S&P 500 Valuation Remains Over Its Skis

In our 2Q20 analysis of the S&P 500's true Core Earnings[1], we noted the steep decline in earnings had not deterred the index's valuation from racing to all-time highs. Through 3Q20, that trend continues. Investors clearly expect the COVID-19-induced economic dip to end soon and earnings to reach new highs in the near future.

Now is the time for investors to re-examine risk in equity portfolios and re-allocate to truly undervalued stocks.

S&P 500 Is Priced for Major Earnings Rebound

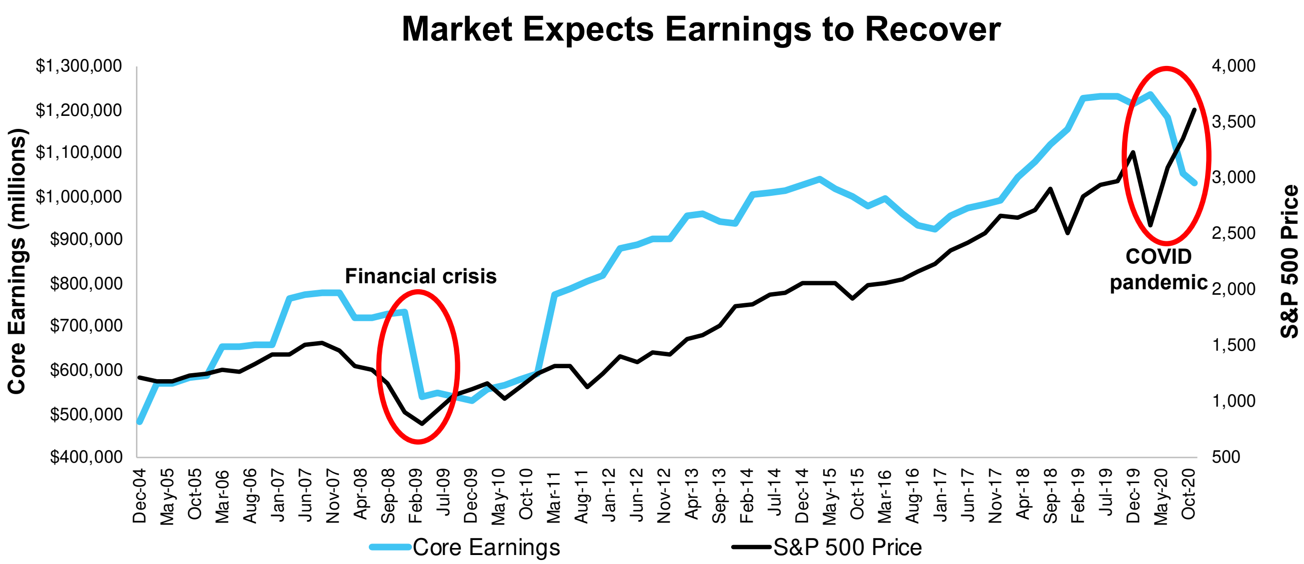
We were wrong to call a market top in our last update, S&P 500 Peaks as Earnings Trough, as the market has continued to rise. Figure 1 shows how the S&P 500 price rises in the face of continued declines in Core Earnings.

Note how different the market's response has been during the current crisis to that of the Financial Crisis in 2008/2009. At that time, the S&P 500's price fell in stride with Core Earnings. The price of the index didn't rebound until 2Q09, around the time Core Earnings bottomed. Flash forward to today, and Core Earnings have yet to bottom, while the markets soar to all-time highs.

Figure 1 illustrates the market is anticipating a strong rebound in profits. As a result, any negative news regarding the vaccine or monetary and fiscal stimulus could knock the S&P down significantly.

On the flip side, continued positive news could push the market slightly higher. Nevertheless, most of the good news appears priced in. Investors with fiduciary duties should consider taking some gains and reallocating to more undervalued and safer stocks, especially if the S&P 500 moves forward with adding The Most Dangerous Stock for Fiduciaries, Tesla (TSLA).

Figure 1: Core Earnings vs. S&P 500 Price: 2004 to Present



Sources: New Constructs, LLC, company filings, and S&P Global (SPGI).
Our Core Earnings analysis is based on aggregated TTM data for the S&P 500 constituents in each measurement period.

