Profits, the Economy and Stock Prices

C15.0042
Lesson 8
Edward M. Kerschner

Does Anyone Really Know . . .

GDP Revisions
Does Anyone Really Know What Time It Is?

**GDP Revisions**

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
<th>1st</th>
<th>2nd</th>
<th>3rd</th>
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<th>5th</th>
<th>6th</th>
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<tbody>
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<td>1995 Q4</td>
<td>0.9%</td>
<td>0.5%</td>
<td>0.3%</td>
<td>2.2%</td>
<td>2.8%</td>
<td>3.3%</td>
<td>3.2%</td>
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<tr>
<td>1993 Q1</td>
<td>1.8%</td>
<td>0.9%</td>
<td>0.7%</td>
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<td>0.0%</td>
<td>-0.1%</td>
<td>0.1%</td>
<td>-0.7%</td>
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<td>1991 Q2</td>
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<td>-0.5%</td>
<td>1.4%</td>
<td>1.7%</td>
<td>1.5%</td>
<td>2.2%</td>
<td>1.7%</td>
<td>2.6%</td>
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<tr>
<td>1985 Q1</td>
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<td>0.7%</td>
<td>0.3%</td>
<td>3.7%</td>
<td>3.1%</td>
<td>3.8%</td>
<td>4.9%</td>
<td>3.4%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

What is the S&P 500

**S&P is not GDP**

- While (1998) exports are only 11% of U.S. GDP, sales of U.S. foreign affiliates are significant. So around 40-45% of the sales of U.S. multinationals are outside the U.S. About half of these foreign sales in Europe with rest split between Asia, Canada and South America.

- Part of the cause of this discrepancy between GDP and EPS growth lies in significantly different sector weightings.
  - Almost 1/4 of the U.S. economy is not represented in the S&P 500 (11% real estate + 13% gov't).
  - Services are greatly underweighted in the S&P 500 while financials and tech are overweighted.
  - Nondurables are 28% of S&P earnings versus only 7% of U.S. GDP.
  - Agriculture, mining & construction are 2% of S&P earnings and 7% of U.S. GDP.
Partly because the S&P 500 does not mimic the U.S. economy, GDP growth is not a good input for projecting S&P EPS growth. But “going global” does not help. While profit-weighted real global GDP growth has ranged from +0.2% to +3.8% between 1990 and 1998, S&P EPS growth has ranged from -13.6% to +23.9%. And, profit-weighted GDP growth of +2.0% has produced EPS growth as low as -4.5%, while GDP growth of +2.1% has produced EPS growth as high as +18.5%.

What is the S&P 500
S&P is not GDP

U.S. GDP
Exports $0.96 tr.
$8.06 tr.

S&P 500
EPS by Region
Canada 6%
Other 1%
USA 58%

Asia 9%
L. Am. 5%
EMU 12%
Europe 21%
What is the S&P 500

S&P is not GDP

U.S. GDP

Sales of U.S. Foreign Affiliates

Exports $0.96 tr.
$2.14 tr.
$8.06 tr.

S&P 500 EPS by Region

USA 58%
Europe 21%
L. Am. 5%
Asia 9%
Canada 6%
EMU 12%
Other 1%

What is the S&P 500

S&P is not GDP

GDP by sector

Government 13%
Real estate 11%
Wholesaling 7%
Trans & Util 11%
Technology 12%
Services 2%
Retailing 6%

S&P 500 EPS by sector

Durables 15%
Financials 21%
Nondurables 28%
Financials 8%
Nondurables 7%
Services 16%
Trans & Util 11%
Technology 6%
Retailing 9%
Ag, mining 7%

E. Kerschner
What is the S&P 500  
*Not a Passive Index*

256 changes to S&P 500 1988-98

- M&A (172)
- Restructurings (35)
- Representation (39)
- Bankruptcies (10)

<table>
<thead>
<tr>
<th>Year</th>
<th>M&amp;A</th>
<th>Restructurings</th>
<th>Representation</th>
<th>Bankruptcies</th>
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<td>98</td>
<td>40</td>
<td>20</td>
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</table>

- Record breaking 48 changes to the index in 1998; driven by:
  - **M&A activity** – by far most important driver accounting for 35 of 48 changes in ’98 and 172 of 256 since 1988.
  - **Restructurings** – relatively high number in ’98; companies trying to uncover hidden value by spinning off attractive businesses.
  - **Representation** – number of companies kicked out for “lack of representation” has increased.
  - **Bankruptcies** – none in last 5 years.

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What is the S&P 500?

