The Earnings Line & Stock/Stock Market Valuations

We continue with what is another key chapter of Peter Lynch's book One Up On Wall Street called: **Earnings, Earnings, Earnings** where he explains his key investing tool:

- **The Earnings Line**, that is connected with
- **The PE ratio**, that again depends on
- **Future Expected Earnings!**

In this lecture we'll explain how earnings drive your investment returns, how stock prices fluctuate around those earnings depending on the PE ratio and how the PE ratio depends on future expected earnings among other things.

Earnings, Earnings, Earnings – key to investing returns

When it comes to investing, earnings are key. Warren Buffett says how:

"Investment returns are perfectly correlated to the performance of the underlying businesses."

Where the performance of the underlying business is reflected within the earnings.

Earnings are both Peter Lynch's and Buffett's investment focus. Earnings is what makes the company valuable to you because owning a stock means owning a part of a business and the business can reward you as a shareholder by distributing those earnings through dividends and buybacks or by reinvesting into growth for more future earnings.

Stock prices are irrational, go up and down, but real investors focus on earnings and compare the value of the business based on its earnings to the price of the stock. Over the long-term, the investment performance will resemble the performance in earnings.

If we take a look at the S&P 500 price movements (blue line) and compare it to the earnings line (white line) we can see how over the last 30 years, the long-term correlation is pretty strong with cyclical divergences depending on investor exuberance or pessimism.

S&P 500 & S&P 500 Earnings – Source: [Bloomberg]

There is currently a big discrepancy between the S&P 500 price and its earnings, but that is due to the price to earnings ratio going from 15 to the current 25 due to low interest rates. When the low interest rate environment reverts, so will the S&P 500 revert to the earnings line.

