New Evidence on the Superiority of Our Earnings Data

In an updated edition of Core Earnings: New Data & Evidence, professors at Harvard Business School (HBS) & MIT Sloan empirically show that our "novel dataset" is superior to "Street Earnings" from Refinitiv's IBES, owned by Blackstone (BX) and Thomson Reuters (TRI), and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI). Specifically, our earnings data is:

(1) More accurate (Section 3.2)
(2) More predictive of future earnings (Section 3.4)
(3) More predictive of future stock prices (Section 4.3).

More Accurate: We Identify More Non-Core and Unusual Items

The purpose of core earnings is to measure the normalized operating profitability of a business. Accordingly, analysts should strip out any gains/losses that are non-core or unusual.

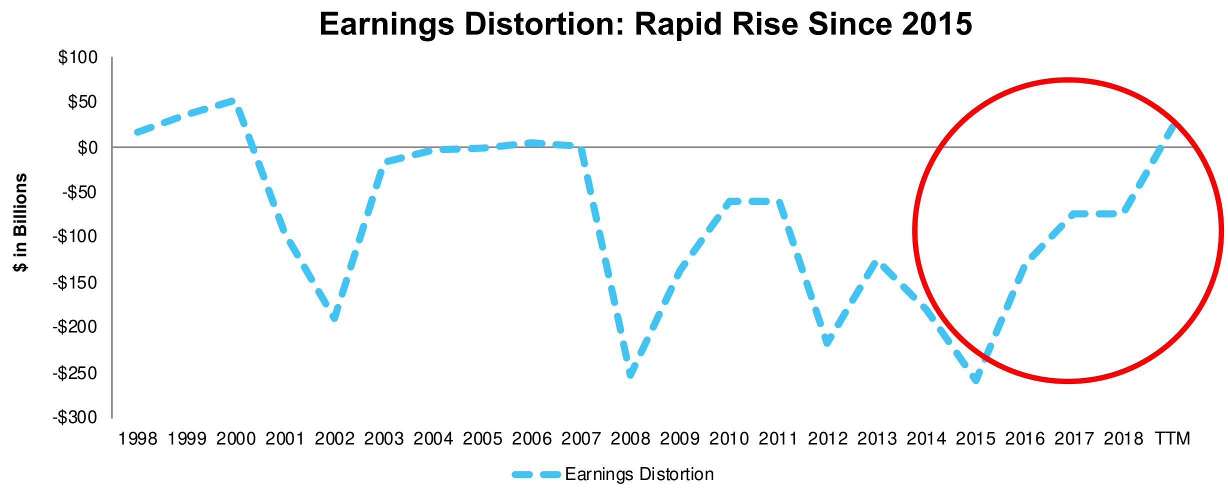
The problem is that identifying unusual items has become increasingly difficult. Professors from HBS and MIT Sloan show in Core Earnings: New Data & Evidence that our "novel dataset" identifies significantly more unusual items than "Special Items" from Compustat and "Street Adjustments" from IBES. Those services capture just half of the non-core items that we capture. See page 26 of the paper for more details. Here are examples from the paper of unusual items we collect that Compustat misses:

- In 2016, CBS reported $211 million in "Pension settlement charges" on its income statement. Compustat "does not report this pension settlement charge in any of the relevant variables." See page 14 and 15.
- In 2016, Bluelinx Holdings (BXC) reported $28 million in income from the "gains from sales of property." Compustat failed to report this gain on sale. See page 37.
- In 2006, ACCO Brands (ACCO) reported a $23 million "restructuring and asset-impairment charge." Compustat failed to report this charge. See page 37.

More examples of non-core items identified in our models, but missing from Compustat, can be found in Table A.1 on page 37 of the paper.

Figure 1 shows that Earnings Distortion, which captures all the non-core items we remove from core earnings, is material, to say the least. The last times Earnings Distortion moved into positive territory, in 2006-2007 and 1998-2000, the market crashed. Investors using traditional data would be none the wiser.

Figure 1: Earnings Distortion is the Highest Since 2000 (Data through November 18, 2019)



Sources: New Constructs, LLC and company filings.
This analysis is based on the top 1,000 companies by market cap in each measurement period.

More Predictive of Future Earnings

Our core earnings predict future earnings better than Compustat and IBES because we strip out more non-core and unusual items. The paper empirically shows that our "Core Earnings is a significantly better forecaster of future Net Income..." See section 3.2 of the paper for more details.

The authors also show that the non-core items we identify produce a measure of core earnings that is "**incremental to alternative measures of operating performance in predicting an array of future income measures**." The alternative measures compared in the paper include "Street Earnings", a proxy for core earnings created by IBES, and Compustat's[1] "Income Before Special Items." See section 3.4 of the paper for more details.

More Predictive of Future Stock Prices

In Section 4.3 of the paper, the professors present a long/short strategy that generates 10% in annual returns using our Earnings Distortion metric. The low turnover strategy holds the stocks with the most understated earnings and shorts the stocks with the most overstated earnings.

To further analyze the impact that properly identifying non-core items has on returns, the professors examined total adjustments, a measure based on our data, to alternative proxies for transitory or non-core earnings. Specifically, they compared total adjustments to Compustat's "special items" and IBES' "street adjustments" and found that our total adjustments is,

> "the only measure of non-core earnings that offers incremental explanatory power for returns."

More details in Table 9 of the paper.

How to Make Money with This New Research

While the paper outlines a long/short portfolio, we provide two strategies to exploit our "novel dataset" of earnings adjustments:

1. Short-term – use our Earnings Distortion Scores to trade stocks most likely to beat or miss earnings estimates. Get started now with our Earnings Distortion Scorecards for the 1Q20 earnings season.
2. Long-term strategy – use our Stock Ratings to own more stocks with understated earnings and avoid/sell stocks with overstated earnings. Get our Stock, ETF & Mutual Fund Ratings here.

For more details on how to use core earnings to pick better stocks, click here. Click here for more details on our data offerings.

We Provide 100% Audit-ability & Transparency

Clients can audit all of the unusual items used in our calculations in the Marked-Up Filings section of each of our Company Valuation models. We are 100% transparent about what goes into our research because we want investors to trust our work and see how much goes into building the best earnings quality and valuation models.

This article originally published on January 27, 2020.

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

Follow us on Twitter, Facebook, LinkedIn, and StockTwits for real-time alerts on all our research.

[1] It's worth noting that Compustat also provides "S&P Core Earnings", a variable that adjusts for eight factors to better measure core earnings. However, the authors did not examine this variable because: "(1) transparency is lacking about what is included in the adjustments, (2) the set of adjustments do not reflect the entire population of adjustments, and (3) the variable is available for only one-third of all firm-years in Compustat."

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

DISCLOSURES

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

DISCLAIMERS

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.