

CHAPTER 5

STABLE EARNINGS, BETTER INVESTMENT?

Larry's Riskless Stock Strategy

Larry had always wanted to invest in stocks but had considered them too risky. Having thought long and hard about why stocks were risky, Larry concluded that the culprit was volatility in earnings. He was convinced that he could construct a portfolio of stocks with stable earnings that would deliver high returns without the risk. Without much effort, Larry was able to identify the companies that had reported the least volatility in their earnings over the previous five years in each sector, and he put his money in the stocks.

Even as he bought the stocks, he found that many of them were pricey, trading at high multiples of earnings, suggesting that other investors had come to the same conclusion as Larry about the low risk and high quality of these stocks. Having bought the stocks, he also noticed that stock prices were volatile at some of these companies, even though their earnings were stable. One of the stocks in Larry's portfolio was a gold mining stock and when gold prices jumped because of a crisis in the Middle East, Larry noticed that the company did not report higher earnings, even though other gold mining companies did. When he confronted management about this, they admitted they used gold futures contracts to hedge risk. While these contracts reduced their exposure to downside risk, it also reduced their upside profits. When Larry assessed the end results of his portfolio, he found that he had still been exposed to risk and had relatively little to show for it. Larry's search for a free lunch had come to an end.

Moral: No downside, no upside.

When you invest in a firm, you are exposed to the risk that the firm's underlying business or businesses may go through rough times and that the earnings and stock price of the firm will reflect these downturns. This will be the case even when a firm dominates its business and the business itself is viewed as a good one. To counter this, some firms diversify into multiple businesses, in the process spreading their risk exposure and reducing the likelihood of sharp downturns in earnings. GE provides a good example in the United States and the same can be said for many European firms. In recent years, firms have also diversified geographically to reduce their risk from a downturn in the local economy. In the 1980s, Coca Cola used this strategy to deliver higher earnings even in the midst of stagnant growth in the beverage market in the United States. The argument that diversifying reduces

risk seems incontestable, but does it follow that investing in diversified companies is a good strategy? Some investors seem to think so.

There are some undiversified firms, however, that manage to report stable earnings even in the presence of economic turmoil. This stability sometimes comes from using financial derivatives to hedge risk and in some cases, through accounting choices. Do smoother earnings streams translate into higher values? Does the markets treat firms differently depending upon how they smooth out earnings? These are the questions that will be addressed in this chapter.

The Core of the Story

Equities are riskier than bonds because equity earnings represent what is left over after everyone else has been paid and is thus are more volatile than operating earnings. But what if you could make your equity earnings more stable? The stock in your firm should become safer and potentially a better investment. As the argument goes, if you can make returns on stocks in these companies that are comparable to what you would make on stocks in more firms in more volatile earnings, you could argue that you are getting the best of both worlds - high returns and low risk. There are three elements to this story.

- *Stocks with stable earnings are less risky than stocks with volatile earnings:* For this story to work, you have to accept the idea that volatility in equity earnings is a good measure of equity risk. Luckily for those who use this story, that is not a difficult sell. The alternative measures of risk used in finance such as stock price volatility or betas are all market-based measures. To those investors who do not trust markets – they feel that markets are subject to mood swings and speculation, for instance – earnings stability or the lack thereof seems to provide a more dependable measure of equity risk.
- *Stocks with more stable earnings generate less volatile returns for stockholders:* According to this argument, firms with stable earnings are less likely to roil markets with earnings announcements that surprise investors. The resulting price stability should make the returns on these stocks much more predictable than returns on the rest of the market, especially if the firm takes advantage of its more stable earnings to pay larger dividends every period.
- *Stocks with more stable earnings tend to be underpriced by markets:* This is perhaps the toughest portion of the argument to sustain. One reason given is that companies with stable earnings are often boring companies that don't make the news, and that investors in search of fads and stars are not interested in them. As a

result, stable earnings companies will be underpriced relative to companies with more volatile histories.

Measuring Earnings Stability

There are three broad choices you have when it comes to measuring the stability or volatility of earnings. The first and perhaps most direct measure is to look at the variability in earnings over time. At one extreme, you would have stocks that deliver the same dollar earnings year after years and thus exhibit no volatility in earnings. At the other, you would have companies whose earnings fluctuate wildly from huge profits to large losses, creating high variance in earnings. The problem with this measure is that the variability in dollar earnings will be greater for companies with higher dollar earnings and lower for companies with smaller dollar earnings. To alleviate the bias created when you work with dollar earnings, you could look at the percentage changes in earnings from period to period and look for companies that exhibit low variance in these changes. By doing this, you are shifting away from stable earnings to stable growth rates in earnings. While this measure has statistical appeal, it has a significant problem that it shares with the prior measure. It treats increases in earnings and decreases in earnings equivalently, when it comes to measuring risk.¹ Generally, investors do not consider increases in earnings as risky; it is declines in earnings that worry them. The third measure of earnings stability focuses only on earnings decreases. A firm that reports higher earnings each year, relative to earnings in the prior year, year after year, would be viewed as safe firm. On the other hand, firms that report increases in earnings in some years and decreases in others would be viewed as risky. In fact, you could construct a measure of variance in earnings that looks at only decreases – this is called semi-variance.

Once you have chosen your measure of earnings stability, you have to decide on the earnings number that you will focus on. Here, you have several choices. You can estimate the variance in operating income, which is before interest expenses and non-operating items. While there are obvious benefits to this, it can be a misleading measure of earnings variability, if you are considering the risk associated with buying stock and the firm has substantial debt. When it comes to income to equity investors, you can look at net income, which is the aggregate income left over for equity investors, or you can examine earnings per share, which adjusts for changes in the number of shares outstanding. The advantage of

¹ To illustrate, a firm with percentage changes in earnings of +5%, -5% and +5% over three years will be classified as having more stable earnings than a firm that reports percentage changes in earnings of +5%, +15% and +25% over three years.

the latter is that it allows you to separate firms that grow their net income by issuing new shares and investing those funds and those that grow earnings by reinvesting internal funds. Other things remaining equal, the latter should be more valuable than the former.

The Theory: Earnings Stability and Value

While it may seem intuitive that companies with more stable earnings should be worth more than otherwise similar companies with volatile earnings, the link between earnings stability and value is weak. In this section, you will begin by considering how having a diversified portfolio can color your views about risk and close by examining whether earnings stability can pay off as higher value for a firm.

Diversification and Risk

Investors have always been told that putting your eggs in one basket (or all your money in one stock) is a dangerous thing to do. In fact, the argument for diversification is at the core of modern portfolio theory. As Nobel prizewinner, Harry Markowitz, noted in his path-breaking paper on portfolio risk, if stocks do not move in tandem (and they do not), a portfolio's risk can be lower than the risk of the individual stocks that go into it.

If you are a diversified investor, you are concerned primarily about the value of your portfolio and the variance in its value. Consequently, you measure the risk of an investment by looking at how it will change the overall risk of your portfolio. In fact, most risk and return models in finance are built on the premise that the investors who set prices by trading in large quantities are diversified and that only the risk added on by a stock to a diversified portfolio (called non-diversifiable or market risk) is rewarded by the market. What does this have to do with earnings stability and its payoff (or lack thereof)? You could construct a portfolio of 50 firms each of whose earnings are volatile. If the earnings volatility in these firms comes from factors that are specific to their operations or management, it is entirely possible that the composite earnings to the portfolio will be stable. If this is the case, you as an investor would not discount the value of an individual firm, just because the firm's earnings are volatile. Nor would you pay a premium for a firm, just because its earnings are stable.

So, when will more stable earnings generate higher value for a firm? The first scenario is when the earnings stability translates into lower market risk; in other words, the earnings of the firm serve to stabilize the composite earnings of the portfolio. The second scenario is when investors are not well diversified and assess the risk of firms as stand-alone investments rather than as part of a portfolio.

Stable Earnings, Risk and Value

To make a link between stable earnings and value, consider the simple discounted cash flow model that was used in the last two chapters to assess value. In that model, where dividends grow at a constant rate forever, you can write the value of a stock as:

$$\text{Value per share today} = \frac{\text{Expected Dividend per share next year}}{\text{Cost of Equity} \square \text{Expected Growth Rate}}$$

The cost of equity is based upon your assessment of the risk in the equity. For stable earnings to affect value, you would first need to make the risk of the equity a function of earnings stability, with the cost of equity being lower for firms with more stable earnings and higher for firms with volatile earnings. If you follow conventional risk and return models in finance and assume diversified investors, the cost of equity will be higher for firms with more market risk and lower for firms with less. If you adopt these models, you will have to establish that the market risk is higher for firms with more volatile earnings.

