

Earnings Don't Matter

At Least Here in the U.S.

Investment Insights Series



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It is said, “stocks prices follow earnings.” As many frustrated quality or growth-at-a-reasonable price portfolio managers will attest, for the past two years, at least in the U.S., the broad U.S. equity indices have turned this adage on its head. It appears what mattered the most for high portfolio returns is the prospect for high top-line growth. Consistent earnings and cash flow growth seems so passé in this ultra-low interest rate environment. If stock prices follow earnings, then positive earnings growth (both historically and prospectively) and positive stock price momentum should go hand-in-hand. For the past two years, however, we have witnessed decoupling of earnings growth and stock price momentum.

KEY TAKEAWAYS

- ▶ It is said, “stocks prices follow earnings;” however, as many frustrated quality or growth-at-a-reasonable price portfolio managers will attest, the broad US equity indices have turned this adage on its head.
- ▶ The weight of non-earners has steadily increased from about 20% in September 2016 to about 37% of the Russell 2000 Index at the end of September 2021.
- ▶ Despite generating positive absolute returns, as long as stock price momentum remains disconnected from the underlying earnings and cash flow growth, actively managed quality or growth-at-a-reasonable price portfolios may continue to underperform their respective benchmarks.

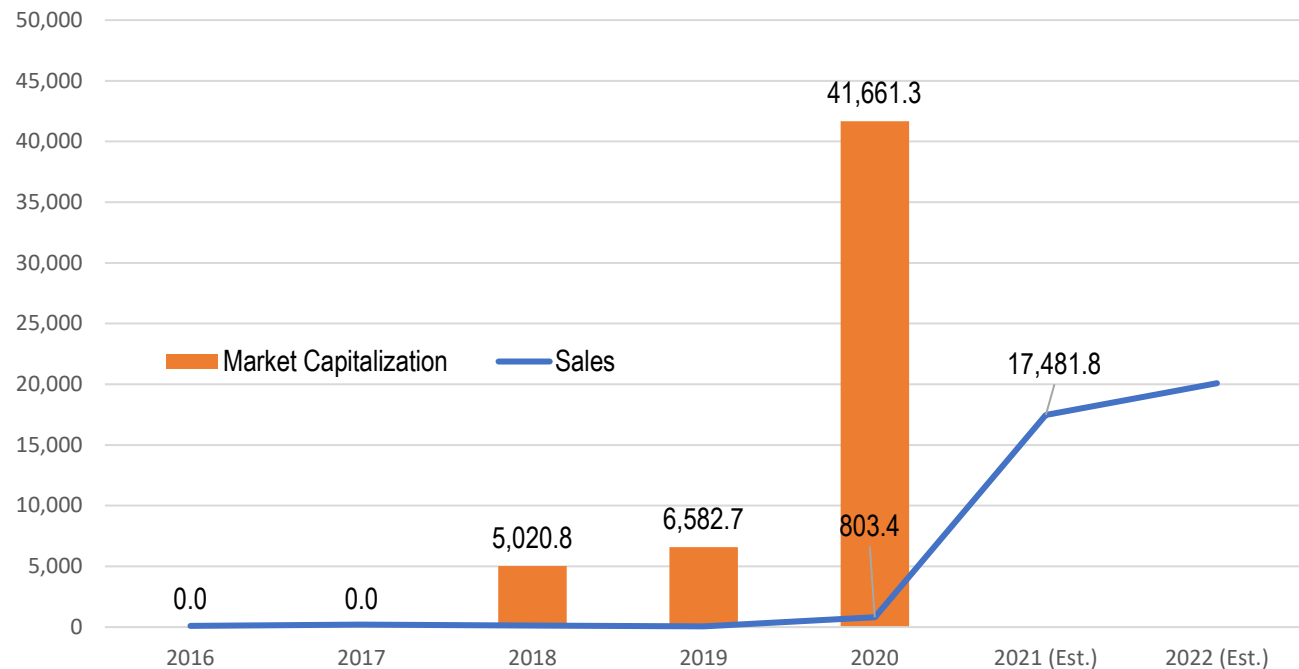
It is all about the J-Curve

Non-earners have often been (but not always) associated with start-ups or venture companies that require a great deal of upfront investments to bring brand new products or services to the marketplace. Even after the successful introduction of new products or services, they often continue to register losses due to the high expenditures required to fund a J-curve type of sales growth. This is exemplified by Moderna in Exhibit 1.

