

Hewitt Heiserman, Jr.

IT'S EARNINGS THAT COUNT

Finding Stocks with Earnings
Power for Long-Term Profits



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HEWITT HEISERMAN JR.

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FOREWORD

A HISTORIC BUBBLE INFLATES

It is only a matter of time until the Great Stock Market Bubble of 1998–2000 takes its proper place, at least metaphorically, in a new edition of *Extraordinary Popular Delusions and the Madness of Crowds*, the classic 1841 compilation of market manias by Charles Mackay. But we already know many of its causes.

Surely the idea that a “New Era” lay before us was one of them. We were entering the Information Age, happily coincident with Y2K and the new millennium. And quantum advances in computer technology, plummeting prices for microchips, and the World Wide Web combined to present tangible evidence that our global society was at the threshold of radical change.

“This time *is* different” was the rallying cry. The stock market headed upward, almost unremittingly, as investors enthusiastically jumped aboard the bull market bandwagon. From the start of 1998 until the peak was reached in March of 2000, the Nasdaq composite index—largely “new economy” stocks—soared by 220 percent, and even its stodgy “old economy” counterpart—the New York Stock Exchange Index—returned 40 percent.

A NEW GILDED AGE

The Great Wall Street Selling Machine was quick to sense, then join, and then promote the idea that a new Gilded Age was at hand. Indeed, fostered by vigorous promotion of existing growth stocks and even more vigorous promotion (often in the guise of “investment research”) of initial public offerings, a new Gilded Age *was* at hand. But not for investors. Rather, those who reaped billions—likely hundreds of billions—of dollars from the Great Bubble were the financial tycoons, the investment bankers, the money managers, the Internet pioneers, and the entrepreneurs, who created new concepts and new companies as fast as the public would accept them.

It was a Gilded Age, too, for corporate executives. The multiplicity of flaws in our executive compensation system—stock

options that rewarded managers for transitory increases in the price of the stock rather than durable enhancement in the intrinsic value of the corporation; the absence of a cost-of-capital hurdle; no requirement, God forbid, that executives actually *hold* the shares acquired through exercise; burying the true costs of options by not characterizing them as corporate expenses—lured our business establishment into turning the classic model of capitalism upside down. That move from the traditional system of *owners'* capitalism into a new system of *managers'* capitalism would gradually erode the moral and ethical standards on which capitalism had traditionally been based. Not only did corporate directors fail to place shareholder interests above management interests, but even the owners of corporate America looked on without knowing, or at least without caring, that it was in fact *their* ox that was being gored.

At the fulcrum of the forces that drove stock prices onward and upward was the improper reporting of corporate earnings. In explaining soaring stock prices, stock market participants came to seek rationalization over reason. The “new economy,” it was said, requires new accounting principles; corporate earnings could be not only “managed,” but managed from each quarter to the next; *pro forma* earnings were more important than earnings determined under generally accepted accounting principles. Yet, amazingly, much of this foolishness took place with the eyes, not just of novice individual investors, but also of experienced institutional investors, wide open.

THE HAPPY CONSPIRACY

Why didn't someone do something or say something? In part, because investors were loving the ride. “Everybody” was getting rich. But shouldn't we have known better? Of course. And didn't we realize that the great bull market was destined to end badly? Again, yes. Indeed, two years before the collapse of Enron, I warned about earnings management. In a speech entitled “The Silence of the Funds,” delivered before the New York Society of Security Analysts on October 20, 1999, I felt like a stranger in a foreign land when I stood up and spoke these words:

Today, we live in a world of managed earnings. While it is corporate executives who do the managing, they do so with at least the tacit approval of corporate directors and auditors, and with the enthusiastic endorsement of institutional investors with short-term time horizons, even speculators and arbitrageurs, rather than in response to the demands of long-term investors. Like it or not, corporate strategy and financial accounting alike focus on meeting the earnings expectations of “the Street” quarter after quarter. The desideratum is steady annual earnings growth—manage it to at least the 12 percent level, if you can—and at all costs avoid falling short of the earnings expectations at which the corporation has hinted, or whispered, or “ballparked” before the year began. If all else fails, obscure the real results by merging, taking a big one-time write-off, and relying on pooling-of-interest accounting. All of this creative financial engineering apparently serves to inflate stock prices, to enrich managers, and to deliver to institutional investors what they want.

