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The Revenge of the Socialites

Wall Street, like your high school, divides itself into cliques. Growth investors are the popular socialites, their work revolving around exciting stories of new products, transforming technologies, potential markets and other, even more, subjective criteria. Value investors are the unpopular nerds, eschewing the subjective in favor of cold hard numbers, breaking down balance sheets and income statements.

High school nerds tend to be more successful later in life than the hard-partying socialites (you can guess which group we think we were in), and value investors have a long-run performance advantage over growth investors. The advantage is not consistent or obvious enough, however, to keep investors from being attracted by growth stock glamour. The late 1990's saw a growth "party" so exciting and exhilarating that the investment world forgot the existence of anything other than technology, media, telecommunications and biotechnology. The nerdy value investors toiled in obscurity, analyzing financial statements, knowing that their time would come, but secretly wishing that once, just once, they could be in the spotlight too.

***We get more cynical every day,
but we still can't keep up.***

The party ended in early 2000, and the hangover has been horrific. The glamorous Nasdaq Composite fell 71 percent while value stocks rose. This was a triumph for the nerds, who are patting themselves on the back and telling anyone who will listen that they just knew those growth guys would come to a bad end. While we are sympathetic to the nerds, we fear they are so proud of their probity and temperance that they haven't noticed that the party of the socialites got so out of control that it destroyed the nerds' house. Value investors rely on the numbers in financial statements, but the new era made the financial statements opaque and, in some cases, worthless.

What were the earnings for the Standard & Poor's 500 index for 2001? First Call, an earnings reporting service, says \$45.09. Standard and Poor's, the creator of the index, says \$38.88. Ned Davis Research, a leading institutional investment research firm, says \$24.70. Your opinion on the valuation of the index depends heavily upon which number you decide to use. How can there be such a variety of opinions about what appears to be a straightforward quantitative question? The problem is that you also have to decide which accounting method you accept as valid.

Michael Goldstein of Sanford C. Bernstein & Co. has analyzed the distortions in earnings resulting from (1) stock options that, unlike salary, aren't treated as an expense; (2) nonrecurring charges that aren't counted against "normal" earnings; and (3) increasing estimates of future investment returns

leading to lower pension contributions. Goldstein estimates these factors account for more than half the earnings growth for the Standard & Poor's 500 index from 1995 through 2000. Make adjustments for these factors and the new era earnings boom turns into below average growth.

Goldstein's study focused on earnings calculated under Generally Accepted Accounting Principles (GAAP). Even more insidious, however, is the practice of companies reporting earnings on other than a GAAP basis, known as "pro-forma" earnings. John May of SmartStockInvestor.com recently analyzed the reported earnings for the companies included in the Nasdaq 100 index, the marquee index for the technology-laden new era. For the first nine months of 2001, the hundred companies reported combined profits of \$19.1 billion to shareholders on a pro-forma basis. During the same period, the companies reported a *loss* under GAAP to the Securities and Exchange Commission of \$82.3 billion. The \$100 billion difference results from the fact that, unlike GAAP earnings, pro-forma numbers are not only unaudited, they aren't subject to any rules at all.

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--Scott McNealy

Scott McNealy, chairman of Sun Microsystems, wins our award for the pithiest summary of reporting pro-forma earnings: "All of the good stuff, none of the bad. We're guilty, but you know, the market buys it, so we do it." Mr. McNealy has gone to the heart of the matter -- bad accounting practices have driven out good because we have rewarded the bad. May's study shows Oracle's reported earnings were closer to GAAP than most other big technology companies, but its stock was selling at a much lower multiple of those real earnings. The stock market has been valuing companies based upon the gaudy pro-forma numbers, not the real GAAP numbers.

If we're looking for the villain that destroyed the credibility of accounting numbers and ruined the trust in the stock market, we should look in the mirror. Investors were credulous, so overcome by the socialite glamour of the tech boom that they were willing to ignore the facts relayed by those annoying, finger-wagging, tongue-clucking, head-shaking nerds. Wall Street analysts, instead of pointing out the accounting discrepancies, appear to have accepted whatever was in the press releases, not burdening themselves with the tedious work of analyzing the GAAP numbers in the SEC filings. Because careful attention to accounting standards was boring, investors are less likely to have faith in the earnings release of any company.

Trust is the foundation of the securities markets. Once lost, it is not easily restored. The new era party is now a memory and many attendees are seeking a new direction. If you would like a guide through the current investment world of questionable accounting and faded glamour, contact us.