Exhibit 1: Moderna Sales Growth

A Textbook Example of J-Curve Sales Growth

(in Millions USD)

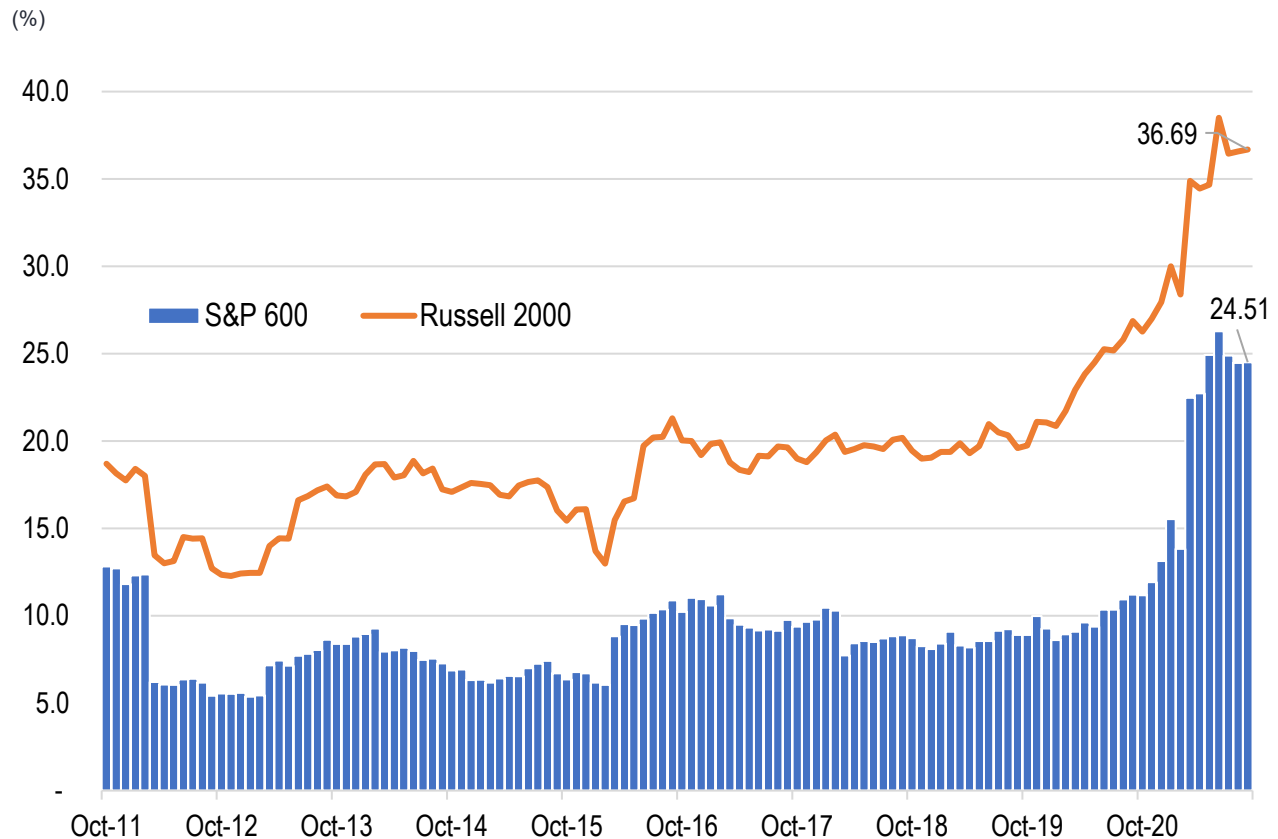


Source: Bloomberg. As of 16 Nov 2021.

Between 2016 and 2020, Moderna consistently lost money, and yet, at the end of 2020, it sported a market capitalization of \$41.7 billion USD. At its peak (\$193.2B on 9 August 2021), Moderna represented one of the largest biotechnology companies in the world, ahead of Amgen. In Moderna's case, the market appeared to correctly assess the future sales potential from the successful launch of the COVID-19 vaccine. Evidence shows, however, the market has been assigning a similar type of success to many small capitalization non-earners.

Exhibit 2: Percentage of Companies with Loss from Continuing Operations

For Small Cap Indices, Non-earners Represent Close to 40% of the Russell 2000



Source: Wilshire Atlas. Data for the period ended on 30 September 2021.