Once you link the cost of equity to earnings stability, you can show, other things remaining equal, that firms with more stable earnings for any given level of dividends and growth will be valued more highly. But can you hold other things constant? To have stable earnings, you often have to enter more mature and safer businesses with little or no growth potential. In this case, earnings stability creates a tradeoff between less risk (a lower cost of equity) and lower growth (which lowers the expected growth rate). It is possible that your stock can become less valuable as you make earnings more stable, if the value of the growth you give up exceeds value created by becoming a safer firm.

The trade off becomes even more negative if you give up growth to have more stable earnings but more stable earnings do not reduce market risk. In this case, the growth rate will decline, the cost of equity will remain unchanged and your value will decrease as earnings stability increase.

Looking at the Evidence

There are a number of ways in which firms attempt to make earnings less volatile. Some firms have stable earnings because they are in predictable and safe businesses, with little or no competition. Others seek stable earnings through a strategy of diversifying into multiple businesses, hoping that higher income in some will compensate for lower income in others. In a variation of this theme, firms also diversify geographically, with the intent of balancing higher income from some countries against lower income from others. Still other firms use the wide range of options and futures contracts that are now available to reduce or even eliminate their risk exposure. Finally, there are firms that use accounting devices and choices to smooth out volatile earnings; this phenomenon, called earnings management,

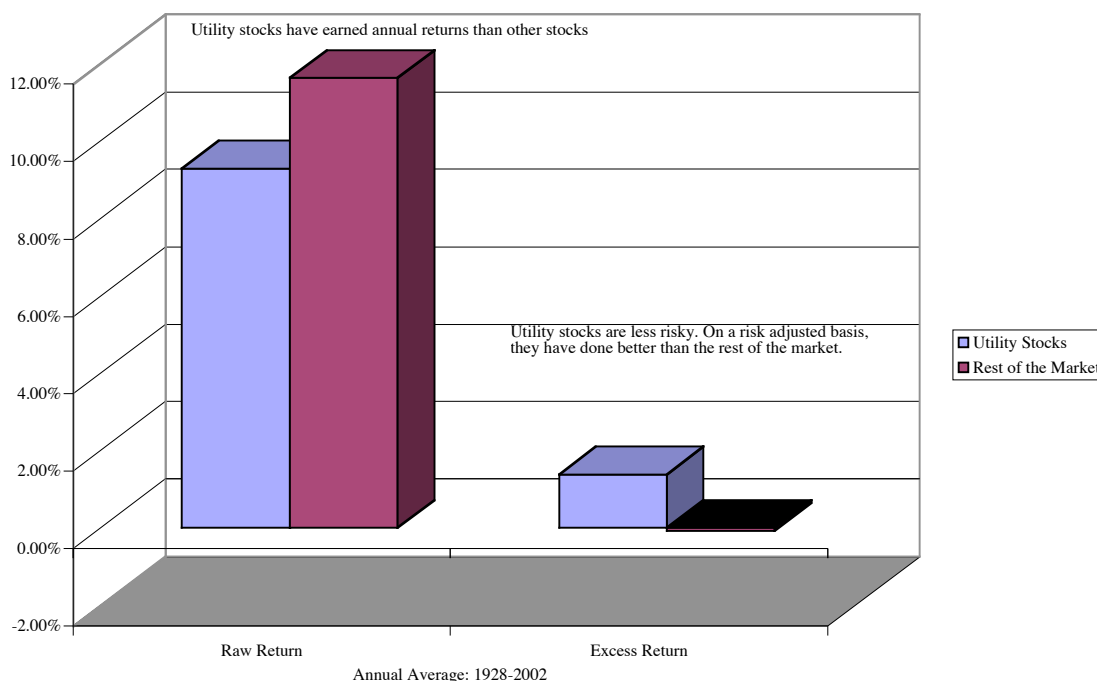
acquired quite a following in the 1990s. The consequences of each of these approaches to reducing earnings volatility in this section for stock prices and returns will be assessed.

Stable Businesses with no competition

For several decades, utility stocks (phone, water and power companies) were prized by risk averse investors for their steady earnings and high dividends. In fact, these firms were able to afford to pay out the high dividends that they did because their earnings were so predictable. The reasons for the stable earnings were not difficult to uncover. These stocks were regulated monopolies that provided basic and necessary services. The fact that their products and services were non-discretionary insulated them from overall economic conditions and the absence of competition gave them secure revenues. In return for the absence of competition, these firms gave up pricing power to the regulatory authorities.

The key question for investors, though, is not whether utility stocks have more stable earnings than other companies, but whether such stable earnings translate into higher stock returns. A simple way of examining this question is to compare the returns earned by utility stocks to returns earned on the overall market. Figure 5.1 contains this comparison:

Figure 5.1: Utility Stocks versus Rest of the Market



Data from Federal Reserve. The risk adjusted returns are computed by comparing the annual return to the expected return given the betas of these stocks.

The average annual returns on utility stocks are lower than the average annual returns on the overall market but this comparison may not be fair to utility stocks. After all, they are less

risky than the rest of the market and the returns they earn should be adjusted for risk. Figure 5.1 also contains a comparison of risk-adjusted returns on utility stocks to the returns on the market. In this comparison, utility stocks perform much better, earning an excess return of about 1.4% a year over the last 50 years. It is worth noting that this result mirrors the findings on high dividend yield stocks (which include a disproportionate number of utility stocks) and many of the caveats about that strategy apply to this one as well. In particular, this strategy is likely to generate higher tax liabilities and will require a long time horizon to pay off.

Diversified Business Mix: The Allure of Conglomerates

Every company, no matter how well run, will be exposed to the risk that the sector it is in can go through hard times. Thus, Intel will be affected by a downturn in the semiconductor business and Microsoft by a decline in the demand for computer software. To insulate against this sector risk, a firm can try to diversify into multiple businesses and become a conglomerate. For the last few decades, strategists have gone back and forth on whether becoming a conglomerate creates or destroys value. In the 1960s and through much of the 1970s, the view was that conglomerates created value, relative to their individual pieces, because you could pool of the strengths of the individual firms to create a more powerful firm. A hidden subtext to many of these arguments was the premise that conglomerates were less risky and more valuable than their individual components, because they were able to diversify away risk. Financial theorists pointed out that the fallacy in this argument by noting that individual investors could have accomplished the same diversification at far lower cost. Later, the argument shifted to one of superior management transferring its skills to poorly managed firms in different businesses, and creating often unnamed synergies.

Researchers have approached this question from a different perspective. They have looked at the question of whether conglomerates trade at a premium or discount to their parts. To make this judgment, they value the pieces of a conglomerate, using the typical multiple at which independent firms in the business trade at. Thus, you could break GE down into nine parts, and value each part based upon what other firms in the business trade at. You can then add up the values of the parts and compare it to the value of the conglomerate. In this comparison, the evidence seems to indicate that conglomerates trade at significant discounts (ranging from 5-10%, depending upon the study) to their piecewise

values.² While one can contest the magnitude of these discounts on estimation grounds – it is difficult to estimate the true earnings of GE Capital, given allocations and other pooled costs – it is clear that some multi-business firms would be worth more as individual businesses. If conglomerate earnings are more stable than the earnings of stand-alone firms, why is there a conglomerate discount? There are at least two reasons. The first is that a conglomerate is often created by one firm paying large premiums over market value to acquire other publicly traded firms. This overpayment drains more value than the stable earnings may create in value. The second is that conglomerates often suffer from a lack of focus and poor management; divisions of conglomerates under perform their stand-alone competition.

While a conglomerate discount may exist, the question of whether investing in conglomerates generates promising returns for investors still has not been addressed. The overall evidence suggests not but there may be a silver lining. If you invest in conglomerates that break up into individual pieces, through divestitures and spin offs, you may be able to capture the increase in value as the conglomerate discount disappears. In other words, you stand to make more money when conglomerates break up than when they are built up.

Global Diversification

An alternative to business diversification (which creates conglomerates) is geographical diversification. By having operations in multiple countries, a firm may be able to offset a decline in business in one country with an increase in another. The net effect should be a reduction in the variability of operating earnings. There is, though, at least one confounding factor at work here that does not apply to business diversification. As your operations spread out over different countries, your earnings will be exposed for foreign currency risk; a U.S. company will find its earnings affected by the strengthening or weakening of the dollar. You can, however, partially protect your earnings from this risk by using futures and options contracts.

Again, there are two basic questions that you need to address in the context of global diversification. The first is whether such diversification results in more stable earnings and the second is whether investing in globally diversified companies generates higher or lower returns. An examination of Swedish firms that diversify globally concluded that

² Lang, Larry H.P., and René M. Stulz, 1994, *Tobin's q, corporate diversification, and firm performance*, *Journal of Political Economy* 102, 1248–1280.

geographical diversification does increase value, unlike industrial diversification.³ This is consistent with the findings of another study in the United States.⁴ The effect is small, though, and investing in a firm is already globally diversified yields little in terms of excess returns. You would need to invest in companies just before they embark on global diversification to gain any potential benefits.