But if the stock market is to be the arbiter of value, it will do its job best, in my judgment, if it sets its valuations based on punctiliously accurate corporate financial reporting and a focus on the long-term prospects of the corporations it values. However, the market’s direction seems quite the opposite. For while the accounting practices of America’s corporations may well be the envy of the world, our nation’s financial environment has become permeated with the concept of managed earnings. The accepted idea is to smooth reported earnings, often by aiding security analysts to establish earnings expectations for the year, and then, each quarter, reporting earnings that “meet expectations,” or, better yet, “exceed expectations.” It is an illusory world that ignores the normal ups and downs of business revenues and expenses, a world in which “negative earnings surprises” are to be avoided at all costs...

...with huge restructuring changes, creative acquisition accounting, “cookie jar” reserves, excessive “immaterial” items, and premature recognition of revenue, earnings management has gone too far. As SEC chairman Arthur Levitt has said, “almost everyone in the financial community shares responsibility [with corporate management] for fostering this climate.” It is, in a perverse sense, a happy conspiracy. But I believe that no corporation can manage its earnings forever, and that managed earnings misrepresent the inherently cyclical nature of business. Even as we begin to take for granted that fluctuating earnings are steady and

ever-growing, we ought to recognize that, somewhere down the road, there lies a day of reckoning that will not be pleasant.

THE DAY OF RECKONING ARRIVES

Only a brief six months later, the inevitable day of reckoning arrived. On March 24, 2000, the great bull market drew to its inevitable close. Since the huge advance in stock prices was unsustainable (using the inspired phraseology of economist Herb Stein), it couldn't be sustained. The aftermath has hardly been pleasant. From the market's peak in March 2000 to the low (so far, at least) in early October 2002, the Nasdaq Index tumbled by 75 percent, and the NYSE Index fell 33 percent. Today, as I write these words, both have recovered smartly from their lows but remain near their pre-bubble levels of late 1997. But brutal damage has been done to investors, to our capitalistic system, and to our society.

The bad behavior of business has rewarded the winners—the executives who cashed in their shares, the IPO entrepreneurs, the Wall Street firms who sold the IPOs to the public, and the mutual fund managers who attracted nearly one trillion (!) dollars of the public's assets, largely in aggressive, risky funds that were focused on the new economy, nearly 500 of them organized solely to capitalize on the market madness as it reached its zenith.

The bad behavior of business has also penalized the losers. *Not* the long-term investors who saw their portfolios rise from reasonable valuations to absurd valuations, only to revert once again to reasonable levels. The real damage was done to short-term stockholders, including millions of public investors lured into the mania by clever marketers or by their own greed or ignorance, as well as, ironically, corporations that repurchased their own shares to avoid the dilution from the shares they issued under excessively generous option plans. While the final returns, as it were, are not yet in, it is fair to say that we have witnessed a massive transfer of wealth, largely *to* those who knew what was truly going on in corporate financial statements, *from* those who either didn't know or, worse, didn't care.

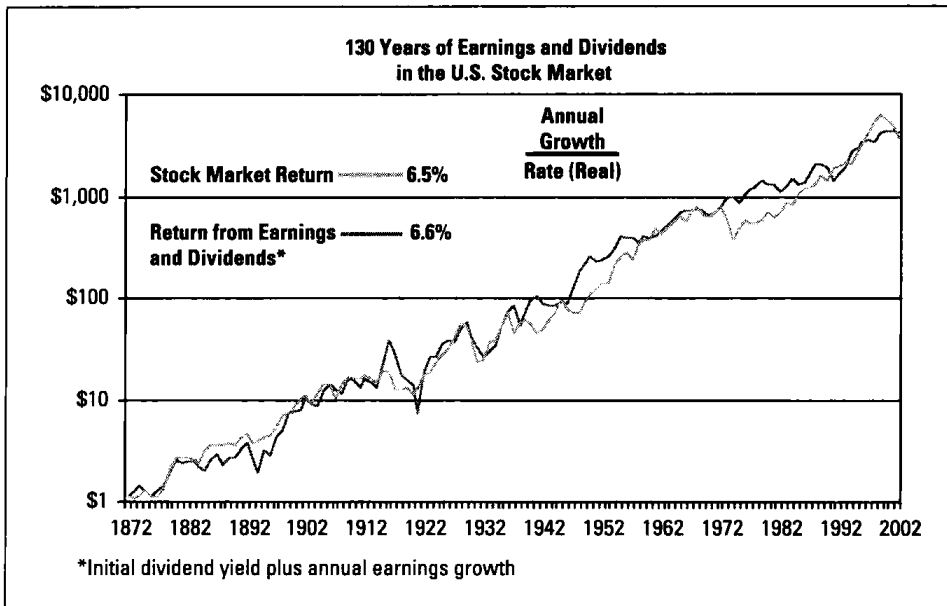
It is my duty to acknowledge that too many mutual fund managers fall into this latter group. By its lackadaisical

