All Cap Index & Sectors: GAAP Vs. Core Update for 3Q23 (Free, Abridged)

We have updated the trailing-twelve-month (TTM) Core Earnings and GAAP Earnings for the NC 2000 and all sectors for 3Q23.

Seeing GAAP Earnings move in the opposite direction of Core Earnings raises red flags about the quality of reported earnings while also raising the risk of earnings misses in coming quarters. In other words, 4Q23 earnings season could be ugly. These results underscore the more stable nature of Core Earnings. Because we remove unusual gains and losses, Core Earnings are not prone to the large swings seen in GAAP Earnings.

This report is an abridged and free version of All Cap Index & Sectors: GAAP Vs. Core Update for 3Q23, one of our quarterly reports on fundamental market and sector trends.

The full version of the report analyzes Core Earnings[1][2] and GAAP earnings of the NC 2000 and each of its sectors (last quarter's analysis is here) from 1998 to present. The full reports are available to Professional and Institutional members.

This report leverages our cutting-edge Robo-Analyst technology to deliver proven-superior fundamental research and support more cost-effective fulfillment of the fiduciary duty of care.

GAAP Earnings Are Again Misleading in 3Q23

Our superior fundamental data protects investors from being fooled by misleading trends in un-scrubbed GAAP Earnings. Looking beyond the headlines reveals that the recent changes in GAAP Earnings may be an illusion for three reasons:

1. Unusual gains are artificially elevating GAAP Earnings and cannot persist forever.
2. Core Earnings growing slower suggests GAAP Earnings have limited room to rise.
3. Understated GAAP earnings in prior quarters (kitchen sink effect) set up easy comps and may cause expectations for future earnings to be too high.

If the rise in GAAP Earnings proves to be an illusion, investors could be in for a tough 4Q23. See Figure 1 in the full report.

Core Earnings Are Less Volatile than GAAP Earnings

Figure 1 in the full report shows GAAP Earnings for the NC 2000 meaningfully differ from Core Earnings for the fifth consecutive quarter.

GAAP Earnings Understate Core Earnings for Nearly Two-Thirds of the NC 2000 (by Market Cap)

For the TTM ended 3Q23, 61% of the companies in the NC 2000 reported GAAP Earnings that are lower than Core Earnings.

When GAAP Earnings are lower than Core Earnings, they are understated by an average of 137%, per Figure 1.

[1] Core Earnings enable investors to overcome the flaws in legacy fundamental data and research, as proven in Core Earnings: New Data & Evidence, written by professors at Harvard Business School (HBS) & MIT Sloan for The Journal of Financial Economics.
[2] Based on the latest audited financial data, which is the 3Q23 10-Q in most cases. Price data as of 11/14/23. QoQ analysis is based on the change since last quarter's report.

Figure 1: NC 2000 GAAP Earnings Understated by 137% On Average

Understated GAAP Earnings	Understated by >10%	Average Understatement %
1,213 companies	694 companies	137%

Sources: New Constructs, LLC and company filings.
We use Funds from Operations (FFO) for Real Estate companies rather than GAAP Earnings.

Key Details on Select NC 2000 Sectors

Six of eleven sectors saw a QoQ rise in Core Earnings through the TTM ended 3Q23.

The Financials sector saw the largest QoQ improvement in Core Earnings.

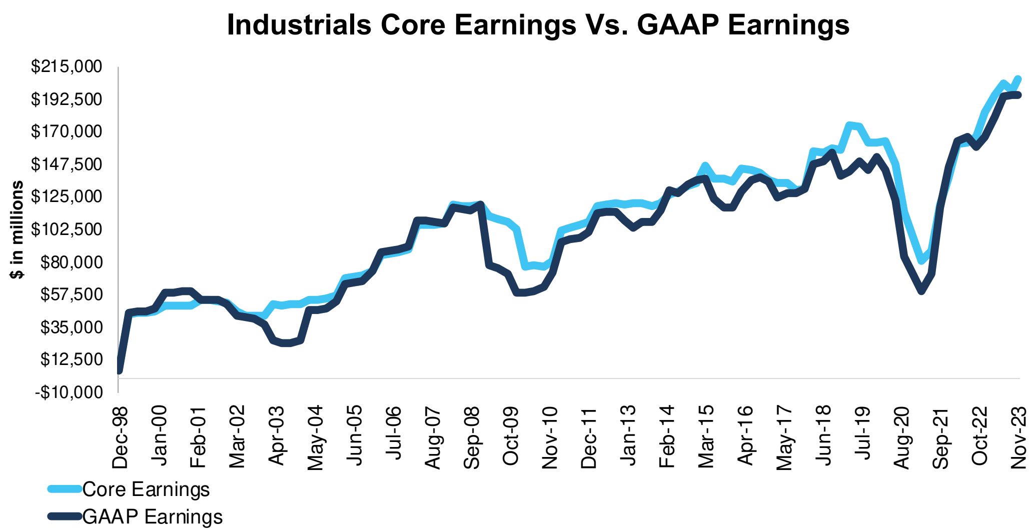
The Technology sector generates the most Core Earnings. On the flip side, the Real Estate sector has the lowest Core Earnings.