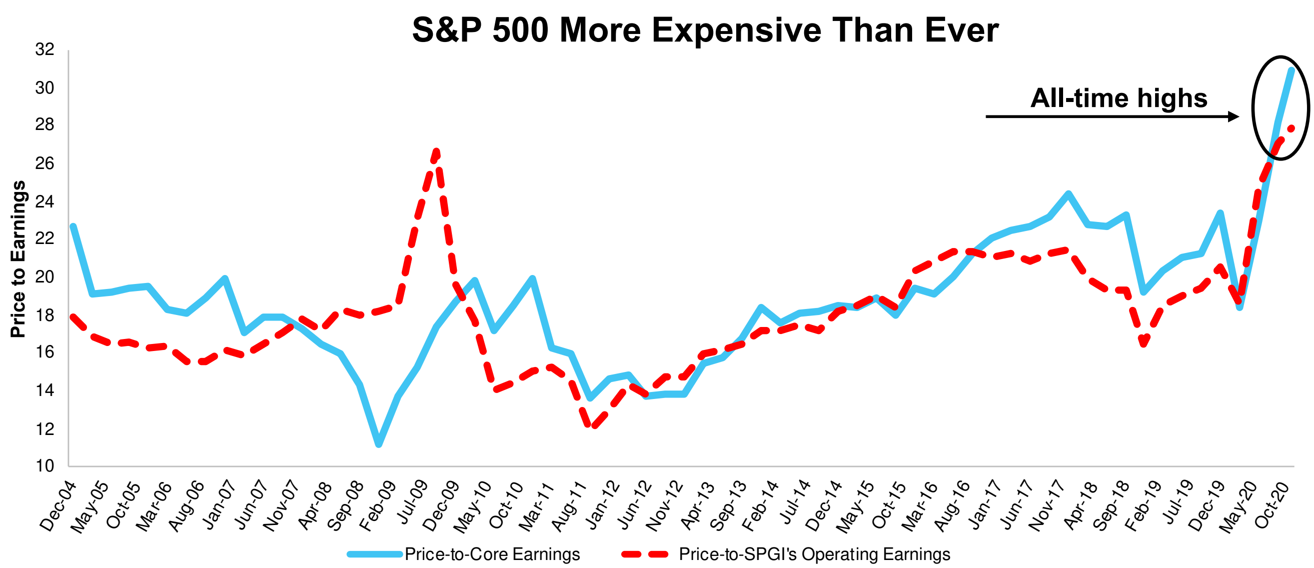
[1] Our Core Earnings are a superior measure of profits, as demonstrated in Core Earnings: New Data & Evidence a paper by professors at Harvard Business School (HBS) & MIT Sloan and the Journal of Financial Economics. The paper empirically shows that our data is superior to "Operating Income After Depreciation" and "Income Before Special Items" from Compustat, owned by S&P Global (SPGI).

More Expensive Than Any Time Since 2004

Figure 2 shows how the price-to-earnings (P/E) ratio based on our Core Earnings and the P/E ratio based on S&P Global's (SPGI) Operating Earnings are currently at all-time highs (our data goes back to December 2004). While our P/E differed from the SPGI P/E during the financial crisis, they currently both agree that the market is fully valuing a significant recovery in earnings.

As mentioned above, anything that threatens that recovery could cause stocks to tumble. All the more to be diligent about analyzing earnings accurately for stocks, sectors and major indices.

Figure 2: Price-to-Core vs. Price-to-SPGI's Operating Earnings: TTM 12/31/04 – Present



Sources: New Constructs, LLC, company filings, and S&P Global.
Our Core Earnings P/E ratio is aggregating the TTM results for constituents in each period. SPGI P/E is based on four quarters of aggregated S&P 500 results in each period. More details in Appendix I.