approach to investment analysis, this industry bears considerable responsibility for the boom and subsequent bust in the stock market. Way back in 1968, Columbia Law School Professor Louis Lowenstein observed that fund managers “exhibit a persistent emphasis on momentary stock prices. The subtleties and nuances of a particular business utterly escape them.” Since then, things have proceeded to get even worse. Annual mutual fund portfolio turnover, about 15 percent during the 1950s, had risen to 40 percent by the late 1960s. But that was only the beginning. Last year, the average turnover of the average fund was 110 percent, the culmination of our transition from an *own-a-stock* industry to a *rent-a-stock* industry. Indeed, when Oscar Wilde described the cynic as one “who knows the price of everything but the value of nothing,” he could have as easily been describing today’s mutual fund manager.

IT’S EARNINGS THAT COUNT

Returning the stock market to a solid footing will require mutual funds and other institutional shareholders to abandon their present focus on short-term speculation based on momentary stock prices and return to their traditional focus on long-term investing based on intrinsic corporate values. And since the value of a corporation depends—as it does, as it must, and as it always will—on the discounted value of its future cash flows, it follows that corporate earnings must be presented fairly, accurately, and dependably. It is here that this fine book by Hewitt Heiserman enters the field of play.

It’s Earnings That Count is a title well chosen. Of course it’s earnings that count! One need only look at the chart on page xvi comparing total stock market returns over the past 130 years with the returns created by corporate earnings growth and dividend yields to see the truth of that statement. While in the short run stock prices may vastly depart from these investment fundamentals, in the long run investment returns are all about earnings and dividends. Dividends, of course, are real. On the other hand, given the remarkably wide parameters of Generally Accounted Accounting Principles (GAAP), earnings have become whatever management wants them to be.



When earnings can't be managed to meet management's projections, just change the terminology. Move the focus from *reported* earnings to *operating* earnings, so that the write-offs of all those earlier foolish capital expenditures and unwise mergers are ignored. If that doesn't do the trick, report pro forma earnings that *exclude* all those "bad" experiences that are said to be nonrecurring and *include* all those "good" revenues, often both nonrecurring and undisclosed. And when operating earnings and pro forma earnings aren't good enough to meet the market's demands, report *fraudulent* earnings. Just "cook the books," and in the post-Enron environment, we've already seen far too many cases of fraud. We can only hope that the cheats receive tough jail sentences in hard penitentiaries for the crimes they have committed. But we should not forget that they have betrayed capitalism as well.

In the rules-based environment of GAAP, it has proven impossible for the *defense*—the public accountants and the directors, even if they are not co-opted by management, and the regulators, struggling with limited resources—to keep up with the *wily offense* so often waged by the CEO and his *eminence*

grise, the chief financial officer. When they control the numbers, the press releases, and the organization itself, they have the *opportunity* to report what they will. Too often our flawed system of executive compensation system gives them the *motive* to push those accounting “principles” to their very limit. And when opportunity and motive meet, don’t be surprised when things go badly awry in financial statements.

