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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

- The Pension Protection Act, passed last week, encourages employers to automatically enroll new employees in the company 401(k) plan. Expect to see an increase in employee participation.

- For the first time ever, household debt levels have surpassed household income in 2005, according to a May 2006 study by the Center for American Progress.

Anatomy of an Earnings Season

American companies are winding up the corporate earnings season for the 2nd quarter of 2006. This is roughly a three week period that starts about 20 days after the end of the quarter. It is a period densely packed with relevant economic information for investors to digest. As you know, I place little faith in market timing. However, it is often helpful to understand the big picture as communicated through corporate profits.

Fundamentally, the value of a stock is the discounted value of its future anticipated earnings. The rate of discounting is tied to market interest rates. There is myriad information that bears upon the direction of interest rates – inflation numbers, employment, fed pronouncements and innuendo, current account deficits. Frankly, much of the data is contradictory and thereby leaves people like me with the belief that interest movements are random noise. Indeed, many academicians believe that random noise is a good approximation of interest rate movements.

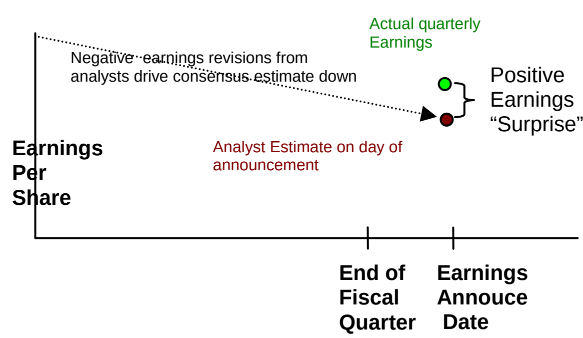
Earnings announcements tend to paint a smoother economic picture. Good news tends to follow other good news and bad news follows bad news. Patterns emerge.

In 2001 and 2002, corporate earnings fell dramatically. In fact, more than one commentator described the period as an earnings "depression". Private sector capital spending collapsed during this period and corporate credit suffered. Over the past 4 years, there has been a major revival in the fortunes of private companies. With 2nd quarter earnings season almost complete, a record 16 consecutive quarters have posted double digit growth rates relative to the same period one year prior.

The numbers emerging this past corporate earnings season have exceeded expectations. With over 82% of the S&P 500 companies reporting, median corporate earnings growth is 13.1%. While a typical company announces earnings that exceed analyst expectations, this season positive surprises have outnumbered negative surprises by more than 4 to 1 – well ahead of historical experience.

Guidance of future earnings over the balance of the year has remained robust. In a typical quarter, the thrust of earnings pronouncements from management is downward. Yet over the past 4 weeks, the consensus earnings estimates for S&P 500 companies for fiscal year 2006 have actually increased about 0.30%. That's both a positive and unusual sign.

In a microcosm, the quarterly earnings projection of a single company tends to fall as the announcement date approaches. Generally analysts take their cue from the company's management and most firms today do not want to disappoint investors with their earnings numbers. Thus, CFOs tend to "talk down" near term earnings forecasts so that their company "surprises" to the upside at the announcement date. The chart below illustrates this rather cynical trend.

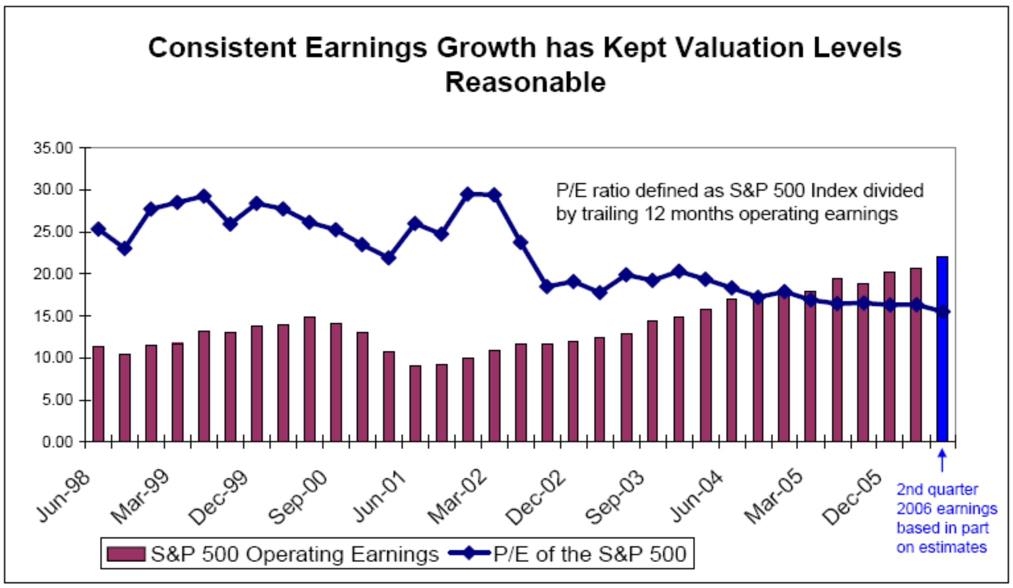


"Analysts continue to forecast double digit earnings growth into 2007 – 10.5% higher than this year."

"As late as 1994, only 92 public companies forecast earnings. That number ballooned to about 1200 by 2001."

The good news is that this quarter has been virtually neutral as to earnings revisions while still offering a strong dose of positive surprises. Just as importantly, analysts continue to forecast double digit earnings growth into 2007 – 10.5% higher than this year. While our economy remains vulnerable to external shocks, these numbers are not the stuff of recession.

Corporate earnings in the US have grown so rapidly that they now comprise over 9% of GDP. This is the highest fraction of the economy that private businesses have captured at least as far back as 1975. Corporate profit margins have also soared to unprecedented heights. In the past, both aggregate profits and profit margins have demonstrated reversion to the mean over time. This cautionary note leads me to believe that corporate earnings will not continue to climb at present rates – especially when the economy grows at less than half that pace. However, the horizon does look bright for the foreseeable future.



A Primer on Corporate Earnings Guidance

In concert with corporate earnings releases, many firms offer guidance to future revenues and profits. Often this occurs at the time of the earnings announcement. The forward looking information is eagerly anticipated by investors – especially guidance offered by companies considered bellwethers in their industry. Just today (August 9), the US market rallied nearly 1% at its open in response to an upbeat sales forecast by Cisco Systems. Until the 1990s, the practice was almost non-existent. As late as 1994, only 92 public companies forecast earnings. That number ballooned to about 1200 by 2001. The practice is shrouded in controversy as many experts in corporate governance believe that setting near term earnings and revenue goals drives companies to a short term outlook and dampens innovation.

In October 2000, the SEC's Regulation FD (Fair Disclosure) came into effect. Companies proffering material information must do so in a manner that is fair to the entire investing public. Guidance must be made available to all – not just favored clients or analysts. The intent of the rule was to level the playing field

Since the stock market bubble burst at the turn of century, the pendulum has moved against this practice. Companies such as Coca-Cola, AT&T, and McDonald's no longer forecast earnings. A survey published this month by the National Investor Relations Institute, found that the share of companies giving guidance has dropped from 71% in 2005 to 66% this year. In fact, The CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics issued a report calling on corporate leaders to break the "short-term obsession harming shareholders" interests by reforming practices involving earnings guidance to investors. The SEC has taken note of these recommendations and may take regulatory measures soon.