ADVISOR PERSPECTIVES

When the Unicorn Eats Your Earnings

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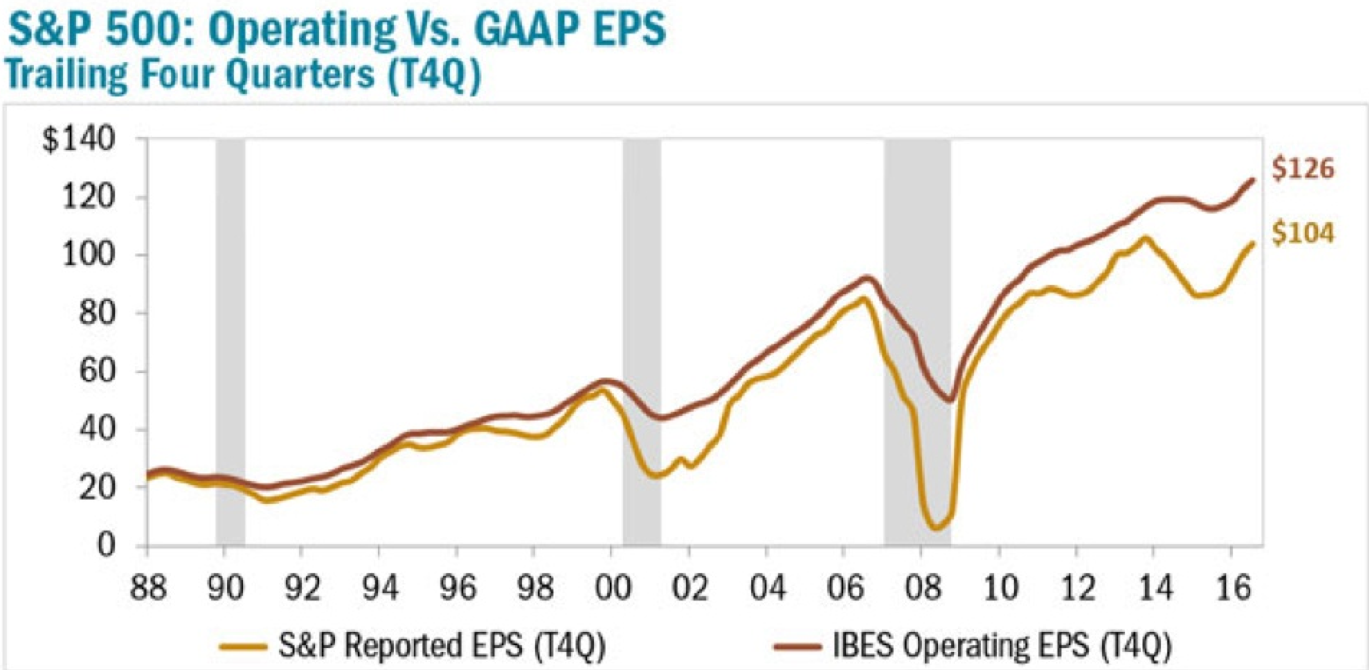

Source: Wolfe Research Portfolio Strategy, Standard & Poor's, Compustat, Thomson Reuters, and FactSet Research Systems Inc., 12/31/1987 to 6/30/2017. Generally Accepted Accounting Principles (GAAP) and Earnings Per Share (EPS).
IBES (owned by Thomson Reuters) calculates consensus bottom-up earnings expectations over the next 12 months for each U.S. company. These earnings are aggregated into one earnings number for the overall S&P 500. Areas highlighted in gray represent recessionary periods: July 1990 to March 1991, March 2001 to November 2001, and December 2007 to June 2009. Economic predictions are based on estimates and are subject to change.
Past performance does not guarantee future results.

They are the unicorns of the corporate accounting world—those "once-in-a-lifetime" charges that creep into quarterly results with remarkable regularity. In financial releases, they are tagged as adjustments and ignored in calculations of non-GAAP earnings.

Originally utilized sparingly as a way to explain unique events, businesses, as shown, have become more aggressive in using the trick to turn lackluster results into income growth. Of course not every company relies on adjustments but we have noticed an uptick in those excluding items ranging from pension costs to stock options when reporting results. For example, Netflix, Inc. (NFLX) backs out stock-based compensation in its adjusted earnings, even though the cost is more than 20% of general expenses and is the third largest expenditure behind only marketing and content purchases. This expense is real and could result in shareholder dilution in the years ahead, yet the only way to find it is to dig through SEC filings.

For active investors, the solution is straight forward—comb through profit and loss statements, evaluate accounting changes to determine if they are extraordinary events, and develop a realistic view of results to determine a business' intrinsic value.

Passive investors don't have that luxury. They can't avoid companies that have come to rely on these "rare" adjustments. Instead, they are forced to buy and sell an index based purely on companies' market value—regardless of valuation or accounting practices. When investors eventually turn their attention back to the quality of profits, passive investors may wish they'd been more selective.

Disclosure:

Past performance does not guarantee future results.

Investing involves risk, including the potential loss of principal. There is no guarantee that a particular investment strategy will be successful. **Value investments are subject to the risk that their intrinsic values may not be recognized by the broad market.**

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As of 9/30/2017, Heartland Advisors on behalf of its clients did not hold Netflix, Inc. Statements regarding securities are not recommendations to buy or sell. Portfolio holdings are subject to change. Current and future holdings are subject to risk.

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Definitions: Active Investing: is an investment strategy involving ongoing buying and selling actions by the investor. Active investors purchase investments and continuously monitor their activity in order to exploit profitable conditions. Consensus Estimate is a figure based on the combined estimates of the analysts covering a public company. Earnings Per Share: is the portion of a company's profit allocated to each outstanding share of common stock. Generally Accepted Accounting Principles (GAAP) Earnings: companies report earnings based on time-honored accounting principles like accrual accounting, revenue recognition and expense matching. Passive Investing: is an investment strategy involving limited ongoing buying and selling actions. Passive investors will purchase investments with the intention of long-term appreciation and limited maintenance. S&P 500 Index: is an index of 500 U.S. stocks chosen for market size, liquidity and industry group representation and is a widely used U.S. equity benchmark. All indices are unmanaged. It is not possible to invest directly in an index.

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