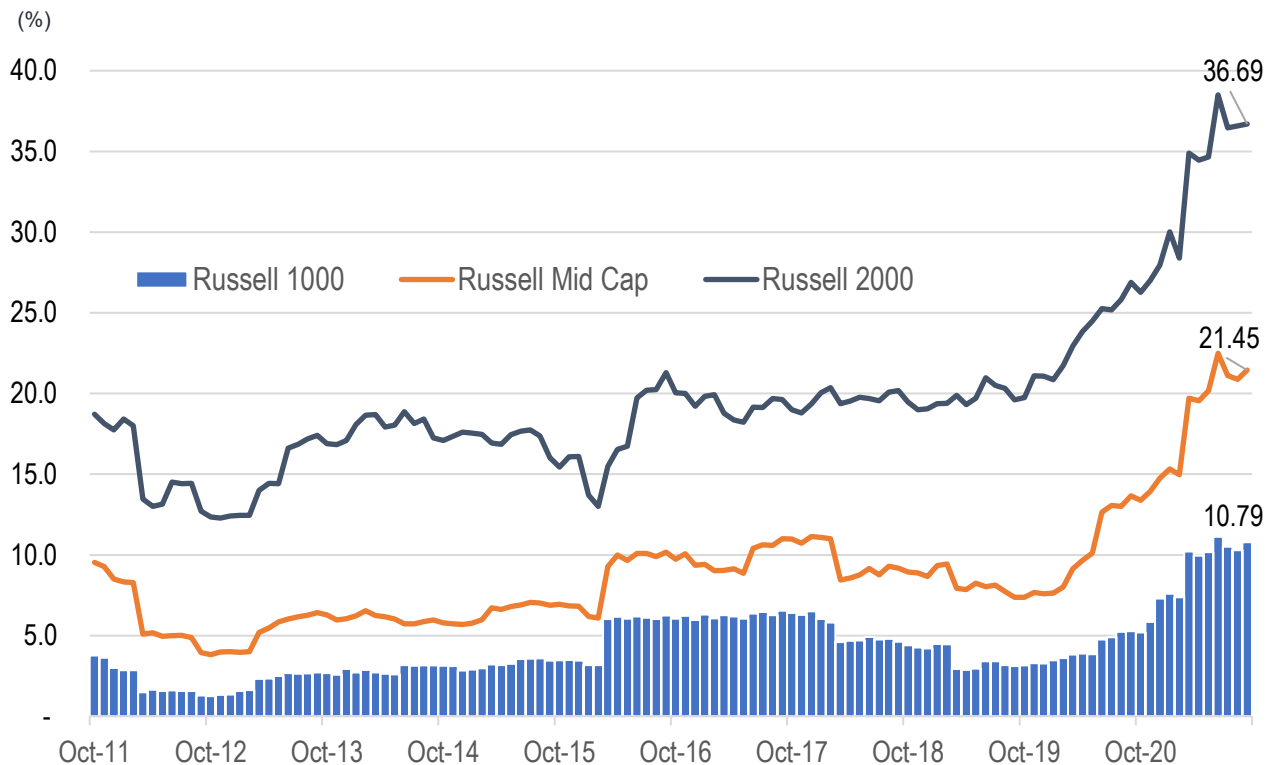
As demonstrated in Exhibit 2, the weight of non-earners has steadily increased from about 20% in September 2016 to about 37% of the Russell 2000 Index at the end of September 2021. One can observe the similar pattern for the S&P 600 Index – a small cap benchmark some consider to be of higher quality than the Russell 2000 Index.

Non-Earners by Size

Albeit not as pronounced, the increase in non-earners has not been limited to the small cap universe. In Exhibit 3, one can appreciate the pervasiveness of non-earners even in the mid and large cap universes.

Exhibit 3: Percentage of Companies with Loss from Continuing Operations (By Size)

Growth of Non-earners Not Limited to Small Caps Only



Source: Wilshire Atlas. Data for the period ended on 30 September 2021.

For the Russell Mid Cap Index, the weight of loss-making companies has more than doubled from 10.16% to 21.45% over the five years ended September 2021. Although not as extreme, the pattern is consistent for the Russell 1000 Index.