Simply put, the fact is that our accounting principles are broad enough to drive a truck through. And even if U.S. business were to move, as many thoughtful observers have suggested, from today’s *rules-based* system to the kind of *principles-based* system that exists in Great Britain, ample room will remain for maneuver designed to produce the best-looking results. One improvement that might be useful would be to have the corporation report *two* sets of earnings, one using the most favorable interpretations (in terms of enhancing earnings)—presumably close to what is reported today—and another using the *least* favorable interpretations (that is, if the tax rate were to rise to 90 percent, how *little* earnings could a company report?).

MEASURE THRICE, CUT ONCE

Even if that idea one day finds acceptance (an unlikely event!), Hewitt Heiserman’s concept of creating two alternative earnings statements makes consummate good sense. One is a *defensive* income statement that reveals the extent to which a company depends on outside sources of capital. The other is an *enterprising* income statement that reveals the company’s return relative to its total capital base, including stockholders’ equity. (Both can be constructed through information publicly available in corporate annual reports and 10-K and 10-Q reports to the U.S. Securities and Exchange Commission.)

The author properly credits others for these two concepts. But by combining them in his simple “Earnings Power Chart” methodology, he presents these two statements in a manner that is accessible to any serious investor who is willing to undertake the modest amount of analysis required. (In *The Intelligent Investor*, Benjamin Graham defines such an investor as the

“enterprising” investor, and the “defensive” investor as one who entrusts others with the responsibility for the stewardship of his assets. Heiserman’s terminology, while using a different context, provides a refreshing echo of Graham’s value-driven approach to stock selection.)

Do we really need *three* earnings statements? I don’t see why not. And when you read the author’s thoughtful case for these two supplements to the existing GAAP statement, I believe you’ll agree that they combine to make a sensible, logical case for intelligent stock selection. An ancient rule for the carpenter advises, “measure twice, cut once.” Since investors have much more at stake than a single piece of lumber when they select a stock, surely it makes good sense to evaluate a company’s earnings in all *three* dimensions—“*Measure thrice, cut once.*”

One can only marvel that this fine book was produced by a mere intelligent investor rather than an academic or an MBA-trained, experienced security analyst. Yet with so much of the investment world now focused on marketing rather than management, we shouldn’t be surprised. Wall Street is, as it always has been, a powerful (and, truth be told, necessary) machine designed to sell securities. And mutual fund managers have greater incentives to increase assets under management than to produce superior records. (After all, *all* managers have the ability to bring in money; only a small minority have the ability—or luck—to beat the market.) Those who were beneficiaries of the “happy conspiracy” that I described earlier had good reason not to point out that the reported earnings “clothes” of the stock market “emperor,” when they existed at all, left much to the imagination.

A PERSONAL NOTE

I must confess that I surprised myself when I agreed to write a foreword to this book on how analyzing earnings statements can improve stock selections. But this book is about much more than earnings quality. It is a wonderful catalog of what went wrong in corporate America, a theme with which I’ve been deeply concerned for the better part of a decade. The book also implicitly raises the question of what other institutional investors within

the financial system could have been thinking as the market madness went on. In that sense, *It's Earnings That Count* is a sort of poke-in-the eye both to those corporate leaders who abused our capitalistic system and to those financial pros who let them get away with it.

I want to be clear that my endorsement is not inconsistent with my philosophy as a dyed-in-the-wool “indexer”—a believer that since stock selection is not only a loser’s game but an expensive one, the best strategy for accumulation of equity capital is to own the entire stock market. And I reaffirm my view that buying a share in every company in America at minimal cost through an all-stock-market index fund, and holding it for Warren Buffett’s favorite holding period—*forever*—is the surest route to long-term investment success.

Nonetheless, for better or worse, nearly all investors love the challenge of matching wits with the market, and no matter what I advise, most investors are probably going to pick at least a stock or two. Using the principles in this book should give those investors a fighting chance to win the game—truly an awesome challenge. The author candidly and humbly acknowledges that he shares my view that “beating the market is hard,” and agrees with my own oft-stated philosophy that an all-stock-market index fund or other widely diversified stock portfolio should represent 95 percent of an investor’s equity assets. I endorse his advice that you follow his principles with no more than 5 percent of your equity assets during the first few years that you use them. If they work for you, “then maybe you double your bet, to 10 percent.”¹

Good luck!