The Risk Hedgers

A number of external factors, including interest rates, commodity prices and exchange rates, can affect the revenues, earnings and value of a firm. Thus, even the best managed airline may see its profits decline if oil prices go up. In recent years, firms have been able to hedge a significant portion of this risk, using financial instruments and products. In this section, you will consider two questions. The first relates to whether firms should try to manage this risk. The second looks at the payoff to investors to risk management.

Should project risk be managed?

Firms are exposed to a multitude of macroeconomic risks in their investments. Sometimes shifts in interest rates and exchange rates can augment income and sometimes they can reduce it. Thus, a portion of the variation in earnings over time for any firm can be attributed to these risks. The manager can leave the firm exposed to these risks and assume that its stockholders in the firm will be able to diversify away the risk, or the manager can hedge the risk, using a variety of financial instruments.

To evaluate whether a firm should try to manage or hedge its exposure to this risk, you need to consider three factors. The first is the magnitude of the risk and the impact that it can have on the overall firm's earnings and value. For instance, variation in oil prices may be responsible for 30% of the volatility of earnings for an airline but only 5% of the variation in earnings at a steel company. Since large shifts in earnings can cause serious problems for firms (including defaulting on debt and going bankrupt), firms should be more likely to hedge large risks than small ones. The second factor is the extent to which different investments the firm may have in different parts of the world may result in diversification of some or a great portion of the risk. For instance, Coca Cola and Citicorp, with operations in dozens of countries, might find that exchange rate movements in some

³ Pramborg, B., *Derivatives Hedging, Geographical Diversification and Firm Value*, Working Paper, Stockholm University.

⁴ Allyannis and Weston, 2000, *Exchange Rate Hedging: Financial versus Operational Strategies*, American Economic Review.

countries that reduce value may be offset by favorable movements in other countries. If firms such as these hedge risk in each country, they will be doing so unnecessarily. The third factor is the degree to which investors in the firm can diversify away the risk on their own, by holding portfolios that include stocks that are affected both positively and negatively by exchange rate movements. Firms such as the Home Depot and Boeing, which have a base of well diversified investors, may find it cheaper not to hedge risk and to allow it to pass through to their investors, who will diversify it away at far less expense.

In addition, you need to consider the cost of managing risk. Hedging risk exposure is cheaper for some types of risk (exchange rate, interest rate) than for others (political risk) and for shorter periods than for longer ones. Other things remaining equal, the greater the cost of hedging risk, the less likely firms will be to hedge. In summary, then, a small, closely held firm considering a large project (relative to the firm's current size) should try to manage project risk. A firm with a diversified investor base, with operations in multiple countries, should be less inclined to manage project risk.

How do you manage project risk?

Assume now that you are a firm that should be managing project risk and that you are considering the different alternatives available to you to do so. When firms decide to manage risk, they have a variety of choices. They can use futures contracts, forward contracts, and options to manage interest rate, exchange rate, and commodity price risk; and insurance products to manage event risk (such as the eventuality of a revolution). They can also manage risk by choosing the financing for the project wisely.

- The simplest way of hedging some of the risk on a project is to choose financing instruments with cash flows that mirror the cash flows on the project. Thus, WalMart can use a loan denominated in Mexican pesos to finance its retail expansion in Mexico. If the peso depreciates, its assets (the stores in Mexico) will be worth less, but so will its liabilities (the loan), leaving it less affected by the exchange rate movement. Matching financing to the assets can only partially reduce risk, but it is generally a low cost or no cost option for risk management. All firms should therefore try to do this as much as they feasibly can.
- The most widely used products in risk management are futures, forwards, options and swaps. These are generally categorized as derivative products, since they derive their value from an underlying asset that is traded. Today, you can buy futures and options contracts to hedge away commodity price risk, currency risk and interest rate risk, to name just a few.

- The alternative route to risk management is to buy insurance to cover specific event risk. Just as a homeowner buys insurance on his or her house to protect against the eventuality of fire or other damage, companies can buy insurance to protect their assets against possible loss. In fact, it can be argued that, in spite of the attention given to the use of derivatives in risk management, traditional insurance remains the primary vehicle for managing risk. Insurance does not eliminate risk. Rather, it shifts the risk from the firm buying the insurance to the insurance firm selling it but doing so may provide a benefit to both sides, for a number of reasons. First, the insurance company may be able to create a portfolio of risks, thereby gaining diversification benefits that the self-insured firm itself cannot obtain. Second, the insurance company might acquire the expertise to evaluate risk and process claims more efficiently as a consequence of its repeated exposure to that risk. Third, insurance companies might provide other services, such as inspection and safety services, that benefit both sides. While a third party could arguably provide the same service, the insurance company has an incentive to ensure the quality of the service.

The Payoff to Risk Management

Firms can use a variety of products to manage risk, and by doing so, they can reduce the variability in their earnings. But do investors in these firms reap benefits, as a consequence? An evaluation⁵ of firms that use foreign currency derivatives to hedge exchange rate risk concluded that they have both smoother earnings and trade at higher values⁶. A subsequent examination suggests that most of the benefit comes from hedging short-term transaction risk and there seems to be little gained from hedging translation exposure (which also affects earnings).⁷ Another strand of the research looks at why some firms hedge risk more than others and uncover interesting factors. Many firms that use derivatives to manage risk often do so to reduce tax liabilities, maintain required investments and to alleviate the fear of financial distress. At the same time, managerial risk aversion also

⁵ Allyannis and Weston, 2000, *Exchange Rate Hedging: Financial versus Operational Strategies*, American Economic Review.

⁶ To standardize value, the authors looked at the market value as a percent of book value. Companies that hedged foreign currency risk using derivatives traded at higher market values, relative to book value, than companies that did not.

⁷ Pramborg, B., 2002, *Derivatives Hedging, Geographical Diversification and Firm Value*, Working Paper, Stockholm University.

plays a role in whether derivatives get used. Studies indicate that managers are more likely to use derivatives when they hold a larger percent of the outstanding stock in a company.

In summary, the evidence indicates that there is a payoff to managing risk and that firms that manage risk are more highly valued than firms that do not. Two notes of caution are in order, though. The first is that the payoff is a small one and it is unlikely that investors will even notice unless they look closely. The second is that payoff occurs when these firms switch to using the risk management products and not subsequently.

The Earnings Smoothers

Firms have become particularly adept at meeting and beating analyst estimates of earnings each quarter. While beating earnings estimates can be viewed as a positive development, some firms adopt accounting techniques that are questionable to accomplish this objective. When valuing these firms, you have to correct operating income for these accounting manipulations to arrive at the correct operating income.

The Phenomenon of Managed Earnings

In the 1990s, firms like Microsoft and Intel set the pattern for technology firms. In fact, Microsoft beat analyst estimates of earnings in 39 of the 40 quarters during the decade and Intel posted a record almost as impressive. Other technology firms followed in their footsteps in trying to deliver earnings that were higher than analyst estimates by at least a few pennies. The evidence is overwhelming that the phenomenon is spreading. For an unprecedented 18 quarters in a row from 1996 to 2000, more firms beat consensus earnings estimates than missed them.⁸ In another indication of the management of earnings, the gap between the earnings reported by firms to the Internal Revenue Service and that reported to equity investors has been growing over the last decade.

Given that these analyst estimates are expectations, what does this tell you? One possibility is that analysts consistently under estimate earnings and never learn from their mistakes. While this is a possibility, it seems extremely unlikely to persist over an entire decade. The other is that technology firms particularly have far more discretion in how they measure and report earnings and are using this discretion to beat estimates. In particular, the treatment of research expenses as operating expenses gives these firms an advantage when it comes to managing earnings.

Does managing earnings really increase a firm's stock price? It might be possible to beat analysts' estimates quarter after quarter, but are markets as gullible? They are not, and

⁸ These estimates are obtained from I/B/E/S, a service that consolidates earnings estimates from analysts.

the advent of “whispered earnings estimates” is in reaction to the consistent delivery of earnings that are above expectations. What are whispered earnings? Whispered earnings are implicit earnings estimates that firms like Intel and Microsoft have to beat to surprise the market and these estimates are usually a few cents higher than analyst estimates. For instance, on April 10, 1997, Intel reported earnings per share of \$2.10 per share, higher than analyst estimates of \$2.06 per share, but saw its stock price drop 5 points, because the whispered earnings estimate had been \$2.15. In other words, markets had built into expectations the amount by which Intel had beaten earnings estimates historically.

Techniques for Managing Earnings

How do firms manage earnings? One aspect of good earnings management is the care and nurturing of analyst expectations, a practice that Microsoft perfected during the 1990s. Executives at the firm monitored analyst estimates of earnings and stepped in to lower expectations when they believed that the estimates were too high.⁹ There are several other techniques that are used and you will consider some of the most common ones in this section. Not all the techniques are harmful to the firm and some may indeed be considered prudent management.

