
DO EARNINGS TRENDS SIGNAL CAUTION?

Jeremy Schwartz — Global Chief Investment Officer
01/28/2020

Last week's "Behind the Markets" podcast featured a conversation about trends in earnings with David Trainer, CEO of New Constructs, a technology company based in Nashville that uses machine learning algorithms to scour the footnotes of financial statements for unusual gains and losses that distort true cash flow and profitability of firms.

WisdomTree recently licensed the New Constructs core earnings data as a primary source for our earnings-weighted Indexes. Our research showed that the New Constructs earnings data is an improvement over the earnings available from other commonly available sources.

Earnings Trends Signal Caution

The New Constructs data on the trends in earnings distortion is one sign of caution for Trainer.

One measure of distortion compares the New Constructs core earnings data with the level of [GAAP](#) net income. The New Constructs core earnings figures are usually higher than GAAP net income due to one-time losses that are eliminated from "core earnings."

But right now, the New Constructs core earnings metrics are below net income, which signals that accounting earnings are potentially more overstated. According to Trainer, the last two times the overstatement in earnings was similar to current levels was in 1999 and 2007—right before the last two [bull markets](#) ended.

Notably, the two sectors with the highest earnings distortion are Real Estate and Information Technology.

Valuations Even More Extended on Core Earnings

Another topic of discussion was the [valuations of market capitalization-weighted indexes versus earnings-weighted indexes](#).

The [S&P 500](#) was trading around 24x trailing 12-month price-to-earnings using the New Constructs core earnings measure, while an earnings-weighted index for [large caps](#) was valued around 18x—a healthy discount.

The more that market multiples rise, the greater the chance for a discounted, lower multiple that is inherent to an earnings approach. Said differently, as valuation ranges widen, there is more opportunity for relative value adjustments.

This potentially is becoming an important time to consider strategies that lower the multiple of the market. The lowest multiples are currently found in [small caps](#): in December, the [WisdomTree U.S. SmallCap Index \(WTSEI\)](#) was valued approximately 10x below the market capitalization-weighted benchmarks, as measured by the trailing 12-month [price-to-earnings ratio](#) using the New Constructs core earnings metric.

Additional Uses for New Constructs

Trainer also discussed the valuation models and stock screeners that New Constructs provides—including his most popular model for firms that best align executive pay with [return on invested capital](#) metrics. There are many different price points for New Constructs' tools as well as a number of trading platforms that provide access to its data.

Listen to this great full conversation on trends in earnings and how [New Constructs](#) might be a useful investing resource.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

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You cannot invest directly in an index.

DEFINITIONS

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

Bullish : a position that benefits when asset prices rise.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Large-Capitalization (Large-Cap) : A term used by the investment community to refer to companies with a market capitalization value of more than \$10 billion. Large cap is an abbreviation of the term "large market capitalization". Market capitalization is calculated by multiplying the number of a company's shares outstanding by its stock price per share.

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Price-to-earnings (P/E) ratio : Share price divided by earnings per share. Lower numbers indicate an ability to access greater amounts of earnings per dollar invested.

Return on Invested Capital (ROIC) : Measures the efficiency of invested capital and how it relates to generated returns.