from HBS & MIT Sloan professors on our research:

Get better research:

"…the NC dataset provides a novel opportunity to study the properties of non-operating items disclosed in 10-Ks, and to examine the extent to which the market impounds their implications." – page 20

Pick better stocks:

"Trading strategies that exploit cross-sectional differences in firms' transitory earnings produce abnormal returns of 7-to-10% per year." – Abstract

Avoid losses from using other firms' data:

"…many of the income-statement-relevant quantitative disclosures collected by NC do not appear to be easily identifiable in Compustat…" – page 14

Build better models:

"Core Earnings [calculated using New Constructs' novel dataset] provides predictive power for various measures of one-year-ahead performance…that is incremental to their current-period counterparts." – page 4

Exploit market inefficiencies:

"These results … suggest that the adjustments made by analysts and Compustat to better capture core earnings are incomplete. Moreover, the non-core items identified by NC produce a measure of core earnings that is incremental to alternative measures of operating performance in predicting an array of future income measures." – page 26

Fulfill fiduciary duties:

"An appropriate measure of accounting performance for purposes of forecasting future performance requires detailed analysis of all quantitative performance disclosures detailed in the annual report, including those reported only in the footnotes and in the MD&A." – page 33-34

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