1. *Planning ahead*: Firms can plan investments and asset sales to keep earnings rising smoothly.
2. *Revenue Recognition*: Firms have some leeway when it comes when revenues have to be recognized. As an example, Microsoft, in 1995, adopted an extremely conservative approach to accounting for revenues from its sale of Windows 95 and chose not to show large chunks of revenues that they were entitled (though not obligated) to show.¹⁰ In fact, the firm had accumulated \$1.1 billion in unearned revenues by the end of 1996 that it could borrow on to supplement earnings in weaker quarter.
3. *Book revenues early*: In an opposite phenomenon, firms sometimes ship products during the final days of a weak quarter to distributors and retailers and record the revenues. Consider the case of MicroStrategy, a technology firm that went public in 1998. In the last two quarters of 1999, the firm reported revenue growth of 20% and 27% respectively, but much of that growth was attributable to large deals announced

⁹ Microsoft preserved its credibility with analysts by also letting them know when their estimates were too low. Firms that are consistently pessimistic in their analyst presentations lose their credibility and consequently their effectiveness in managing earnings.

¹⁰ Firms that bought Windows 95 in 1995 also bought the right to upgrades and support in 1996 and 1997. Microsoft could have shown these as revenues in 1995.

just days before each quarter ended. In a more elaborate variant of this strategy, two technology firms, both of which need to boost revenues, can enter into a transaction swapping revenues.¹¹

4. *Capitalize operating expenses*: Just as with revenue recognition, firms are given some discretion in whether they classify expenses as operating or capital expenses, especially for items like software R&D. AOL's practice of capitalizing and writing off the cost of the CDs and disks it provided with magazines, for instance, allowed it to report positive earnings through much of the late 1990s.
5. *Write offs*: A major restructuring charge can result in lower income in the current period, but it provides two benefits to the firm taking it. Since operating earnings are reported both before and after the restructuring charge, it allows the firm to separate the expense from operations. It also makes beating earnings easier in future quarters. To see how restructuring can boost earnings, consider the case of IBM. By writing off old plants and equipment in the year they are closed, IBM was able to drop depreciation expenses to 5% of revenue in 1996 from an average of 7% in 1990-94. The difference, in 1996 revenue, was \$1.64 billion, or 18% of the company's \$9.02 billion in pretax profit last year. Technology firms have been particularly adept at writing off a large portion of acquisition costs as "in-process R&D" to register increases in earnings in subsequent quarters. Lev and Deng (1997) studied 389 firms that wrote off in-process R&D between 1990 and 1996; these write offs amounted, on average, to 72% of the purchase price on these acquisitions and increased the acquiring firm's earnings 22% in the fourth quarter after the acquisition.¹²
6. *Use reserves*: Firms are allowed to build up reserves for bad debts, product returns and other potential losses. Some firms are conservative in their estimates in good years and use the excess reserves that they have built up during these years to smooth out earnings in other years.
7. *Income from Investments*: Firms with substantial holdings of marketable securities or investments in other firms often have these investments recorded on their books at values well below their market values. Thus, liquidating these investments can

¹¹ Forbes magazine carried an article on March 6, 2000, on MicroStrategy, with this excerpt: "On Oct. 4 MicroStrategy and NCR announced what they described as a \$52.5 million licensing and technology agreement. NCR agreed to pay MicroStrategy \$27.5 million to license its software. MicroStrategy bought an NCR unit that had been a competitor for what was then \$14 million in stock and agreed to pay \$11 million cash for a data warehousing system. MicroStrategy reported \$17.5 million of the licensing money as revenue in the third quarter, which had closed four days earlier.

¹² Only 3 firms wrote off in-process R&D during the prior decade (1980-89).

result in large capital gains, which can boost income in the period. Technology firms such as Intel have used this route to beat earnings estimates.

Is there a payoff to managing earnings?

Firms generally manage earnings because they believe that they will be rewarded by markets for delivering earnings that are smoother and come in consistently above analyst estimates. As evidence, the point to the success of firms like Microsoft and Intel and the brutal punishment meted out, especially at technology firms, for firms that do not deliver expectations. Many financial managers also seem to believe that investors take earnings numbers at face value and work at delivering bottom lines that reflect this belief. This may explain why any attempts by the Financial Accounting Standards Board (FASB) to change the way earnings are measured are fought with vigor, even when the changes make sense. For instance, any attempts by FASB to value the options granted by these firms to their managers at a fair value and charging them against earnings or change the way to mergers are accounted for have been consistently opposed by technology firms. It may also be in the best interests of the managers of firms to manage earnings. Managers know that they are more likely to be fired when earnings drop significantly, relative to prior periods. Furthermore, there are firms where managerial compensation is still built around profit targets and meeting these targets can lead to lucrative bonuses.

Whatever the reason for managed earnings, there are questions that you need to answer. The first is whether firms that manage earnings trade at higher multiples of earnings than otherwise similar firms that do not resort to this practice. A study of the relationship between price to book value ratios and earnings stability concludes that stocks with lower earnings volatility trade at higher values and finds that this is true even when the earnings stability reflects accounting choices rather than operating stability; firms where earnings are stable but cashflows remain volatile continue to trade at higher values.¹³

Crunching the Numbers

In this section, you will begin by looking at the distribution of earnings volatility across the market. Specifically, you will consider what a high earnings volatility firm would look like and contrast it with a firm with stable earnings. The section is concluded by creating a portfolio of stocks that pass the “stable earnings’ test.

¹³ Barnes, R., *Earnings Volatility and Market Valuation*, London Business School, Working Paper.

Earnings Volatility across the Market

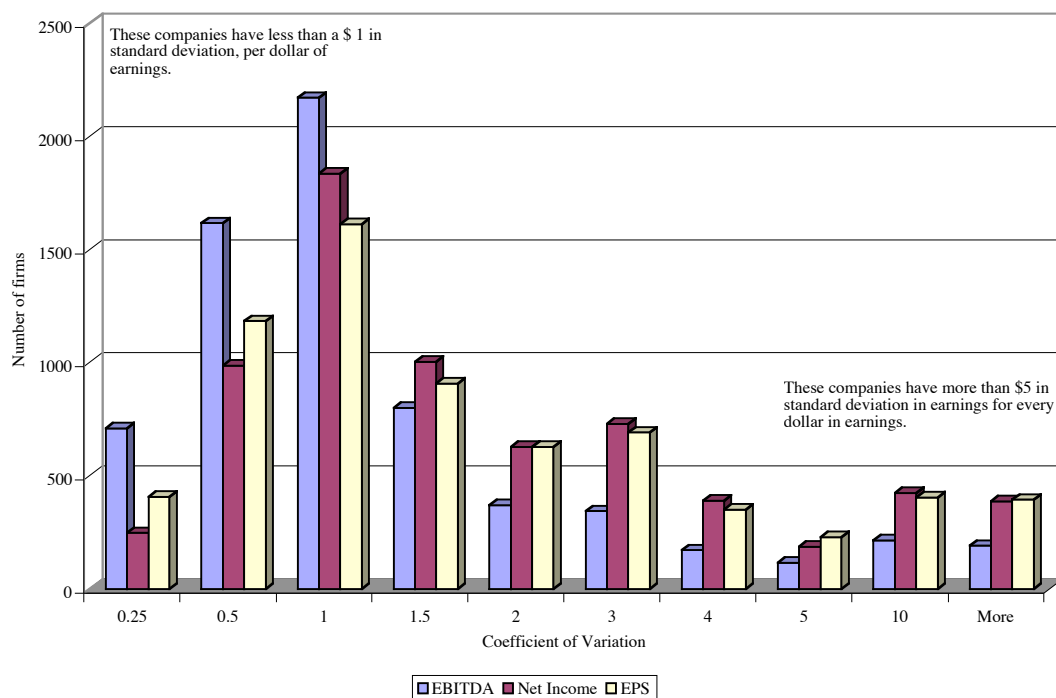
As noted early in the chapter, there is no one accepted measure of earnings volatility. While you could construct statistical measures of volatility – standard deviation or variance in earnings – you would still have to standardize the numbers to make them comparable across firms. Having considered and rejected a number of different approaches to standardization, the coefficient of variation in earnings, estimated by dividing the standard deviation in earnings between 1997 and 2001 by the absolute value of average earnings during that period, was used to measure earnings volatility.

$$\text{Coefficient of variation in earnings} = \frac{\text{Standard Deviation in Earnings}}{\text{Absolute value (Average Earnings over the period)}}$$

To provide an example, consider a firm that had earnings per share of \$ 1.75, \$ 1.00, \$2.25 and \$ 3.00 each year for the last 4 years. The standard deviation across these four values is \$0.84 and the average earning per share is \$ 2.00, resulting in a coefficient of variation of 0.42. You are converting the standard deviation in earnings to a standard deviation per dollar of earnings; this firm has a standard deviation of 42 cents per dollar of earnings. Since the average earnings can be negative over the period, you have to use the absolute value of earnings to get a meaningful number.