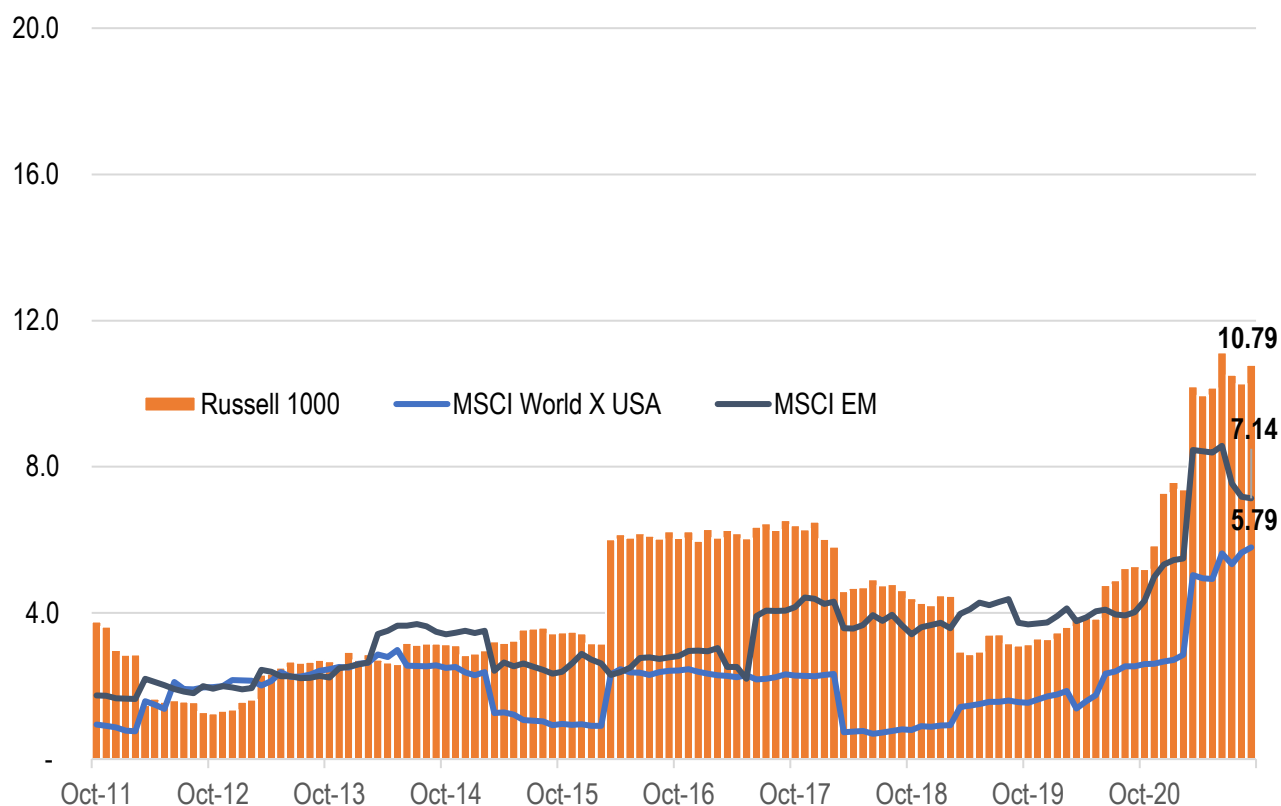
Non-Earners by Region

Although the pattern is somewhat similar, the absolute weights of loss-making companies in non-U.S. developed and emerging markets are meaningfully lower than in U.S. markets.

Exhibit 4: Percentage of Companies with Loss from Continuing Operations (By Region)

Non-earners are Much More Prevalent in the U.S.

(%)



Source: Wilshire Atlas. Data for the period ended on 30 September 2021.