Despite Decline, Earnings Aren't as Bad as They Seem

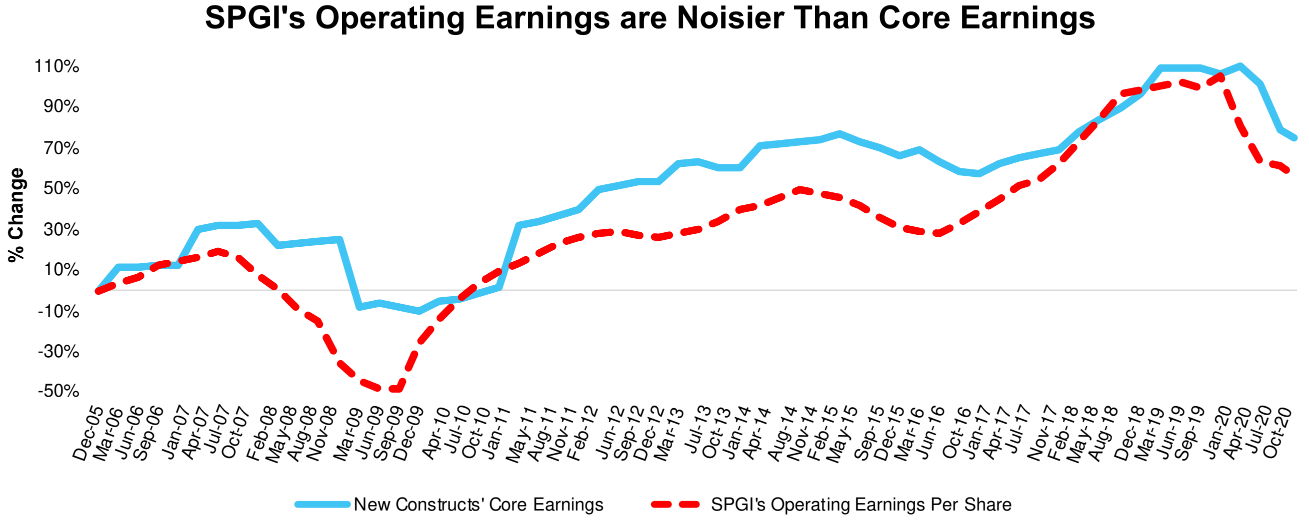
A differentiated view on earnings can lead to a differentiated view on valuation. Our measure of Core Earnings leverages cutting-edge technology to provide clients with a cleaner and more comprehensive view of earnings[2], which shows that Core Earnings, while lower than any point since December 2017, aren't as bad as Wall Street would have you believe.

Trailing-twelve month (TTM) Core Earnings for the S&P 500 have fallen 15% since the end of 2019 while consensus TTM S&P Global Operating Earnings per share[3] for the S&P 500 have fallen 24%. For reference, during the Financial Crisis, Core Earnings bottomed in December 2009, which was two years after the U.S. economy entered the recession and fell 32% during that time.

Figure 3 charts the percentage change in our Core Earnings and SPGI's operating earnings and more clearly illustrates that our Core Earnings are less volatile and present a cleaner measure of the normalized performance of businesses.

[2] For 3rd-party reviews on the benefits of adjusted Core Earnings, historically and prospectively, across all stocks, click here and here.
[3] We think SPGI's Operating Earnings provide the best comparison to how we calculate Core Earnings.

Figure 3: Core vs. SPGI's Operating Earnings for the S&P 500 – % Change: TTM 12/30/05 – 11/17/20

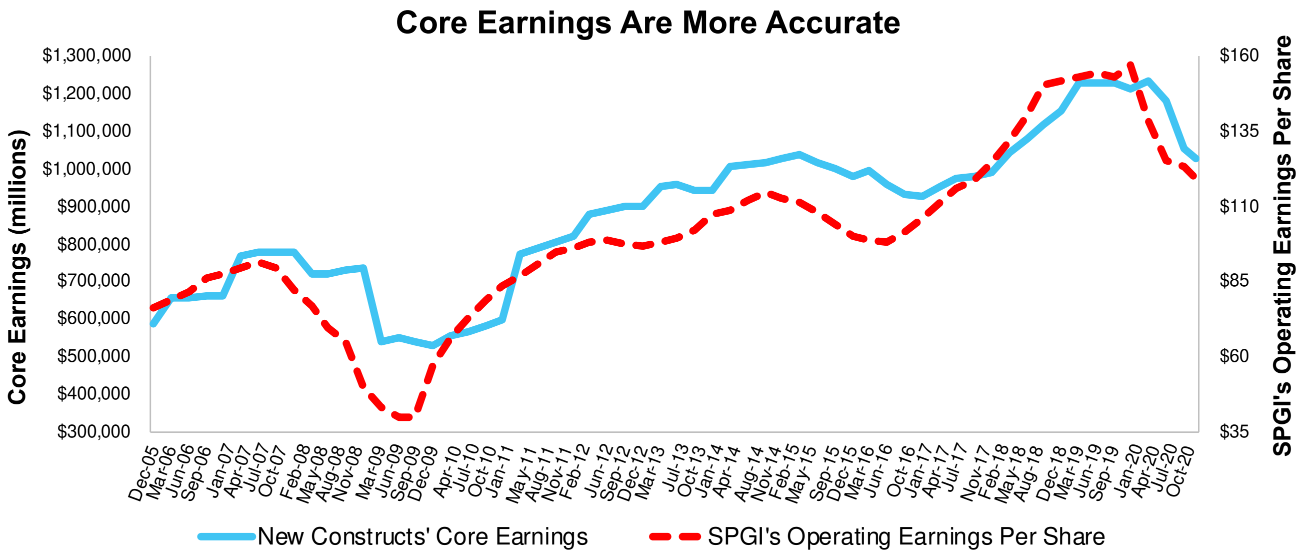


Sources: New Constructs, LLC, company filings, and S&P Global (SPGI). Note: the most recent periods' data for SPGI's Operating Earnings is based on consensus.
Our Core Earnings analysis is based on aggregated TTM data for the S&P 500 constituents in each measurement period.