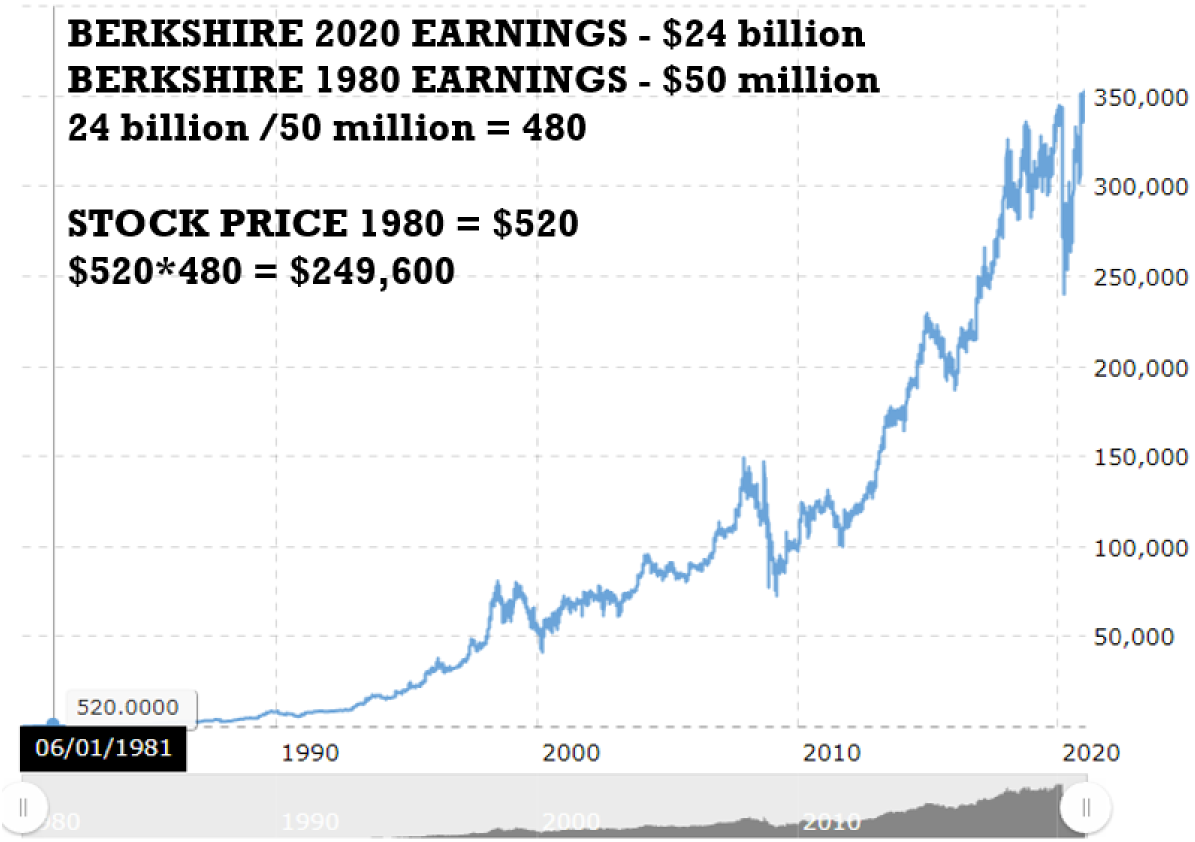
Berkshire 40 year investing example

Similarly, Berkshire's net income is around $24 billion per year, when adjusted for the new accounting rule that takes into account changes in the stock market portfolio. 40 years ago, net earnings were $50 million.

	Earnings Before Income Taxes				Net Earnings After Tax	
	Total		Berkshire Share		Berkshire Share	
(in thousands of dollars)	1980	1979	1980	1979	1980	1979
Total Earnings - all entities	$ 85,945	$ 68,632	$ 70,146	$ 56,427	$ 53,122	$ 42,817
Earnings from Operations:						
Insurance Group:						
Underwriting	$ 6,738	$ 3,742	$ 6,737	$ 3,741	$ 3,637	$ 2,214
Net Investment Income ...	30,939	24,224	30,927	24,216	25,607	20,106
Berkshire-Waumbec Textiles	(508)	1,723	(508)	1,723	202	848
Associated Retail Stores ..	2,440	2,775	2,440	2,775	1,169	1,280
See's Candies	15,031	12,785	8,958	7,598	4,212	3,448
Buffalo Evening News	(2,805)	(4,617)	(1,672)	(2,744)	(816)	(1,333)
Blue Chip Stamps - Parent	7,699	2,397	4,588	1,425	3,060	1,624
Illinois National Bank	5,324	5,747	5,200	5,614	4,731	5,027
Wesco Financial - Parent ..	2,916	2,413	1,392	1,098	1,044	937
Mutual Savings and Loan ...	5,814	10,447	2,775	4,751	1,974	3,261
Precision Steel	2,833	3,254	1,352	1,480	656	723
Interest on Debt	(12,230)	(8,248)	(9,390)	(5,860)	(4,809)	(2,900)
Other	2,170	1,342	1,590	996	1,255	753
Total Earnings from Operations	$ 66,361	$ 57,984	$ 54,389	$ 46,813	$ 41,922	$ 35,988
Mutual Savings and Loan - sale of branches	5,873	--	2,803	--	1,293	--
Realized Securities Gain	13,711	10,648	12,954	9,614	9,907	6,829
Total Earnings - all entities	$ 85,945	$ 68,632	$ 70,146	$ 56,427	$ 53,122	$ 42,817

Berkshire Earnings - [Berkshire 1980 letter to shareholders]

If I divide $24 billion with $50 million, I get 480. If we multiply the 1981 stock price of $520 with 480 we get to $249,600 which is pretty close to where BRK's stock is trading now. Of course, valuations are much higher now than in 1981, but this shows how earnings are key. A normalization in valuations and we could quickly see BRK down to $250k per share.



Berkshire's stock price follows earnings

Coca Cola is another good longer-term example. Current earnings are around $9 billion if we take an average.

Coca-Cola net income – Source: [Macrotrends]

Coca-Cola's net income in 1920, the first year it traded as a public company was $4.1 million. If I divide the current $9 billion with the 1920 $4.1 million, I get to 2,195. Over 100 years that gives us a compounding rate of 8%.

Coca-cola went public in 1920 at $40 per share. Since then, it has done 11 stock splits that means the initial one stock is now 9.216 stocks.

THE Coca-Cola COMPANY | Investors

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Overview Charts Dividends Year-End Splits Historical Data Share History

History Of Stock Splits For The Coca-Cola Company

RECORD DATE	ACTIVITY	CUMULATIVE SHARES
07/27/2012	2-for-1 Stock Split	9,216
05/01/1996	2-for-1 Stock Split	4,608
05/01/1992	2-for-1 Stock Split	2,304
05/01/1990	2-for-1 Stock Split	1,152
06/16/1986	3-for-1 Stock Split	576
05/09/1977	2-for-1 Stock Split	192
05/13/1968	2-for-1 Stock Split	96
01/22/1965	2-for-1 Stock Split	48
01/22/1960	3-for-1 Stock Split	24
11/15/1935	4-for-1 Stock Split	8
04/25/1927	1-for-1 Stock Dividend	2
09/05/1919		1

