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TANDEM Investment Advisors

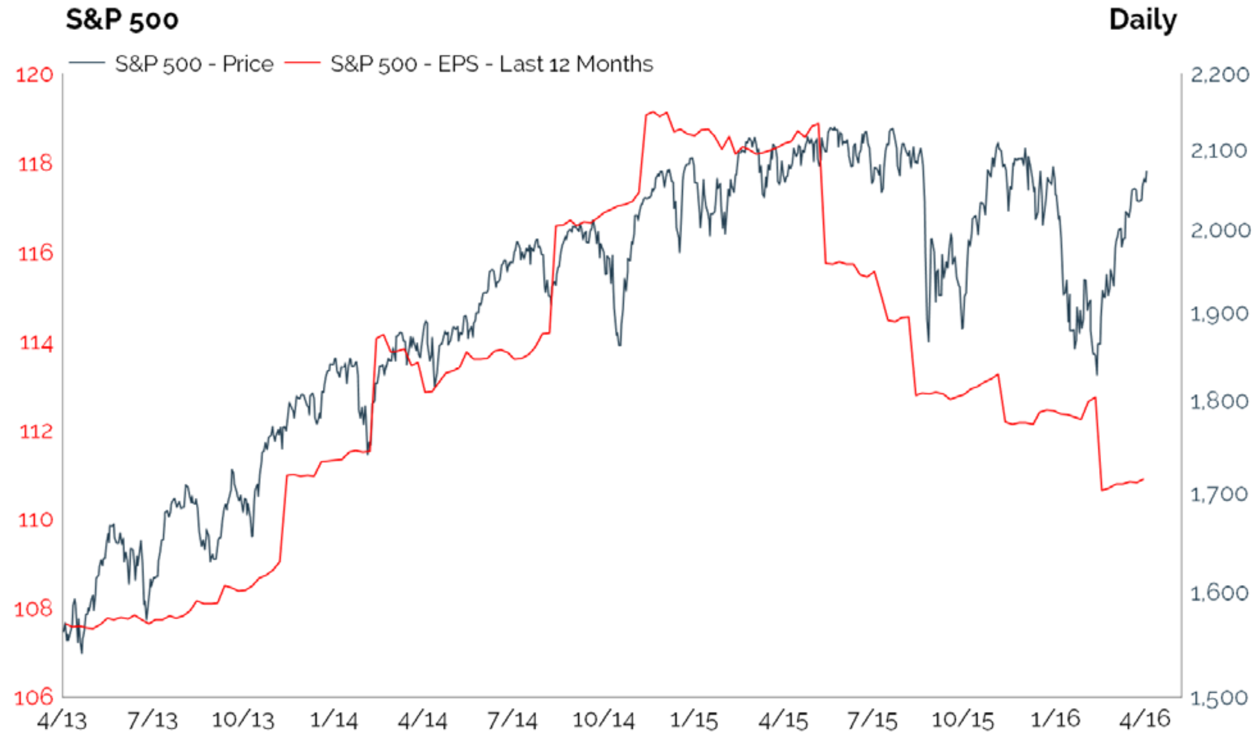
The Elephant in the Room

Can you see it? Because if you can't, you need to look closer. Corporate earnings are the 800 pound gorilla riding the valuation elephant around the room. Some people see it, others don't and many just choose to look the other way. I'm here to tell you that earnings and valuation are extremely important, as they dictate future returns. So, please don't put your head in the sand and ignore them. Doing such a thing would ultimately be hazardous to your investment health.

Earnings matter. And, what you decide to pay for those earnings matters even more. There are times in history when real revenues and profits get thrown by the wayside for a new method of valuing stocks. The reasoning is always the same... "this time really is different". During the Tech Bubble, revenue and earnings were replaced by "eyeballs". At the time, a premium was placed on site viewership over the amount of money a company actually made. We all know how that played out. "Eyeballs" were never supported by real fundamentals. Earnings declined and so did stock prices. The first part of this century proved to be no different than any other time in history. Eventually real earnings and valuations reigned supreme. You can clearly see from the chart below how strong the correlation has been between stock prices and corporate earnings over the past 15 years.

Source: Factset

However, ever since the back half of 2014, the path of earnings has deviated from the overall stock market.



Source: Factset

The stock market today is roughly at the same level as it was around the end of 2014. However, corporations have generated fewer profits over this same time frame. Not only has this divergence manifested itself over the past year and half, but it has worsened over the first three months of this year. At the start of the quarter, estimates called for 1.4% growth in first quarter earnings. They are now expected to decline by 8.6%. During this span, the S&P 500 is practically unchanged. Granted, the first three months will go down in the history books as one of the most volatile starts to a year ever. However, at the end of the day, we basically ended the quarter right where we started, albeit just at a higher valuation. We are now paying more for less earnings.

Now, many will quickly say, "But, if you back out energy, earnings would be growing." Yes, you are correct. It's no secret that if you remove everything that detracts from growth, you will be left with... positive growth! It's crazy how that happens. And, I guess if we were to forget about the negative effects housing and the financial institutions had on the world's economy in 2008, we never really experienced a financial crisis. You need to always take the good with the bad and the bad with the good. If you are one of those people who think we should discount the negative contribution the energy sector has on S&P 500 earnings, then you also need to discount the positive contribution the energy sector had on earnings from 2010 to 2014. It's only fair. Up

until recently, energy has been the main culprit to the deteriorating corporate profit picture. However, as you'll see from the table below, seven out of the ten sectors in the S&P 500 are estimated to have a negative contribution to the overall earnings growth rate in the first quarter of this year. I guess it's not just energy companies that are pulling down earnings any more, is it?