Figure 4 highlights how different our measure of Core Earnings is from SPGI's Operating Earnings. The differences are due to SPGI's data systems not capturing the full impact of unusual gains/losses buried in footnotes, as shown in the Journal of Financial Economics paper, "Core Earnings: New Data and Evidence." Missing these unusual gains and losses causes earnings measures to be unreliable and subject to management manipulation.

Relying on legacy providers' data can put investors at risk of not understanding the true trajectory of earnings and holding the wrong stocks.

Figure 4: Core Earnings vs. SPGI's Operating Earnings: 2005 – Present



Sources: New Constructs, LLC, company filings, and S&P Global. Note: the most recent periods' data for SPGI's Operating Earnings is based on consensus.
Our Core Earnings analysis is based on aggregated TTM data for the S&P 500 constituents in each measurement period

Where to Put Your Money

Starting in mid-April, we identified several companies with strong underlying Core Earnings and valuations that implied profits would never recover from COVID-induced lows. These firms in our "See Through the Dip" thesis have seen profits decline in the short term. However, their strong fundamentals will enable them to thrive in a recovery. These stocks should be held through the economic turmoil as we expect them to outperform crowded passive strategies over the long term.

Figure 5 lists the stocks from our See Through The Dip thesis with TTM Core Earnings greater than 2019 Core Earnings. In other words, these firms not only weathered the economic downturn, they grew Core Earnings.

Figure 5: See Through the Dip Stocks with Improved TTM Core Earnings

Company	Ticker
Intel Corporation	INTC
Allstate Corp	ALL
The Hershey Company	HSY
Meritage Homes Corp	MTH
Universal Health Services	UHS
HCA Healthcare	HCA
Standard Motor Products	SMP
John B. Sanfilippo & Son	JBSS

Sources: New Constructs, LLC and company filings.

Where Not to Put Your Money

Below are stocks from our Most Dangerous Stocks for Fiduciaries reports that we think present abnormally high risk. Opposite of Figure 5, the stocks in Figure 6 have seen their TTM Core Earnings decline during 2020.

Selling these stocks would provide most investors with more than healthy gains to reallocate in stocks with much better long-term prospects. Nevertheless, this strategy is directed more to fiduciaries than traders, who may see the recent price performance as reason for holding these positions. Fiduciaries need more than price momentum to justify investing in a given stock.

Figure 6: Most Dangerous Stocks for Fiduciaries with TTM Core Earnings Less than 2019

Company	Ticker
Spotify Technology	SPOT
Snap Inc.	SNAP
Beyond Meat	BYND
Carvana Co.	CVNA

Sources: New Constructs, LLC and company filings.

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Disclosure: David Trainer owns SYY, DHI, H, JPM, SPG, and LUV. Matt Shuler owns HFC. David Trainer, Kyle Guske II, and Matt Shuler receive no compensation to write about any specific stock, style, or theme.

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Appendix I: P/E Ratio Methodology for Core & SPGI's Operating Earnings

In Figure 2 above, we calculate the price-to-Core Earnings ratio as follows:

1. Calculate a TTM earnings yield for every S&P 500 constituent
2. Weight the earnings yields by each stock's respective S&P 500 weight
3. Sum the weighted earnings yields and take the inverse (1/Earnings Yield)

We use the earnings yield methodology because P/E ratios don't follow a linear trend. A P/E ratio of 1 is "better" than a P/E ratio of 30, but a P/E ratio of 30 is "better" than a P/E ratio of -15. In other words, aggregating P/E ratios can result in a low multiple due the inclusion of just a few stocks with negative P/Es.

Using earnings yields solves this problem because a high earnings yield is always "better" than a low earnings yield. There is no conceptual difference when flipping from positive to negative earnings yields as there is with traditional P/E ratios.

For all periods in Figure 3, we calculate the price-to-SPGI's Operating Earnings ratio by summing the preceding 4 quarters of Operating Earnings per share and, then, dividing by the S&P 500 price at the end of each measurement period.

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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