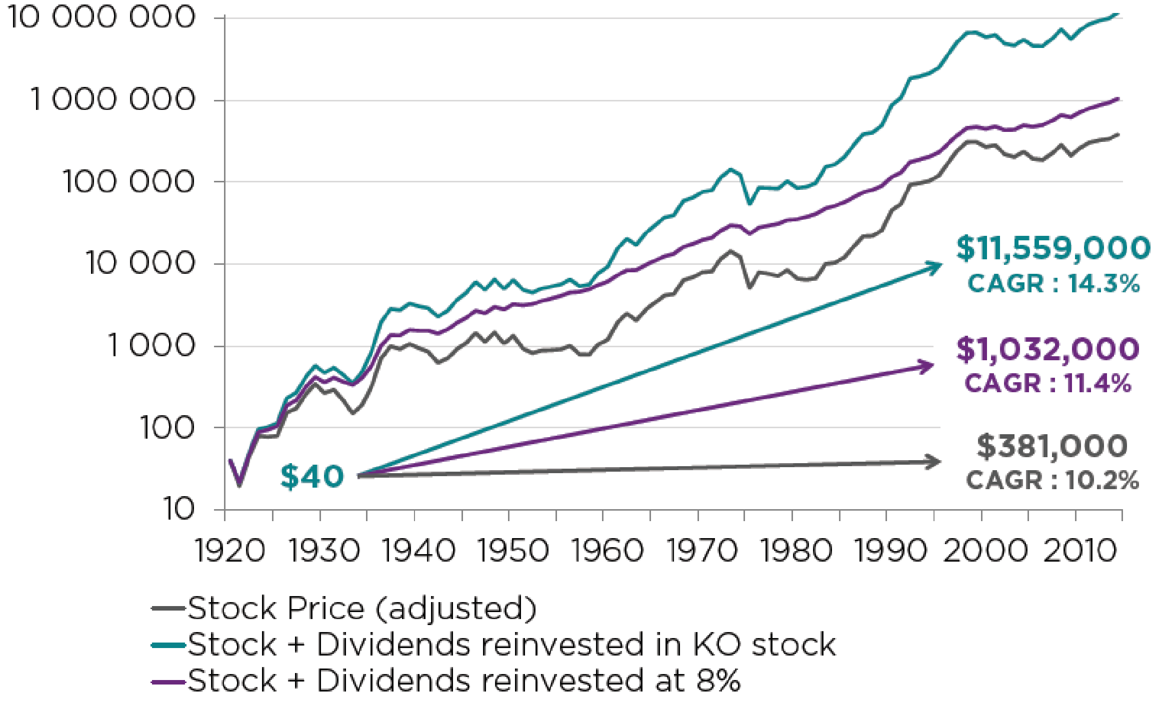
Coca-Cola stock split history – Source: Coca-Cola

So, one $40 share in 1920 would have turned into 9,216 shares currently priced at $48.96 for a total of $451,215 for a compounding investment return of 9.7%. This is a big higher than the net income growth rate but keep in mind Coca-Cola did also buybacks in its history so that adds to the investment return.

Coca-Cola stock price

Then it is up to you if you wish to add the dividend to the calculation and reinvest it. The average dividend yield of around 4% adds 4 percentage points to the stock price return and has a huge compounding effect on total returns. I have found this chart making the calculations up to the end of 2013 where a $40 investment would have turned into $11.5 million.