Since you need a few years of data for the standard deviation to be meaningful, all active publicly traded firms in the United States with at least 5 years of earnings information available, ending in 2001, were considered as the overall sample. The coefficient of variation in three measures of earnings – earnings before interest, taxes and depreciation (EBITDA), net income and earnings per share – was computed for each firm. Figure 5.2 presents the distribution of values across the market:

Figure 5.2: Coefficient of Variation in Earnings- U.S. Companies in October 2002

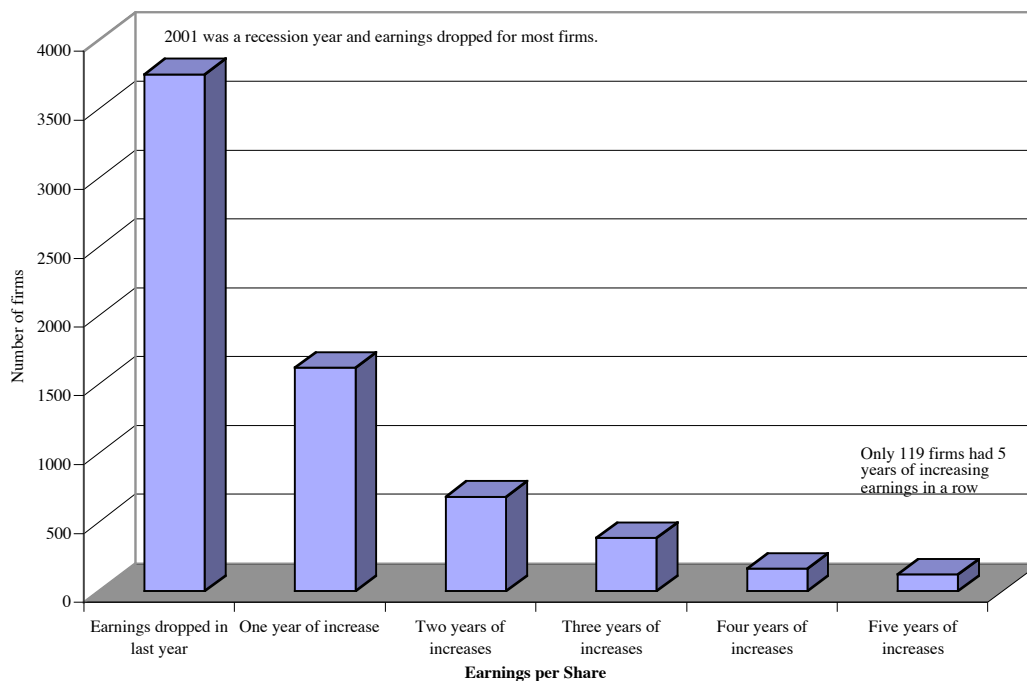


Data from Compustat. The coefficient of variation is obtained by dividing the standard deviation in earnings over five years by the average earnings over the period.

Of the 6700 firms that had earnings data for 5 years or more, about two thirds of all firms have standard deviations of less than a dollar for every dollar of EBITDA and about half of all firms have standard deviations of less than a dollar for every dollar of net income or EPS. In other words, the volatility in equity earnings (net income and earnings per share) is greater than the volatility in operating income or cashflow.

A more intuitive measure of earnings stability is the number of consecutive years of earnings increases; presumably a firm that has reported increasing earnings every year for the last 5 years has more predictable (and safer) earnings than a firm whose earnings have gone up and down over the same period. Figure 5.3 presents the number of firms, with earnings per share available for at least 5 years, that have reported increasing earnings per share every year for the last 5 years, the last 4 years and so on.

Figure 5.3: Consecutive Years of Earnings Increases: U.S. Companies through 2001



Data from Compustat. Looking across all U.S. companies through 2001, this is the number of firms that had reported rising earnings each year over the previous 5 years, 4 years, 3 years etc.

It should come as no surprise, given that the economy slowed in 2001, that the vast majority of firms reported earnings decreases in 2001. Even in this challenging environment, though, 119 firms reported increasing earnings per share each year for the last 5 years and 158 firms reported increasing earnings per share each year for the last 4 years.

A Portfolio of Stable Earnings Companies

To create a portfolio of stable earnings companies, all firms with at least five years of earnings data were examined and the coefficient of variation in earnings per share for each firm was computed. In addition to looking for firms with low coefficients of variation in earnings, two additional tests were imposed. The first was that the firm did not report a loss in any of the last five years. The second was that the earnings per share had increased each year for at least the last two years. Incorporating a cap on the coefficient of variation of 0.25 generated a portfolio of 120 companies. This portfolio is presented in Table 5.1:

Taking a closer look at the portfolio, you can see that financial service companies are disproportionately represented, representing about 25% of the stocks in the portfolio.