John C. Bogle
Founder and former CEO, The Vanguard Group

About John C. Bogle

Mr. Bogle has worked in the investment management field since graduating magna cum laude from Princeton University in 1951 with a degree in Economics. In 1974 he created The Vanguard Group, Inc., which today has \$600 billion in assets. The Vanguard 500 Index Fund, the first of its kind, was conceived

by Mr. Bogle in 1975. In 1999 he received the Woodrow Wilson Award from Princeton University for “distinguished achievement in the Nation’s service.” That same year *Fortune* named Mr. Bogle one of the investment industry’s four “Giants of the 20th Century.” He is the author of four books, including *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor*, a best-seller since its publication in 1993. Mr. Bogle remains at Vanguard as president of the Bogle Financial Markets Research Center, where he continues to speak forcefully on the behalf of individual investors. Mr. Bogle is also chairman of the National Constitution Center, in Philadelphia, Pennsylvania.

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INTRODUCTION

In the winter of 1994 the New York Society of Security Analysts celebrated the one hundredth birthday of Benjamin Graham, the father of security analysis. Graham had died 18 years earlier, in 1976, but several of his friends, colleagues, former students, and admirers attended the event.

The highlight of the occasion was a question-and-answer session with three successful investors who had known Graham well. Irving Kahn, founder of Kahn Brothers & Co., Inc., and Warren Buffett, who had been a student of Graham's at Columbia University, as well as Walter Schloss, had all worked with Graham at one time or another. Buffett, who has been famous for owning just a few stocks at a time, asked by a guest toward the end of the session whether he was comfortable owning such a concentrated portfolio, replied that he'd be "even more comfortable if it were smaller because that would mean that I would like those securities even that much more. And there aren't that many wonderful businesses." Buffett paused, then blurted out: "A lot of great fortunes in the world have been made by owning a single wonderful business. If you understand the business, you don't need to own very many of them."¹

Buffett is right, of course. You can prosper handsomely by finding the right company and investing in its success for long-term profits. Microsoft Corporation is just one of the many success stories from the last decade. But how do you find that single wonderful business?

Many investors look for stocks of companies that keep making more and more money every year—a growth stock, in other words. If you own one Microsoft in your lifetime, the capital gains can bail you out of a lot of bad stock picks plus leave you with extra cash for the future.

Unfortunately, growth investing is tricky for three reasons.

First, growth stocks tend to be expensive because investors' optimism about a company's bright future often pushes the stock price beyond its true worth. Should these expectations change for the worse, the stock collapses under its own vertiginous weight. Look at Microsoft: After years of rapid growth in the 1990s its market value dropped by two-thirds in 2000.

Second, many promising growth companies get eclipsed when a competitor comes out with a better product. So these firms that once had so much potential become like meteors in the sky, burning brightly for a time and then flickering out because they can't adapt to changes in consumer preferences.

Third, a firm that appears to be profitable on its income statements, in the way that accountants define profits might, in fact, have low earnings quality. That's not to say that its earnings are misstated or inflated or that there is any evidence of fraud (although it's always a possibility). Instead, net income, without breaking a single law or accounting rule, can, upon close examination, prove to be less than it appears.

How can an investor determine earnings quality? That's where this book can help. Although I address the first two points—of valuation and competitive advantage—the main objective of *It's Earnings That Count* is to help you with point number three. Specifically, we will learn that the income statement in every annual report, 10-K and 10-Q has four substantive limitations. As a result, a company may be profitable in the traditional sense of the word but not have authentic earnings power. My advice is that you build two alternate income statements, a defensive income statement and an enterprising income statement.

- The defensive income statement reveals the degree to which a company depends on outside sources of capital and, in the extreme, the risk of going bankrupt. The defensive income statement matches the mindset of the defensive investor, for whom not losing money is paramount. (Think commercial banker.)
- The enterprising income statement assesses the return generated by all of a company's sources of capital, including stockholders' equity. The enterprising income statement appeals to the enterprising investor who wants to find a big opportunity before everyone else. (Think venture capitalist.)

Albeit valuable, even these two alternate perspectives have their own limitations. The defensive income statement is too defensive for the enterprising investor, the enterprising income