*Changes in Sector Representation*

**S&P 500 Sector Analysis**

| Sector     | '88 | '93 | '96 | Chg | Chg | '94 | '95 | '96 | '97 | '98 | Total | ‘88-
<table>
<thead>
<tr>
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<td>New companies added</td>
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<td>Company</td>
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<td></td>
<td></td>
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<tr>
<td>Cap Goods</td>
<td>9.9%</td>
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<td>-1.1%</td>
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<td>Commodities</td>
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<td>3.1</td>
<td>3.2</td>
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<td>-6.0</td>
<td>3</td>
<td>3</td>
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<td>Cons nondur</td>
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<td>+6.4</td>
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<td>0</td>
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<tr>
<td>Cyclical</td>
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<td>13.1</td>
<td>9.2</td>
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<td>4</td>
<td>3</td>
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<td>2</td>
<td>15</td>
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<td>Energy</td>
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<td>6</td>
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<td>Transports</td>
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<td>Utilities</td>
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<td>13.9</td>
<td>11.3</td>
<td>+0.0</td>
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<td>0</td>
<td>0</td>
<td>2</td>
<td>1</td>
<td>0</td>
<td>2</td>
<td>6</td>
</tr>
</tbody>
</table>

E. Kerschner

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**What is the S&P 500**

*Changes in Sector Representation*

- Between 1988 and 1998 tech sector has exploded from 8.4% of S&P market cap to 18.7% and financials up from 8.0% to 15.4%. These gains have come at expense of cyclicals (-6.9%) and energy (-6.0%).
- Between 1993 and 1998, 42 companies added to financial sector with a net change of 14; 28 tech companies added for a net change of 25. Cyclicals offset these gains with net decline of 23.

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What is the S&P 500

*S&P 500 additions do not outperform*

Relative annual performance of S&P stocks following inclusion

-5%  -11%  -17%  -17%  -21%  -32%


What is the S&P 500

*S&P 500 additions do not outperform*

- Companies added in ’98 outperformed by 9.7% from announcement date to actual addition to the index (6 days on average). But after their addition companies tend to perform poorly.
- Of 120 stocks added from ’93-’98 average annual underperformance is 13.9% with median underperformance of 17.1%.
What is the S&P 500

*S&P is not increasingly big cap*

Share of S&P 500 market cap claimed by:

- 10 largest stocks
- 25 largest stocks
- 50 largest stocks

<table>
<thead>
<tr>
<th>Year</th>
<th>10 Largest Stocks</th>
<th>25 Largest Stocks</th>
<th>50 Largest Stocks</th>
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</thead>
<tbody>
<tr>
<td>1978</td>
<td>27%</td>
<td>41%</td>
<td>54%</td>
</tr>
<tr>
<td>1988</td>
<td>18%</td>
<td>31%</td>
<td>46%</td>
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<tr>
<td>1998</td>
<td>21%</td>
<td>38%</td>
<td>55%</td>
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</table>

What is the S&P 500

*S&P is not increasingly big cap*

- 1998 is not increasingly big cap versus 1988 and less top heavy, by some measures, than it was in 1978.
- But, the top decile of the S&P 500 has accounted for more than 50% of performance in each of the last four years and more than two-thirds of 1998’s performance.
What is the S&P 500

*Largest stocks are growing faster*

- So what’s causing the “narrowness” of the market?
- Large-cap stocks are driving S&P 500 performance not because the index has become more top-heavy, but because the largest stocks are growing faster than in the past.
- The top of the S&P is increasingly dominated by fast-growing “Gorilla” stocks that dominate their industries.
- Average growth rate of top ten today is 15.5% versus 9% in 1988 and 1978 despite lower inflation rate, even as S&P 500 growth slowed.

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**Expected earnings growth rates of the largest S&P 500 companies**

<table>
<thead>
<tr>
<th>Company</th>
<th>1978 Rate</th>
<th>Company</th>
<th>1998 Rate</th>
<th>Company</th>
<th>1998 Rate</th>
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<tbody>
<tr>
<td>AT&amp;T</td>
<td>6.0%</td>
<td>IBM</td>
<td>9.3%</td>
<td>Microsoft</td>
<td>24.0%</td>
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<tr>
<td>IBM</td>
<td>13.0%</td>
<td>Exxon</td>
<td>6.5%</td>
<td>General Electric</td>
<td>16.0%</td>
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<tr>
<td>Exxon</td>
<td>6.0%</td>
<td>General Electric</td>
<td>9.5%</td>
<td>Intel</td>
<td>17.0%</td>
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<tr>
<td>General Motors</td>
<td>5.0%</td>
<td>AT&amp;T</td>
<td>9.5%</td>
<td>Wal-Mart</td>
<td>13.0%</td>
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<tr>
<td>General Electric</td>
<td>9.0%</td>
<td>Royal Dutch</td>
<td>7.5%</td>
<td>Exxon</td>
<td>4.5%</td>
</tr>
<tr>
<td>Kodak</td>
<td>13.0%</td>
<td>General Motors</td>
<td>6.0%</td>
<td>Merck</td>
<td>12.0%</td>
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<tr>
<td>Royal Dutch</td>
<td>5.5%</td>
<td>Ford</td>
<td>6.5%</td>
<td>IBM</td>
<td>13.0%</td>
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<tr>
<td>Standard Oil Cal.</td>
<td>6.5%</td>
<td>Philip Morris</td>
<td>11.0%</td>
<td>Coca-Cola</td>
<td>13.0%</td>
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<tr>
<td>Standard Oil Ind.</td>
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<td>Merck</td>
<td>13.0%</td>
<td>Pfizer</td>
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<td>Schlumberger</td>
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<td>DuPont</td>
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<td>Average</td>
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<td>13.5%</td>
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<td>S&amp;P 500 Index</td>
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<td>7.5%</td>
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<td>6.9%</td>
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