Table 5.1: Stable Earnings Companies – United States in October 2002

Company Name	Industry	Company Name	Industry	Company Name	Industry
PROGEN INDUSTRIES LTD	BIOLOGICAL PDS,EX DIAGNSTICS	WILLIAMS COAL SEAM RYL TRUST	OIL ROYALTY TRADERS	INTERCHANGE FINL SVCS CP/NJ	STATE COMMERCIAL BANKS
NUTRACEUTICAL INTL CP	MEDICINAL CHEMS,BOTANICL PDS	HILLENBRAND IND-PRE FASB	MISC FURNITURE AND FIXTURES	NORWOOD FINANCIAL CORP	STATE COMMERCIAL BANKS
ASB FINANCIAL CORP.	SAVINGS INSTN,FED CHARTERED	REALTY INCOME CORP	REAL ESTATE INVESTMENT TRUST	MONRO MUFFLER BRAKE INC	AUTO REPAIR,SERVICES,PARKING
GRIFFON CORP	METAL DOORS,FRAMES,MOLD,TRIM	CAMBRIDGE HEART INC	ELECTROMEDICAL APPARATUS	MOCON INC	MEAS & CONTROLLING DEV, NEC
ARCADIS N V	ENGINEERING SERVICES	DELTA NATURAL GAS CO INC	NATURAL GAS TRANSMIS & DISTR	SYNOVUS FINANCIAL CP	NATIONAL COMMERCIAL BANKS
TPG NV -ADR	TRUCKING,COURIER SVC,EX AIR	FIRSTBANK NW CORP/DE	SAVINGS INSTN,FED CHARTERED	FIRST FED CAP CORP	SAVINGS INSTN,FED CHARTERED
LEESPORT FINANCIAL CORP	NATIONAL COMMERCIAL BANKS	FIRST NATL CP ORANGEBURG SC	NATIONAL COMMERCIAL BANKS	BANCFIRST CORP/OK	STATE COMMERCIAL BANKS
SMUCKER (JM) CO	CAN FRUIT,VEG,PRESRV,JAM,JEL	VOICEFLASH NETWORKS INC	PREPACKAGED SOFTWARE	FIRST BUSEY CORP -CL A	STATE COMMERCIAL BANKS
LANDAUER INC	TESTING LABORATORIES	O REILLY AUTOMOTIVE INC	AUTO AND HOME SUPPLY STORES	TECO ENERGY INC	ELECTRIC & OTHER SERV COMB
CORNING NATURAL GAS CORP	NATURAL GAS TRANSMIS & DISTR	COPYTELE INC	COMPUTER PERIPHERAL EQ, NEC	AFFYMETRIX INC	ELECTROMEDICAL APPARATUS
CINTAS CORP	MEN,YTH,BOYS FRNSH,WRK CLTHG	AMERICAN WATER WORKS INC	WATER SUPPLY	COMMUNITY FIRST BANKSHARES	NATIONAL COMMERCIAL BANKS
HORIZON FINANCIAL CORP/WA	SAVINGS INSTN, NOT FED CHART	CAMCO FINANCIAL CORP	SAVINGS INSTN, NOT FED CHART	VIEWCAST.COM INC	RADIO,TV BROADCAST, COMM EQ
WAL-MART STORES	VARIETY STORES	SKYEPHARMA PLC -ADR	BIOLOGICAL PDS,EX DIAGNSTICS	S & T BANCORP INC	STATE COMMERCIAL BANKS
F & M BANCORP/MD	NATIONAL COMMERCIAL BANKS	FAMILY DOLLAR STORES	VARIETY STORES	R&G FINANCIAL CORP -CL B	STATE COMMERCIAL BANKS
AQUILA INC	ELECTRIC & OTHER SERV COMB	TBC CORP	MOTOR VEH PARTS, SUPPLY-WHSL	TEXAS REGL BCSHS INC -CL A	STATE COMMERCIAL BANKS
EASTERN AMERN NATURAL GAS TR	OIL ROYALTY TRADERS	MIDSOUTH BANCORP INC	NATIONAL COMMERCIAL BANKS	ROYAL BANCSHARES/PA -CL A	STATE COMMERCIAL BANKS
S Y BANCORP INC	STATE COMMERCIAL BANKS	BEDFORD BANCSHARES INC	SAVINGS INSTN,FED CHARTERED	AMCORE FINL INC	NATIONAL COMMERCIAL BANKS
NATIONAL PENN BANCSHARES INC	NATIONAL COMMERCIAL BANKS	PENNFED FINANCIAL SVCS INC	SAVINGS INSTN,FED CHARTERED	FIRST MUTUAL BANCSHARES INC	SAVINGS INSTN, NOT FED CHART
OLD REPUBLIC INTL CORP	FIRE, MARINE, CASUALTY INS	PRIMA ENERGY CORP	CRUDE PETROLEUM & NATURAL GS	BANCORP CONN INC	SAVINGS INSTN, NOT FED CHART
COMPASS BANCSHARES INC	NATIONAL COMMERCIAL BANKS	CLARCOR INC	INDL COML FANS,BLOWRS,OTH EQ	SUFFOLK BANCORP	NATIONAL COMMERCIAL BANKS
HOSPITALITY PROPERTIES TRUST	REAL ESTATE INVESTMENT TRUST	DONALDSON CO INC	INDL COML FANS,BLOWRS,OTH EQ	MERCANTILE BANKSHARES CORP	STATE COMMERCIAL BANKS
OLD SECOND BANCORP INC/IL	NATIONAL COMMERCIAL BANKS	SOUTH JERSEY INDUSTRIES	NATURAL GAS DISTRIBUTION	TELEFLEX INC	CONGLOMERATES
TOMPKINSTRLSTCO INC	STATE COMMERCIAL BANKS	SEMPRA ENERGY	GAS & OTHER SERV COMBINED	PUBLIC SERVICE ENTRP	ELECTRIC & OTHER SERV COMB
DOMINION RES BLACK WARRIOR	OIL ROYALTY TRADERS	PACIFIC CAPITAL BANCORP	STATE COMMERCIAL BANKS	SPECTRX INC	COML PHYSICAL, BIOLOGCL RESH
CH ENERGY GROUP INC	ELECTRIC & OTHER SERV COMB	ENERGEN CORP	NATURAL GAS DISTRIBUTION	BOSTONFED BANCORP INC	SAVINGS INSTN,FED CHARTERED
AMEREN CORP	ELECTRIC SERVICES	CVB FINANCIAL CORP	STATE COMMERCIAL BANKS	UST INC	TOBACCO PRODUCTS
HEALTHCARE SERVICES GROUP	SVCS TO DWELLINGS, OTH BLDGS	RAVEN INDUSTRIES INC	MISC PLASTICS PRODUCTS	ALLIED CAPITAL CP	MISC BUSINESS CREDIT INSTN
LSB FINANCIAL CORP	SAVINGS INSTN,FED CHARTERED	BUNZL PUB LTD CO -SPON ADR	PAPER & PAPER PRODUCTS-WHSL	MISSISSIPPI VY BANCSHARES	STATE COMMERCIAL BANKS
WILMINGTON TRUST CORP	STATE COMMERCIAL BANKS	ALBERTO-CULVER CO -CL B	RETAIL STORES	ROPER INDUSTRIES INC/DE	INDUSTRIAL MEASUREMENT INSTR
HARLEYSVILLE SVGS FINL CORP	SAVINGS INSTN, NOT FED CHART	FIRST MERCHANTS CORP	NATIONAL COMMERCIAL BANKS	FRESH BRANDS INC	GROCERIES & RELATED PDS-WHSL
SANTA FE ENERGY TRUST	OIL ROYALTY TRADERS	NSD BANCORP INC	STATE COMMERCIAL BANKS	UTAH MEDICAL PRODUCTS INC	ELECTROMEDICAL APPARATUS
PAYCHEX INC	ACCOUNT,AUDIT,BOOKKEEP SVCS	WPS RESOURCES CORP	ELECTRIC & OTHER SERV COMB	LOGANSPORT FINANCIAL CORP	SAVINGS INSTN,FED CHARTERED
BOK FINANCIAL CORP	NATIONAL COMMERCIAL BANKS	WEBSTER FINL CORP WATERBURY	SAVINGS INSTN,FED CHARTERED	FIRST UTD CORP	NATIONAL COMMERCIAL BANKS
NORTHERN TRUST CORP	STATE COMMERCIAL BANKS	FST FINL CORP IND	NATIONAL COMMERCIAL BANKS	GORMAN-RUPP CO	PUMPS AND PUMPING EQUIPMENT
FIRST STATE BANCORPORATION	STATE COMMERCIAL BANKS	FIRST LONG ISLAND CORP	NATIONAL COMMERCIAL BANKS	WAYNE BANCORP INC/OH	NATIONAL COMMERCIAL BANKS
ALLEGiant BANCORP INC	STATE COMMERCIAL BANKS	SUNTRUST BANKS INC	STATE COMMERCIAL BANKS	NEW JERSEY RESOURCES	NATURAL GAS DISTRIBUTION
CASH TECHNOLOGIES INC	BUSINESS SERVICES, NEC	HANCOCK HLDG CO	STATE COMMERCIAL BANKS	FPL GROUP INC	ELECTRIC SERVICES
HOME DEPOT INC	LUMBER & OTH BLDG MATL-RETL	MAF BANCORP INC	SAVINGS INSTN,FED CHARTERED	PARK NATIONAL CORP	NATIONAL COMMERCIAL BANKS
SOUTHWEST BANCORPORATION/TX	NATIONAL COMMERCIAL BANKS	WESBANCO INC	NATIONAL COMMERCIAL BANKS	WASHINGTON REIT	REAL ESTATE INVESTMENT TRUST
SIGMA-ALDRICH	BIOLOGICAL PDS,EX DIAGNSTICS	FIRST BANCORP P R	COMMERCIAL BANKS, NEC	TTX CO	TRANSPORTATION SERVICES

The Rest of the Story

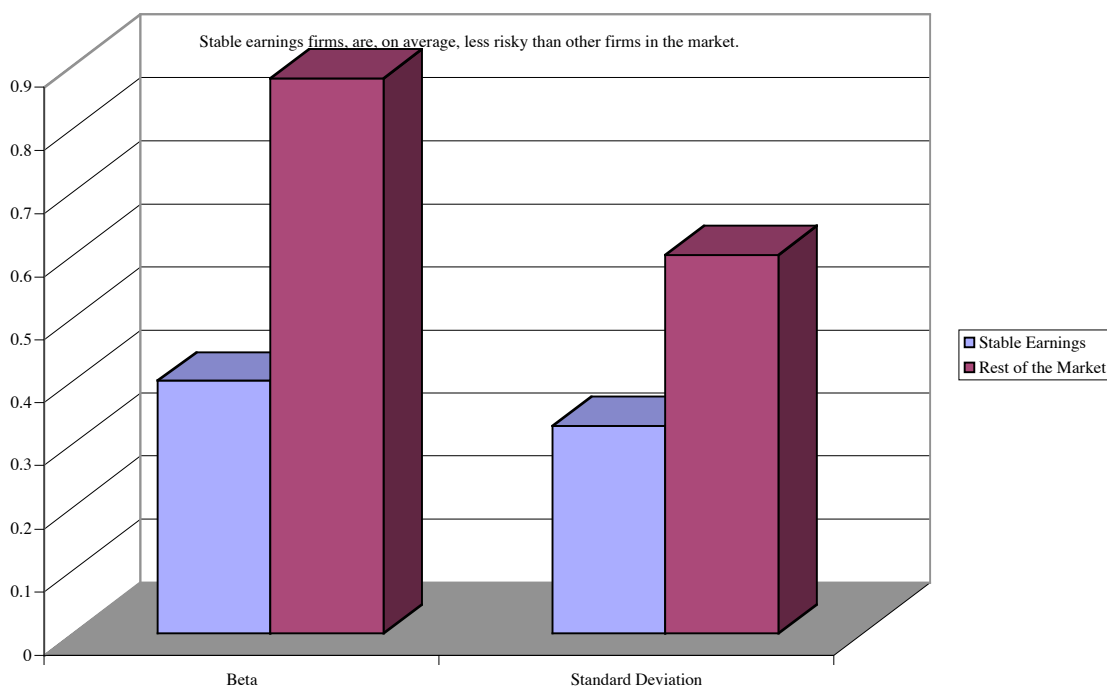
Are stable earnings companies safer investments and, more importantly, better investments than companies with more volatile earnings? To answer these questions, you need to consider four potential weaknesses in a stable earnings company strategy. The first is that companies with stable earnings can still be volatile investments. The second is that companies with stable earnings may offer little growth potential, thus creating a tradeoff between stable earnings and high growth. The third is that companies may use accounting games to make their earnings look more stable. The fourth is that stable earnings companies may be priced right and provide little opportunity for high returns.

Stable Earnings, Risky Investment?