Figure 2: The power of compounding

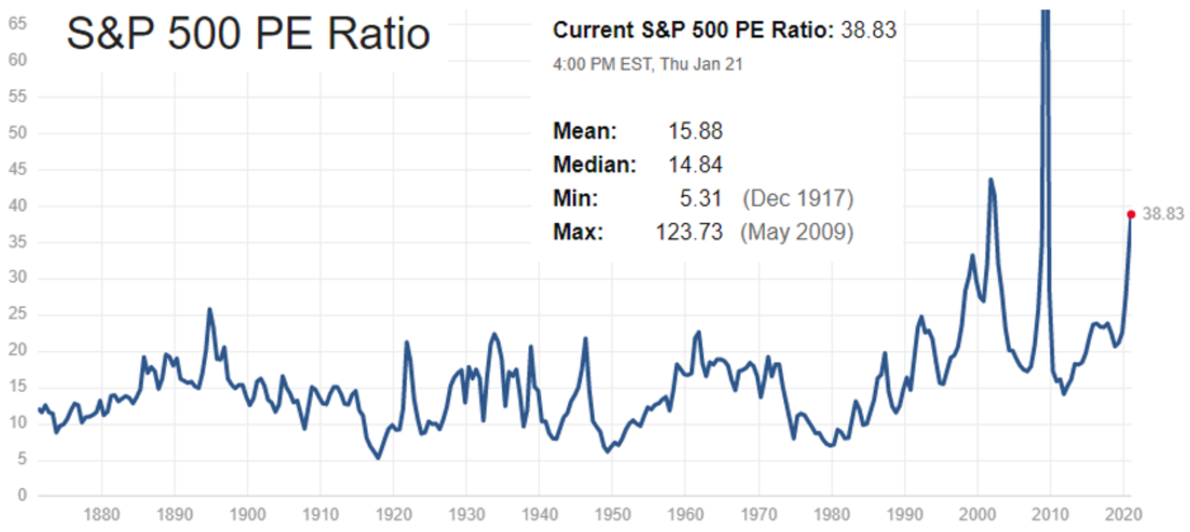


Source: Comgest

Since 2013 there have been 7 dividends of around 3% and the stock has increased 20% which gives a compounding return of around 5.5% per year since. Adding 5.5% per year to the return over the last 7 years to $11.5 million we get to $16.72 million. Over 100 years that gives us a compounding return of 13.8% from Coca-Cola.

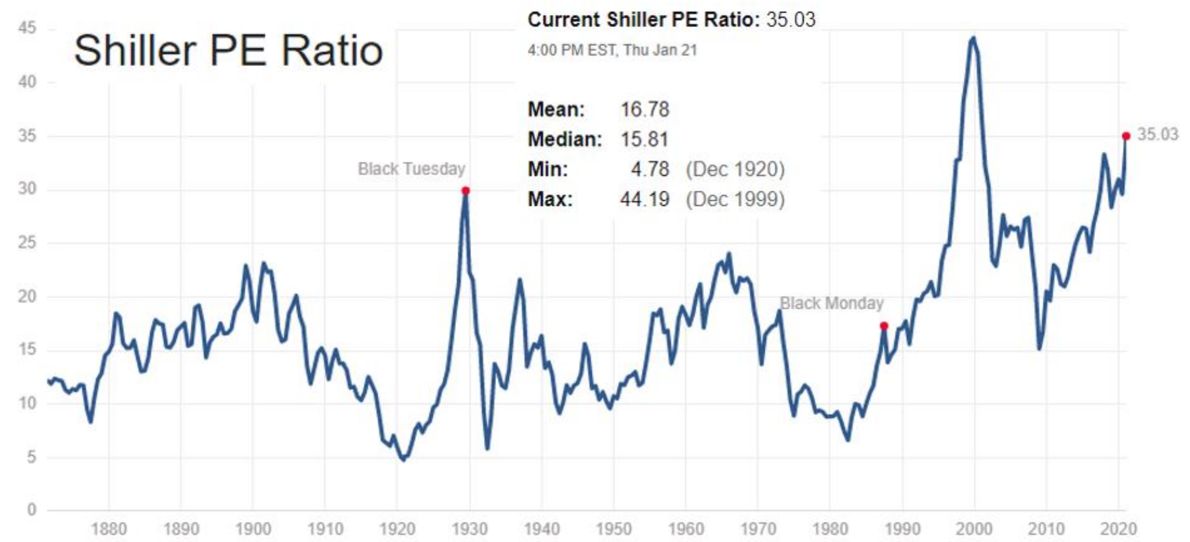
THE PE RATIO - Earnings line and stock price

As we have seen with stock prices above, those will always fluctuate, but if you understand a business well, you can estimate when it is undervalued or overvalued in relation to the price. Going back to the S&P 500 example, the current price to earnings ratio is 38 but that is distorted due to the COVID crisis hit earnings.



S&P 500 PE ratio – Source: [Multpl]

To adjust for crises like the current one, we can use the CAPE ratio, the cyclically adjusted price to earnings ratio that takes into account 10 years of earnings and uses the average, also called the Shiller PE ratio as it was developed by Nobel price winner professor Shiller from Yale.