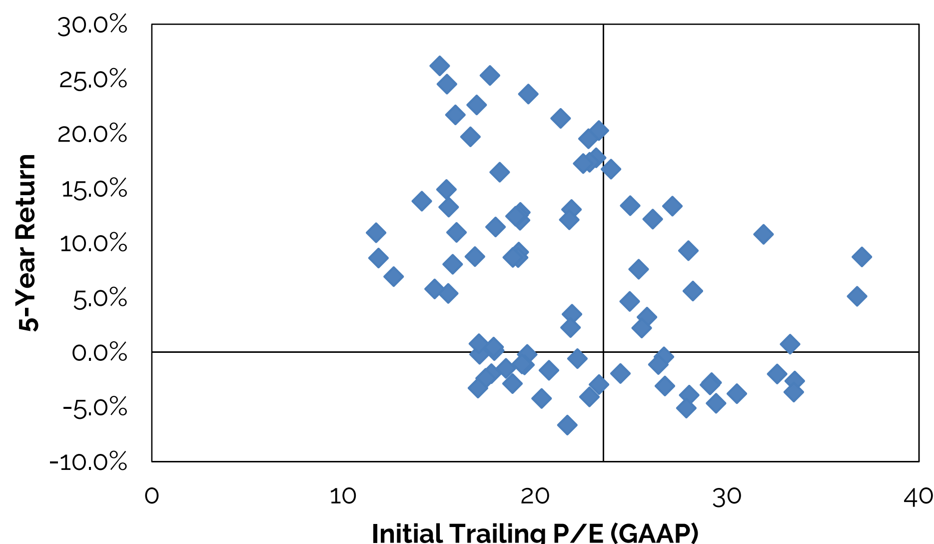
Name	Growth Blended (%)	Contribution
S&P 500	**-8.6**	**-8.6**
Consumer Discretionary	10.0	0.94
Consumer Staples	-3.1	-0.27
Energy	-102	-5.1
Financials	-8.6	-1.8
Health Care	2.4	0.37
Industrials	-8.9	-0.85
Information Technology	-7.1	-1.5
Materials	-22.1	-0.74
Telecommunication Services	13.1	0.40
Utilities	-0.91	-0.03

Source: Factset

It is becoming evident that the earnings decline we've witnessed over the past few quarters is starting to seep into the other sectors of the stock market. It is not just an energy problem anymore. Beginning in the next couple of weeks, we are going to be inundated with first quarter earnings reports. Every quarter it seems as if someone on TV is telling you that this is the most important earnings season ever. It has been quite some time since I've agreed with this statement, but I believe they are now correct with that assessment. This upcoming earnings season is important in that one of the other main detractors to growth, not named energy, has the potential to show signs of a reversal. For the first time in quite a while, the negative effects that currency fluctuations have on revenues and earnings should be somewhat muted. Over the first three months of this year, the U.S. Dollar Index averaged $97.39 compared to an average of $95.19 over the first three months of 2015. This represents a 2.3% gain. In the context of recent double digit percentage increases in this index, a 2.3% move exhibits some semblance of stability. Couple the stability in the U.S. dollar with already depressed expectations and you have the ingredients for a potential upward surprise and positive reversal in corporate earnings over the near future. A lot has to be done and companies need to prove themselves again, but I can see a possible way out of this earnings funk.

Believe me, a reversal in the trend of declining corporate earnings would be well embraced within our office. It's been far too long that I've written about deteriorating company fundamentals. However, even if first quarter earnings came in half as bad as is expected, the S&P 500 (at its current level of 2,060) would be trading close to a P/E of 19x last twelve months non-GAAP earnings and close to a P/E of 22x GAAP earnings. Based on historical valuation readings, by no means is the stock market

trading at a bargain. As I mentioned earlier, valuations are extremely important. At the end of the day, what you decide to pay for a stock will go a long way in dictating your future return potential in that investment. Below is a chart that shows the distribution of five year returns based on the initial trailing P/E over the past 25 years.



Source: www.standardandpoors.com

What you clearly see is the further out you go on the X-axis (P/E), the smaller the returns get. It's not rocket science and all of you know this information already. The potential for the highest returns can be expected when the starting valuation is low. And, the potential for low or negative returns is the greatest when the starting valuation is high. The problem is many of us get lost in the day to day gyrations of the stock market and lose sight of the big picture as far as valuations are concerned. My point to all of this is that you must reign in your future return expectations every day that the stock market continues to go up in the face of declining earnings.

It has been a frustrating couple of years as a portfolio manager whose job is to invest clients' money. As you know, we've been holding a significant amount of cash for some time now. Our cash levels are not increasing because we are trying to make some bold call on the overall stock market. Don't get me wrong, the performance buffer that cash provides during a stock market decline, as seen in the first 6 weeks of this year, is certainly nice. But, that is not the reason we hold cash. We hold cash because the stocks we own got expensive relative to their underlying fundamentals. As we began to take profits in some of our core positions, there have been very few new investments worth pursuing at their given valuation. We currently have a list of 75 companies that meet all of our fundamental criteria, but their current valuations can't be justified. The stock price needs to come down or their revenues and earnings need to accelerate. Until then, the trade-off between risk and return is just not in your favor. There is no reason to reach or chase a stock in this environment. Let's wait a few more weeks to hear what companies have to say and just maybe earnings and valuations will become more closely aligned.

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson

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