A company with stable earnings may not necessarily represent a stable investment. This is because stock prices are affected by far more than earnings news from the company. Non-earnings news about growth prospects and management changes, macroeconomic news about interest rates and economic growth and information released by competitors in the same business can all cause prices to move even when earnings do not. An investor ultimately measures risk based upon stock price movement and a stock with stable earnings and a volatile price path would still be categorized as risky.

You can look at two stock price based measures of risk for the companies in the stable earnings portfolio – the beta which measures how these stocks move with the market and the standard deviation in stock prices over the previous five years. To provide a contrast, the differences between the averages for these two measures for the stable earnings portfolio and for the market are examined in Figure 5.4

Figure 5.4: Stable Earnings versus Rest of Market - Risk Comparison



Data from Value Line: The average beta and standard deviation, estimated over the previous 3 years, is reported for firms in the stable earnings portfolio and for the rest of the market.

Companies with stable earnings are less volatile and have much lower betas, on average, than other companies in the rest of the market. There are, however, a few firms in the sample of stable earnings companies with high betas (>1.25) and standard deviations that exceed the average for the market (approximately 60%). If you introduce these risk levels as screens and eliminate firms with stable earnings that have betas that exceed 1.25 or betas that exceed 60%, you lose eight firms out of the initial sample of 100 firms and these firms are listed in Table 5.2.

Table 5.2: Stable Earnings Firms that fail Risk Test

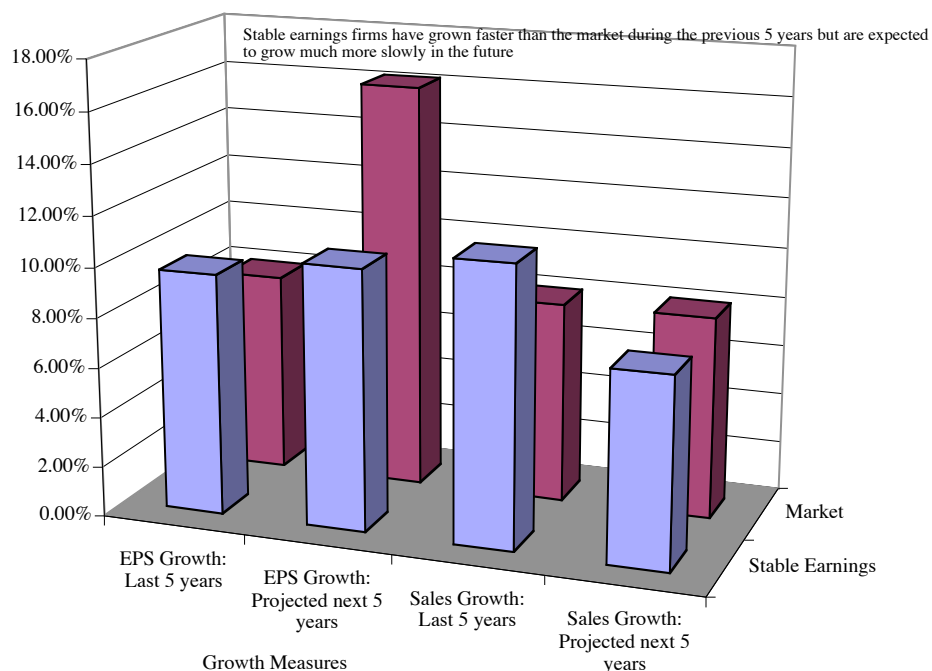
Company Name	Ticker Symbol	Beta 5-Year	Std Dev 5-Year
Northern Trust Corp.	NTRS	1.28	31.4
Home Depot	HD	1.29	36.73
Progen Industries Limited	PGLAF	0.48	62.38
Fresh Choice	SALD	0.62	70.72
SpectRx Inc	SPRX	0.73	70.82
Cambridge Heart Inc	CAMH	1.86	79.28
CopyTele Inc.	COPY	1.48	96.29
Affymetrix Inc.	AFFX	1.84	97.54

Giving up on Growth Opportunities

While it is true that lower risk companies, other things remaining equal, should be worth more than higher risk companies, it is also true that investors often have to trade off lower risk for lower growth. While it would be unrealistic to expect companies that have stable earnings to also have high growth, you should be wary about companies with stable earnings that report no or very low growth. After all, a stock that delivers the same earnings year after year begins to look like a bond and will be priced as such.

How does the portfolio of stable earnings companies compiled at the end of the last section measure up against the rest of the market, when it comes to earnings growth? The average growth in earnings per share and revenues over the last five years and the projected growth in earnings per share (as estimated by analysts) over the next five years for the companies in the portfolio and for the rest of the market were estimated. Figure 5.5 presents the comparison:

Figure 5.5: Stable Earnings Firms versus Market - Growth



Data from Value Line. The projected growth rates in earnings and sales are from analyst projections.

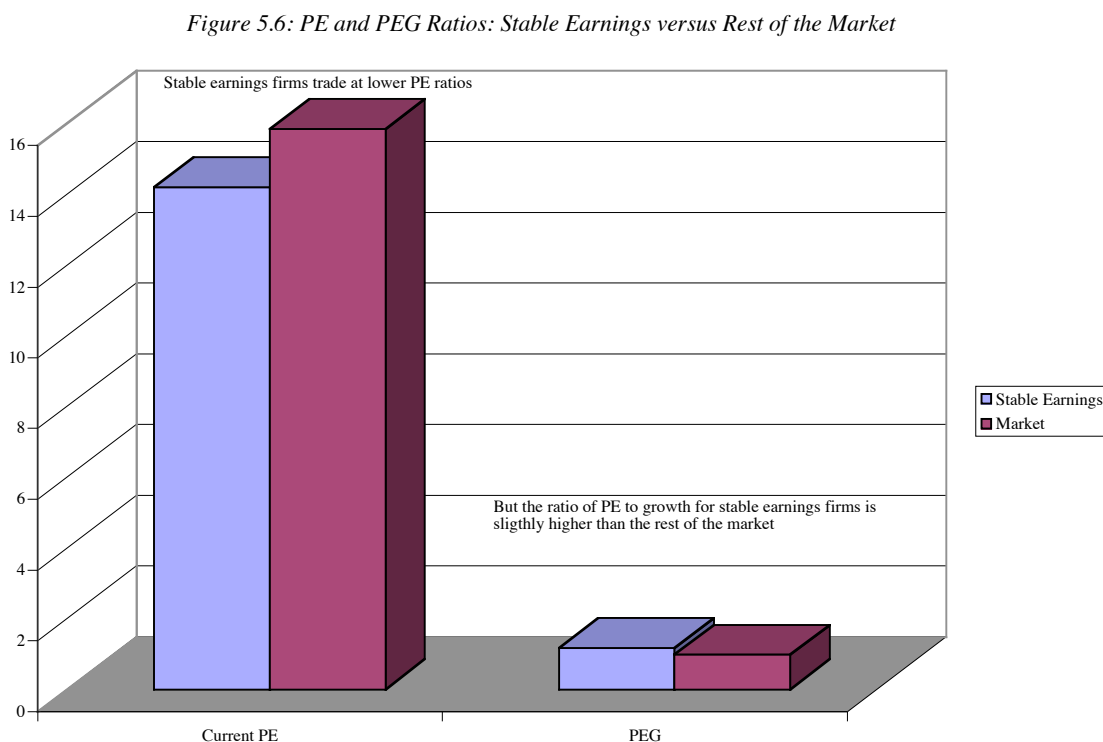
The stable earnings companies have had higher growth in earnings per share and sales than companies in the rest of the market over the previous five years. However, the projected growth over the next five years is lower in both earnings per share and sales for the stable earnings firms, which suggests that investors do bear a cost when they buy stable earnings companies.

To ensure that the stocks in the portfolio register at least some growth, all firms that had projected growth in earnings per share for the next five years of less than 5% were eliminated. With this screen, you lose 38 firms out of the remaining 92 stocks in the portfolio. With a growth rate screen of 10% or higher in earnings per share for the next five years, you would have eliminated another 20 firms from the sample.

Priced Right?

Even if you do find a stock with stable earnings and adequate expected growth, there is no guarantee that this stock will be a good investment, if it is not priced right. In other words, if you pay a high multiple of earnings because of the earnings stability and growth, you may very well neutralize the advantages that drew you to this stock in the first place.

The price earnings ratios, using current earnings, for the stocks in the stable earnings portfolio and also the ratio of the PE to the expected growth rate (called the PEG ratio) were computed. Figure 5.6 compares the average PE and PEG ratio for the stocks in the stable earnings portfolio and the rest of the market.



Data from Value Line. The price earnings ratio is the current price divided by current EPS and the PEG ratio is the ratio of current PE to expected growth in earnings per share over the next 5 years.

The stable earnings firms have slightly lower PE ratios than firms in the rest of the market but trade at higher PEG ratios.