S&P 500 CAPE ratio – Source: [Multpl]

The huge cycles in valuation reflect investors’ expectations about future earnings and comparisons to interest rates. When interest rates are low and expectations about the future are positive, stock prices use to be on a higher valuation level and the opposite is true when investors are pessimistic and interest rates are high.

As nobody can predict where will interest rates go, let’s stick to earnings, in this case future earnings.

Future earnings impact on stock valuations

As we have discussed in our intrinsic value lecture, the value of the stock is the discounted present value of all cash flows given to shareholders from today till judgement day. So, investing is more about the future than about the past.

If we take a look at S&P 500 forecasted earnings, the level is at 195 points now that would give a price to earnings ratio of 19.48 at the current S&P 500 level of 3,800 points.

2019	**163.00 a**	**0.7**	**162.97 a**	**0.6**
Q1	39.15 a	2.8	39.15 a	2.8
Q2	41.31 a	0.8	41.31 a	0.8
Q3	42.14 a	-1.2	42.14 a	-1.2
Q4	42.00 a	2.0	41.99 a	2.0
2020	**140.00 e**	**-14.1**	**135.79 e**	**-16.7**
Q1	33.13 a	-15.4	33.13 a	-15.4
Q2	27.98 a	-32.3	27.98 a	-32.3
Q3	38.69 a	-8.2	38.69 a	-8.2
Q4	39.20 e	-6.7	36.92 e	-12.1
2021	**170.00 e**	**21.4**	**167.61 e**	**23.4**
Q1	39.00 e	17.7	37.64 e	13.6
Q2	40.00 e	43.0	40.45 e	44.6
Q3	45.00 e	16.3	44.22 e	14.3
Q4	46.00 e	17.3	45.28 e	22.6
2022	**195.00 e**	**14.7**	**195.51 e**	**16.6**

e=estimate.
* Historical earnings growth rates and earnings are not adjusted for accounting and index composition changes.
Source: Yardeni Research, Inc. and I/B/E/S data by Refinitiv.

S&P 500 estimates earnings – Source: [Yardeni]

We could say what the market is pricing in now are future earnings and not current earnings. Earnings of 195 on a price of 3,800 should lead to long-term returns of around 5%. If we add the historical growth of 2% in line with economic growth, we are at a great return of 7% from the S&P 500.

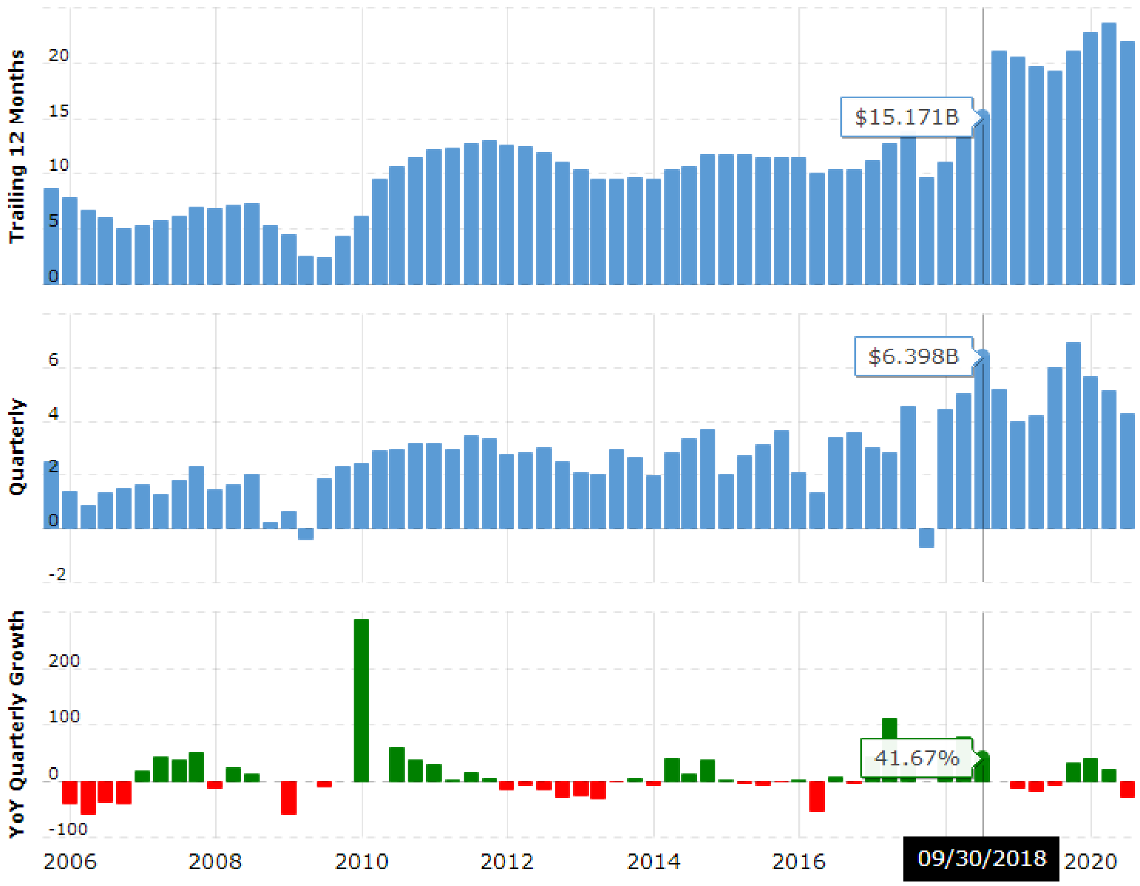
But long-term earnings estimations are always a bit exuberant so let's take 163 from 2019, which was a normal year. The PE ratio goes to 23 that now implies a long term returns closer to 4%, plus 2% growth and we are at 6%, which is still good.