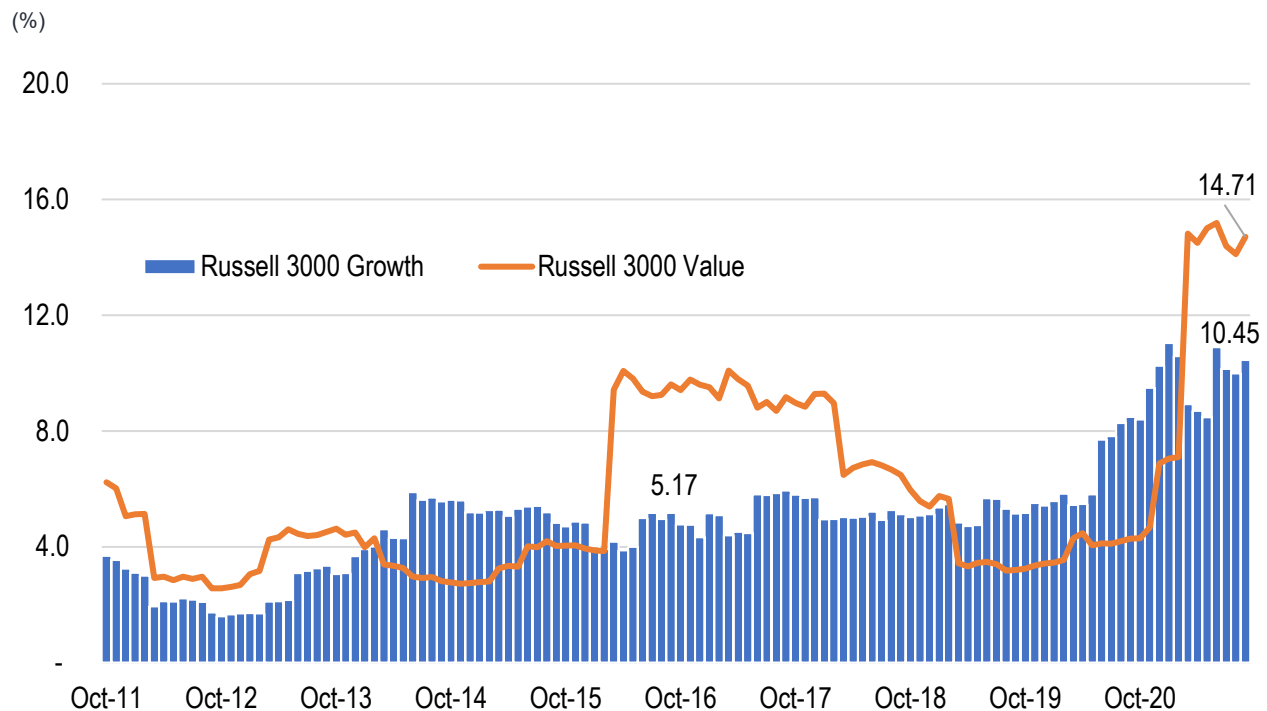
The weight for non-U.S. developed markets as proxied by the MSCI World ex USA Index was roughly one-half the weight of the Russell 1000 Index. While higher than non-U.S. developed markets, the weight of loss-making companies in emerging markets stood at about 7.0% at the end of September.

Non-Earners by Style

While the weight of non-earners has increased for both the Russell 3000 Growth and the Russell 3000 Value indices, the pattern of increases in non-earners is much more consistent for the Growth index than for the Value index where the pattern is much more erratic. The weight of loss-making companies in the Russell 3000 Growth Index more than doubled from 5.17% to 10.45% during the span of five years ended September 2021.

Exhibit 5: Percentage of Companies with Loss from Continuing Operations (By Style)

The Growth of Non-Earners Extends Across Styles



Source: Wilshire Atlas. Data for the period ended on 30 September 2021.

Established companies often fall into the Value index when their earnings growth slows or turns negative; conversely, newer companies often fall into the Growth index when their revenues are expected to grow rapidly despite recording current negative earnings (see Exhibit 1). Therefore, it may be that non-earners in the Growth index represent very different types of companies when compared to non-earners in the Value index (i.e., in terms of trajectory of future sales and earnings growth).

So What? What does it all mean?

As remarked at the beginning, as long as stock price momentum remains disconnected from the underlying earnings and cash flow growth, actively managed quality or growth-at-a-reasonable price ('GARP') portfolios may continue to underperform their respective benchmarks. That is not to say that these active portfolio managers are not generating positive returns. Most likely they are still generating attractive positive absolute returns, just not as high as benchmark returns greatly influenced by the positive price momentum of non-earners.

The current environment poses a serious challenge to GARP portfolio managers and plan sponsors who invested with GARP portfolio managers. As the duration of underperformance prolongs, the former must decide whether to remain true to their investing style or close the underweight to non-earners to close the performance gap. Likewise, plan sponsors must decide whether to keep the underperforming GARP managers or to swap out into more price momentum-driven growth managers. That question faced by plan sponsors is not solely

limited to actively managed portfolios. The implications of the increase in non-earners affects the outlook for passive portfolios as well. Should the disconnect between stock momentum and underlying earnings and cash flow growth quickly reverse, index-oriented and passive portfolios may be impacted equally or more so than earnings and cash flow growth driven actively managed portfolios.

No one knows when non-earners will fall out-of-favor with investors or when stock prices could again closely follow earnings and cash flow growth. Intellectually, most active portfolio managers recognize changing their investing approach in an attempt to close the relative underperformance is a fool's errand; likewise, most plan sponsors recognize that GARP managers were hired in a multi-manager structure to play a role. Therefore, as long as the conviction runs deep, the right course of action may be to remain steadfast to one's investment approach for portfolio managers and to keep existing portfolio managers for plan sponsors. Underperformance hurts (even with high absolute returns). The question, however, that portfolio managers and plan sponsors must ask is this: "Do you have the emotional fortitude to remain true to your investment approach and the reason you hired that manager in the first place in the face of growing career risk?"

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