Below we highlight the Industrials sector and a stock with some of the most negative Earnings Distortion (i.e. understated GAAP earnings) in the sector.

Sample Sector Analysis[3]: Industrials Sector

Figure 2 shows Core Earnings for the Industrials sector, at $206.4 billion, rose 4% QoQ in 3Q23, while GAAP earnings, at $195.6 billion, rose <1% over the same time.

Figure 2: Industrials Core Earnings Vs. GAAP: 1998 – 3Q23



Sources: New Constructs, LLC and company filings.
Our Core Earnings analysis is based on aggregated TTM data for the sector constituents in each measurement period.
The November 14, 2023 measurement period incorporates the financial data from calendar 3Q23 10-Qs, as this is the earliest date for which all of the calendar 3Q23 10-Qs for the NC 2000 constituents were available.

GAAP Earnings Understatement Details: Caterpillar (CAT)

Below, we detail the hidden and reported unusual items overlooked in GAAP Earnings and captured in Core Earnings for Caterpillar (CAT). After adjusting for unusual items, we find that Caterpillar's Core Earnings of $10.5 billion, or $20.27/share are much higher than reported GAAP Earnings of $9.1 billion, or $17.62/share.

Caterpillar's Stock Rating is Attractive, in part due to its rising economic earnings, high free cash flow yield, and low price-to-economic book value (PEBV) ratio of 1.0.

Below, we detail the differences between Core Earnings and GAAP Earnings so readers can audit our research.

[3] The full version of this report provides analyses for all eleven sectors.

Figure 3: Caterpillar's GAAP Earnings to Core Earnings Reconciliation: TTM through 3Q23

	TTM ($ per share)
GAAP Net Income	$17.62
– Hidden Unusual Expenses, Net	($1.73)
– Reported Unusual Expenses Pre-Tax, Net	($1.27)
– Tax Distortion	$0.35
= Core Earnings	**$20.27**

Sources: New Constructs, LLC and company filings.

More details:

Total Earnings Distortion of -$2.65/share, which equals -$1.4 billion, is comprised of the following:

Hidden Unusual Expenses Pre-Tax, Net = -$1.73/per share, which equals -$892 million and is comprised of:

- -$586 million in Longwall divestiture restructuring costs – Page 39 1Q23 10-Q
- -$255 million in Other restructuring costs in the TTM period based on
  - -$34 million in 3Q23
  - -$19 million in 2Q23
  - -$13 million in 1Q23
  - -$189 million in 4Q23
- -$47 million in employee separation restructuring costs in the TTM period based on
  - -$10 million in 3Q23
  - -$10 million in 2Q23
  - -$12 million in 1Q23
  - -$15 million in 4Q23
- -$4 million in long-lived asset impairment restructuring costs in the TTM period based on
  - -$2 million in 3Q23
  - -$2 million in 2Q23

Reported Unusual Expenses Pre-Tax, Net = -$1.27/per share, which equals -$659 million and is comprised of:

- -$925 million goodwill impairment charge in the TTM based on -$925 million charge reported in 2022 10-K
- -$624 million contra adjustment for recurring pension costs. These recurring expenses are reported in non-recurring line items, so we add them back and exclude them from Earnings Distortion.
- -$316 million in foreign exchange losses in the TTM period based on
  - $17 million gain in 3Q23
  - $40 million gain in 2Q23
  - -$72 million loss in 1Q23
  - -$301 million loss in 4Q22
- $48 million in miscellaneous income in the TTM period based on
  - $12 million income in 3Q23
  - -$30 million loss in 2Q23
  - $4 million income in 1Q23
  - $62 million income in 4Q22
- $393 million in investment and interest income in the TTM period based on
  - $135 million in 3Q23
  - $96 million in 2Q23
  - $93 million in 1Q23
  - $69 million in 4Q22
- $765 million in other non-operating income in the TTM period based on