Earnings, earnings, earnings – investment conclusion

I hope the above shows how earnings, current or future are the key when it comes to any type of investing as that is the driver of long-term investing returns.

So, to actively invest in businesses you need to understand the business and put the earnings in a valuation table like we did when we calculated intrinsic values.

For example, with Intel stock (INTC) The free cash flows or earnings are around $20 billion but if those settle to $15 where those were just 2 years ago, that would make huge changes to the valuation of the stock.



Intel net income from 2006 to 2020 – Source: Macrotrends

The key is to know the business because the more you know about it the better you will be about estimating future earnings that will consequently drive long-term investment returns.

If Intel keeps growing its earnings on the current $20 billion base, the stock is strongly undervalued. If cash flows slow down a bit, then the stock could be considered fairly valued for a 10% discount rate that I used here.

INTEL **LINK** https://sven-carlin-research-platform.teachable.com/courses/335443/lectures/20924528

TO VALUE LIST

		2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	Terminal Value 2030	Growth rate	
Scenario 1	FCF												4%	next 5 years
normal case	15.00	15.60	16.22	16.87	17.55	18.25	18.98	19.74	20.53	21.35	22.20	320.25	4%	5 to 10 years
in EUR	10%)	14.18	13.41	12.68	11.99	11.33	10.71	10.13	9.58	9.05	8.56	123.47	10%	Discount rate
	INTRINSIC VALUE	235.09											15.0	Terminal multiple

		2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	Terminal Value 2030	Growth rate	
Scenario 2	FCF												5%	next 5 years
best case	20.00	21.00	22.05	23.15	24.31	25.53	26.80	28.14	29.55	31.03	32.58	775.66	5%	5 to 10 years
in EUR	10%)	19.09	18.22	17.39	16.60	15.85	15.13	14.44	13.78	13.16	12.56	299.05	10%	Discount rate
	Present value sum	455.29											25.0	Terminal multiple

		2021	2022	2023	2024	2025	2026	2027	2028	2029	2030	Terminal Value 2030	Growth rate	
Scenario 3	FCF												0%	next 5 years
worst case	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	12.00	84.00	0%	5 to 10 years
in EUR	10%)	10.91	9.92	9.02	8.20	7.45	6.77	6.16	5.60	5.09	4.63	32.39	10%	Discount rate
	Present value sum	106.12											7.0	Terminal multiple

Scenario	Probability	PV	Part
Scenario 1 (normal case)	0.6	235.09	141.05
Scenario 2 (best case)	0.2	455.29	91.06
Scenario 3 (worst case)	0.2	106.12	21.22
		Sum	253.33

SVEN CARLIN RESEARCH PLATFORM

Disclaimer: This is just for educational purposes and not for investing advice!

Intel stock intrinsic value – Source: Sven Carlin Research Platform

Of course, to know what is going on you need to follow a business, analyse the sector, learn and understand how it breathes over time because business are dynamic beings, not just a frozen snapshot of a balance sheet. This is what I do on my Stock Market Research Platform so feel free to check it out to learn more about how to invest or simply to save time and have me do the heavy lifting so that you can simply see how something fits your portfolio.