To screen for stocks that may be over priced, all firms that trade at PE ratios that exceed 15 and PEG ratios greater than 1 were eliminated. If used in conjunction with the risk and growth screens outlined in the prior parts of this section, the portfolio shrinks to 8 firms. The firms listed in Table 5.3 pass all of the tests – have growth that exceeds 5%, betas less than 1.25, standard deviations less than 60%, PE ratios less than 15 and PEG ratios less than one.

Table 5.3: Stable Earnings Firms with low risk, growth potential and reasonable pricing

<i>Company Name</i>	<i>Projected Growth Rate</i>	<i>Current PE</i>	<i>PEG ratio</i>	<i>Beta 5-Year</i>	<i>Std Dev 5-Year</i>
Prima Energy Corp.	23.50%	12.25	0.52	0.53	52.37
First BanCorp PR	14.00%	11.43	0.82	0.44	30.37
R & G Financial Corp	12.00%	10.25	0.85	0.48	40.22
Sempra Energy	7.50%	6.84	0.91	0.66	38.16
Dominion Resources	15.50%	14.35	0.93	0.26	24.61
Public Svc Enter.	6.00%	5.62	0.94	0.26	29.94
BOK Financial	15.10%	14.40	0.95	0.53	26.08
Allied Capital Corp.	11.00%	10.71	0.97	0.81	31.45

The firms are primarily utilities and financial service firms.

Earnings Quality

Firms that manage to report stable earnings while having volatile operations may be using accounting ploys to smooth out earnings. If this is the case, the volatility cannot be hidden forever and investors who buy stocks in these firms are likely to wake up to large (and unpleasant surprises) sooner rather than later.

Since it would be impractical to look at each firm's financial statements over time to detect earnings smoothing, a simpler test was used. In addition to the coefficient of variation in earnings, the coefficient of variation in earnings before interest, taxes, depreciation and amortization (EBITDA) was used. Since the latter is a general measure of operating cashflows, you could argue that firms that report stable earnings while reporting much more volatile cashflows are indulging in accounting sleight of hand and should not be treated as stable earnings companies. When applied to this portfolio, there is some evidence that at least some of the stocks in the portfolio are guilty of earnings management. These are the firms that report high standard deviations in EBITDA while also reporting low standard deviations in earnings per share.

Lessons for Investors

Not all firms that report stable earnings are good investments. At the minimum, you need to consider whether these firms offer any growth potential, whether earnings stability translates into price stability and finally, whether the market is pricing these stocks correctly. It is no bargain to buy a stock with stable earnings, low or no growth, substantial price volatility and a high price earnings ratio. Reverting back to the sample of all firms in the United States, the following screens were used:

- ❑ The coefficient of variation in earnings per share has to be in the bottom 10% of the overall sample: You can use alternate measures of earnings stability to make this judgment but the argument for using earnings per share rather than net income or operating income were presented earlier in the chapter. You can also add on additional screens such as the requirement that earnings have increased every year for the last few years.
- ❑ The beta of the stock has to be less than 1.25 and the standard deviation in stock prices over the last 3 years has to be less than 60%. While it is unlikely that many stable earnings companies will be high risk, there will be some companies where prices remain volatile even as earnings are stable. The risk screens will eliminate these firms.
- ❑ The price earnings ratio has to be less than 15. Buying a great company at too high a price is no bargain. Consequently, you need to make sure that you are not paying a premium for earnings stability that you are not willing to pay.
- ❑ The expected growth rate in earnings per share over the next 5 years has to be 10% or higher. Earnings growth is always a bonus. A company with stable and growing earnings is clearly a better investment than one with stable and stagnant earnings.

The resulting portfolio of 37 companies, compiled based upon data available in January 2003, is reported in the appendix.

Conclusion

Firms that report a steady and stable stream of positive earnings per share are considered by some investors to be good investments because they are safe. Both the theoretical backing and the empirical evidence for this proposition are weak. Firms that pay a large price (on risk management products or acquisitions) to reduce or eliminate risk that investors could have diversified away at no cost are doing a disservice to their stockholders. Stable earnings notwithstanding, you should not expect these firms to be great investments. In this chapter, this issue was considered by first looking at how best to measure earnings volatility. When you construct a portfolio of stocks that have the most stable earnings, other

problems show up. The first is that some of these firms, notwithstanding their earnings stability, have high stock price volatility and seem risky. The second is that a substantial number of these firms have low or negative growth rates. Finally, many of the remaining firms trade at high PE ratios and do not seem to be bargains at prevailing prices.

Appendix: Stable Earnings, Growth Potential and Low Risk

<i>Company Name</i>	<i>Ticker Symbol</i>	<i>Earnings Predictability</i>	<i>Stock Price</i>	<i>Current EPS</i>	<i>Current P/E Ratio</i>	<i>Beta</i>	<i>Standard Deviation</i>	<i>Expected growth in EPS: Next 5 years</i>
Ametek Inc.	AME	95	\$38.49	\$2.66	14.47	0.90	33.24%	11.50%
Applebee's Int'l	APPB	100	\$23.19	\$1.58	14.68	0.95	40.35%	14.50%
Baxter Int'l Inc.	BAX	100	\$28.00	\$2.06	13.59	0.70	32.56%	14.50%
BB&T Corp.	BBT	95	\$36.99	\$2.89	12.80	1.05	27.01%	12.00%
BJ's Wholesale Club	BJ	95	\$18.30	\$2.09	8.76	0.95	37.65%	12.50%
City National Corp.	CYN	95	\$43.99	\$3.69	11.92	1.00	28.92%	14.50%
Fannie Mae	FNM	100	\$64.33	\$6.52	9.87	0.95	31.71%	11.00%
First Midwest Bancorp	FMBI	100	\$26.71	\$1.91	13.98	0.85	19.98%	11.50%
Fortune Brands	FO	90	\$46.51	\$3.29	14.14	0.90	30.64%	14.50%
Freddie Mac	FRE	100	\$59.05	\$5.31	11.12	1.00	28.76%	12.00%
Gen'l Electric	GE	100	\$24.35	\$1.72	14.16	1.30	30.47%	11.00%
Golden West Fin'l	GDW	90	\$71.81	\$5.98	12.01	0.90	32.21%	16.00%
Horton D.R.	DHI	90	\$17.35	\$3.10	5.60	1.35	42.39%	17.50%
Household Int'l	HI	100	\$27.81	\$4.79	5.81	1.45	36.90%	11.50%
IHOP Corp.	IHP	100	\$24.00	\$2.05	11.71	0.80	30.49%	11.50%
Johnson Controls	JCI	95	\$80.17	\$6.67	12.02	1.00	29.13%	11.00%
Kroger Co.	KR	100	\$15.45	\$1.66	9.31	0.95	31.68%	12.50%
Lincoln Elec Hldgs.	LECO	90	\$23.15	\$1.86	12.45	0.75	37.04%	11.00%
Magna Int'l 'A'	MGA	95	\$56.15	\$6.49	8.65	0.90	27.29%	10.50%
Moog Inc. 'A'	MOG/A	95	\$31.04	\$2.67	11.63	0.80	50.50%	10.50%
North Fork Bancorp	NFB	90	\$33.74	\$2.60	12.98	1.05	26.36%	12.50%
PMI Group	PMI	100	\$30.04	\$3.97	7.57	1.05	39.16%	12.00%
Polaris Inds.	PII	100	\$58.60	\$4.60	12.74	1.00	33.72%	12.00%
Popular Inc.	BPOP	100	\$33.80	\$2.68	12.61	0.85	29.27%	12.00%

Roslyn Bancorp	RSLN	90	\$18.03	\$1.85	9.75	1.00	30.14%	14.50%
Ruby Tuesday	RI	95	\$17.29	\$1.35	12.81	0.80	39.72%	19.00%
Ryan's Family	RYAN	100	\$11.35	\$1.16	9.78	0.70	34.86%	11.50%
Safeway Inc.	SWY	95	\$23.36	\$2.57	9.09	0.80	31.50%	12.00%
SouthTrust Corp.	SOTR	100	\$24.85	\$1.89	13.15	1.00	32.02%	11.00%
TCF Financial	TCB	90	\$43.69	\$3.30	13.24	1.05	28.52%	12.50%
Teleflex Inc.	TFX	95	\$42.89	\$3.13	13.70	0.95	32.89%	10.50%
Universal Forest	UFPI	90	\$21.32	\$2.08	10.25	0.80	34.15%	12.00%
Washington Federal	WFSL	90	\$24.85	\$2.32	10.71	0.90	32.91%	11.50%
WellPoint Health Ntwks	WLP	95	\$71.16	\$4.85	14.67	0.80	29.66%	21.50%
Wendy's Int'l	WEN	95	\$27.07	\$1.95	13.88	0.60	34.37%	14.50%
Zions Bancorp.	ZION	100	\$39.35	\$3.82	10.30	1.05	31.19%	10.50%