- $630 million in net periodic pension and OPEB income, excluding service cost based on
    - -$12 million cost in 3Q23
    - -$12 million cost in 2Q23
    - -$13 million cost in 1Q23
    - $667 million income in 4Q22
- $147 million in license fee income based on
    - $37 million in 3Q23
    - $43 million in 2Q23
    - $31 million in 1Q23
    - $36 million in 4Q22
- -$12 million in losses on securities based on
    - $6 million in gains in 3Q23
    - -$10 million in losses in 2Q23
    - -$11 million in losses in 1Q23
    - $3 million in gains in 4Q22

Tax Distortion = $0.35/per share, which equals $183 million.

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Disclosure: David Trainer, Kyle Guske II, Italo Mendonça, and Hakan Salt receive no compensation to write about any specific stock, style, or theme.

Questions on this report or others? Join our Society of Intelligent Investors and connect with us directly.

Appendix: Calculation Methodology

We derive the Core Earnings and GAAP Earnings metrics above by summing up the trailing-twelve-month individual NC 2000 constituent values for Core Earnings and GAAP Earnings in each sector for each measurement period. We call this approach the “Aggregate” methodology.

The Aggregate methodology provides a straightforward look at the entire sector, regardless of market cap or index weighting and matches how S&P Global (SPGI) calculates metrics for the S&P 500.

It's Official: We Offer the Best Fundamental Data in the World

Many firms claim their research is superior, but none of them can prove it with independent studies from highly-respected institutions as we can. Three different papers from both the public and private sectors show:

1. Legacy fundamental datasets suffer from significant inaccuracies, omissions and biases.
2. Only our "novel database" enables investors to overcome these flaws and apply reliable fundamental data in their research.
3. Our proprietary measures of Core Earnings and Earnings Distortion materially improve stock picking and forecasting of profits.

Best Fundamental Data in the World

Forthcoming in The Journal of Financial Economics, a top peer-reviewed journal, Core Earnings: New Data & Evidence proves our Robo-Analyst technology overcomes material shortcomings in legacy firms' data collection processes to provide superior fundamental data, earnings models, and research. More details.

Key quotes from the paper:

- "[New Constructs'] *Total Adjustments* differs significantly from the items identified and excluded from Compustat's adjusted earnings measures. For example… 50% to 70% of the variation in *Total Adjustments* is not explained by *S&P Global's (SPGI) Adjustments* individually." – pp. 14, 1st para.
- "A final source of differences [between New Constructs' and S&P Global's data] is due to data collection oversights…we identified cases where Compustat did not collect information relating to firms' income that is useful in assessing core earnings." – pp. 16, 2nd para.

Superior Models

A top accounting firm features the superiority of our ROIC, NOPAT and Invested Capital research to Capital IQ & Bloomberg's in Getting ROIC Right. See the Appendix for direct comparison details.

Key quotes from the paper:

- "…an accurate calculation of ROIC requires more diligence than often occurs in some of the common, off-the-shelf ROIC calculations. Only by scouring the footnotes and the MD&A [as New Constructs does] can investors get an accurate calculation of ROIC." – pp. 8, 5th para.
- "The majority of the difference…comes from New Constructs' machine learning approach, which leverages technology to calculate ROIC by applying accounting adjustments that may be buried deeply in the footnotes across thousands of companies." – pp. 4, 2nd para.

Superior Stock Ratings

Robo-Analysts' stock ratings outperform those from human analysts as shown in this paper from Indiana's Kelley School of Business. Bloomberg features the paper here.

Key quotes from the paper:

- "the portfolios formed following the buy recommendations of Robo-Analysts earn abnormal returns that are statistically and economically significant." – pp. 6, 3rd para.
- "Our results ultimately suggest that Robo-Analysts are a valuable, alternative information intermediary to traditional sell-side analysts." – pp. 20, 3rd para.

Our mission is to provide the best fundamental analysis of public and private businesses in the world and make it affordable for all investors, not just Wall Street insiders.

We believe every investor deserves to know the whole truth about the profitability and valuation of any company they consider for investment. More details on our cutting-edge technology and how we use it are here.

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