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FUNDAMENTALLY

Don't Worry, Be Happy (Even if Earnings Go Soft)

By PAUL J. LIM

IN the long run, the two main drivers of a stock price are the profits the company produces and the amount that investors are willing to pay for them. So whenever investors turn cautious, as they have recently, and price-to-earnings ratios flatten out or fall, attention turns naturally to the other driver: the profits themselves.

Until recently, the earnings picture looked amazingly bright, as companies in the Standard & Poor's 500-stock index posted four consecutive quarters of profit growth of more than 20 percent.

But the mood has started to shift. The big concern now is that growth in earnings, while still healthy by historical standards, has been decelerating. A majority of American fund managers surveyed this month by Merrill Lynch say they think that profits will "deteriorate slightly" in the coming months. And the consensus forecast for third-quarter earnings growth for the S.& P. 500 companies is 14.2 percent, down sharply from the estimated 25.3 percent in the second quarter this year, according to Thomson First Call.

Conventional wisdom says that when earnings growth begins to slow, it's time to worry. That is especially the case when investors aren't willing to pay exorbitant P/E ratios for stocks. After all, if both earnings growth and P/E ratios plateau at the same time, what is left to propel equity prices higher?

A slowdown in earnings, even if actual profits are growing by double digits, "is considered to be a warning sign" of poorer economic and business prospects to come, noted Sung Won Sohn, chief economic officer at Wells Fargo Banks.

But while decelerating earnings have proved to be challenging for investors in the past, they do not automatically lead to lower stock prices. "If you look at the very, very long term, there's clearly a high correlation between growth in earnings and growth in the market," said Stuart H. Wester, vice president for equity investments at USAA

Investment Management. But as you narrow the time frame, he added, "you can find yourself in a situation where the two can diverge dramatically."

Certainly, equity prices have sometimes soared even as corporate earnings have begun to sour. That happened most recently in 1995, when the S.& P. 500 delivered a total return of more than 37 percent despite the start of a slowdown in earnings growth. No one is predicting a repeat of that, but it goes to show that while earnings drive stock prices in the long term, other factors can also influence the markets in the short term.

Sam Stovall, chief investment strategist at S.& P., studied periods of decelerating earnings among S.& P. 500 stocks dating back to 1966. In the six months after the peaks of profit cycles, stocks were up on 4 out of 10 occasions. Twelve months after such peaks, stocks were showing positive returns 6 out of 10 times.

But this time around, consider where earnings are decelerating from. Starting with the third quarter of 2003, S.& P. 500 earnings have climbed by more than 20 percent for four consecutive quarters - something that has happened only seven other times since the end of World War II, according to Ned Davis Research.

Ed Clissold, senior global analyst at Ned Davis, recently looked at the performance of the equity markets emerging from those seven periods. He found that in the 12 months after the end of such streaks, the S.& P. 500 has risen 8.3 percent, on average. The median increase was closer to 15.3 percent.

The numbers defy the current level of market concern over deceleration. "The markets in the short term are almost always drunk with too much optimism or pessimism," said Alan F. Skrainka, chief market strategist at Edward Jones. He added: "I'm not overly concerned that the rate of growth has peaked and is about to moderate."

But what if the earnings growth rate didn't just moderate, but fell substantially? Even if the third-quarter forecast of 14.2 percent proves way too high, stocks' performance in the next year could still be decent.

Ned Davis researchers studied the performance of the markets based on actual earnings growth dating back to 1927. In periods when actual S.& P. 500 earnings growth came in at 5 percent to 20 percent, the markets have gained 5.3 percent, annualized. But when profits were worse - in a range of 5 percent growth to 20 percent earnings declines - stocks have actually done better, gaining 13.1 percent, on average.

The reason for that outperformance has a lot to do with anticipation. "By the time earnings growth gets extremely high, a lot of the good news is already priced into the stock market," Mr. Clissold said. Similarly, decelerating earnings may already have been priced into this market, as investors have been expecting the trend for months.

That isn't to say earnings growth is unimportant. But it tends to matter most when determining the types of stocks to hold, not whether to stay in the stock market at all.

"If you're thinking about rotating, between high-quality and low-quality stocks or growth and value, then you're going to want to pay attention to accelerating or decelerating earnings," said Richard Bernstein, chief United States strategist at Merrill Lynch.

For example, while low-quality and economically sensitive stocks thrived in 2003, in anticipation of the upswing in the profit cycle that began in the third quarter that year, Mr. Bernstein says that now is the time to be moving into higher-quality names with strong balance sheets - companies strong enough to thrive as profit growth begins to shrink.

HE recently looked at the last three periods of decelerating earnings growth - periods of varying durations that began in 1989, 1995 and 2000. From the peaks to the troughs, high-quality stocks - those rated A+ by S.& P., based

on earnings quality - gained 63 percent, on average, for the three periods. By contrast, stocks graded C or D advanced just 20 percent.

Investors who fail to recognize the deceleration in earnings may be tempted to keep putting money into yesterday's winners, Mr. Bernstein said. Typically, he said, at the peak of profit cycles, "people extrapolate the trends and assume that what did well yesterday will continue to do well today." But history shows that this could be a big mistake - just as it would be to assume that the broad stock market will automatically fall, now that earnings growth is slowing.

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