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Commentary

Market Opinions and Topics of Interest

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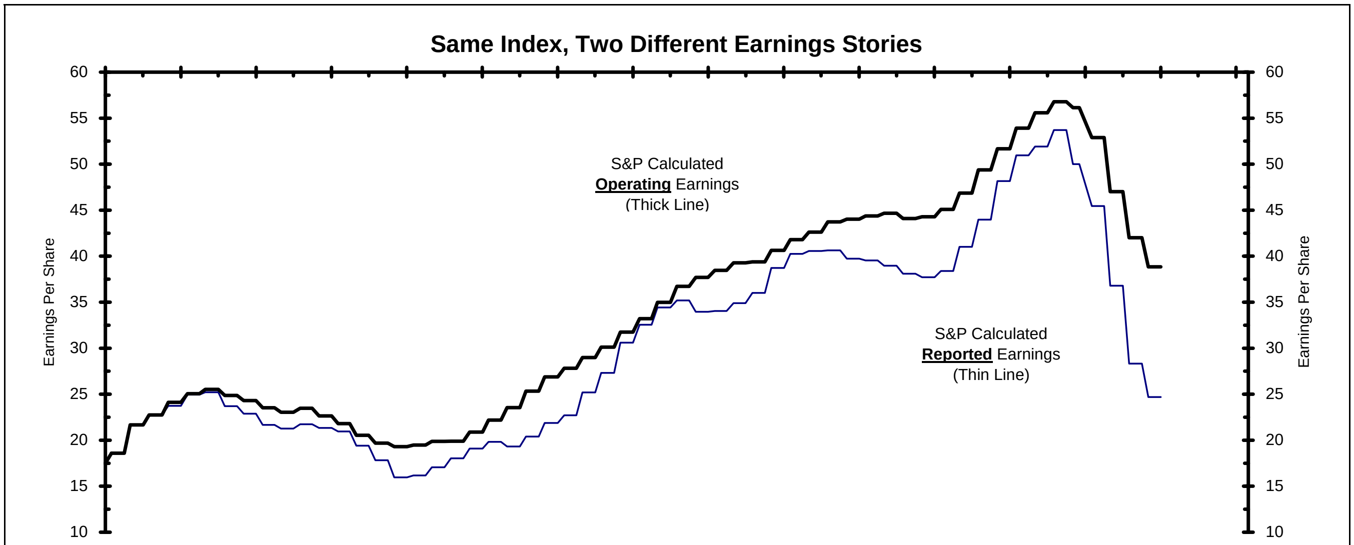
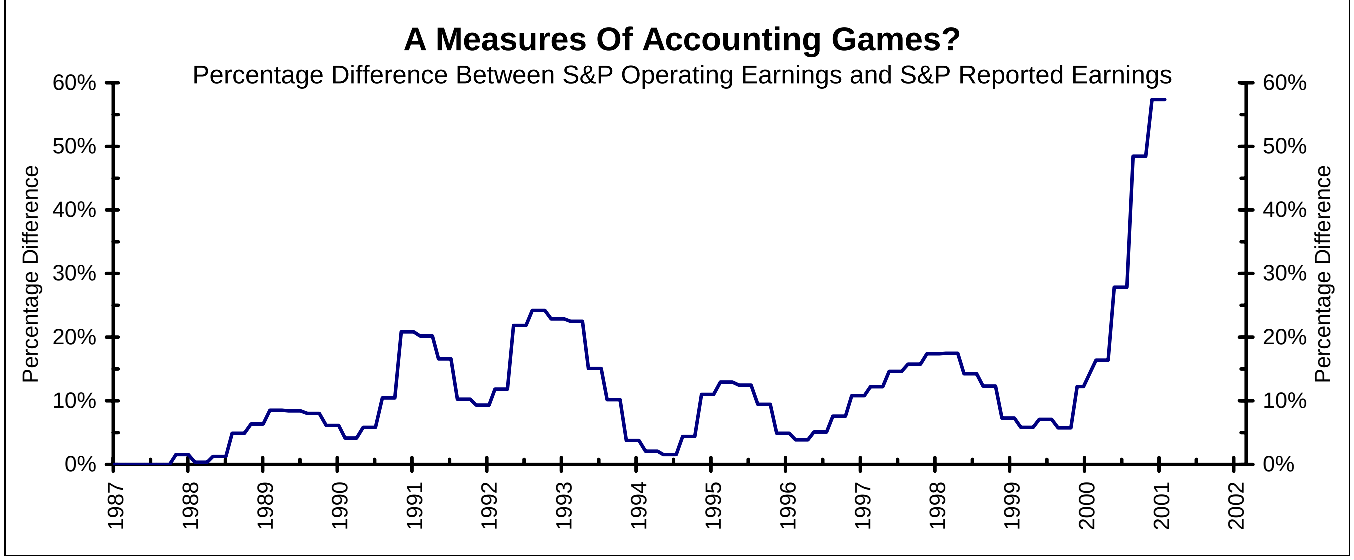
Is The Market Responding To The Accounting Scandals Rationally? A Look at "Reported" vs. "Operating" Earnings For The S&P 500

A dominant story in the market over the last few months has been the accounting scandals coming from corporate America. With the benefit of hindsight, it appears as if the problems at Enron last December were only the tip of the iceberg. How has the marketplace responded to this crisis? Is it discriminating between "suspect" and "non-suspect" companies or does it believe any company is the next potential "Enron of the week"?





What To Look At

Since the bull market (bubble) peak in early 2000, investors have become highly skeptical of many companies' financial statements. The belief is that companies are under so much pressure to meet earnings expectations that they will stop at nothing, including fraud, to "hit the number."

While this idea of "cooking the books" is hardly a new concept, every cycle has it own "signature" that makes it unique. This cycle's signature is the manipulation of "operating" net income versus reported net income.

"Reported Net Income" is net income according to GAAP (Generally Accepted Accounting Principles). "Operating Net Income" is net sales minus various "recurring" expenses but **excluding** "non-recurring" expenses. The problem with operating net income is that there is no uniform standard for calculating it. We use the standards set forth by Bloomberg when calculating individual companies' earnings and S&P when calculating earnings for the S&P 500.

The difference between these two measures for the S&P 500 is shown on the previous page. Notice that the divergence is the largest it has ever been (S&P began its operating net income measure in 1986). Not surprisingly, over 92% of all companies in the S&P 500 reported higher "Operating Net Income" than "Reported Net Income" this past quarter. This difference is so large because companies in the S&P 500 are targeting operating earnings and doing the things necessary to make this measure look as favorable as possible.

Comparing the "Top 100 Earnings Difference" Stocks to the S&P 500

	Percentage of Sector's Companies in the		
S&P 500 Sector	Top 100 Earnings Differences	S&P 500	Diff.
Basic Materials	4%	7%	-3%
Communications	20%	9%	11%
Consumer, Cyclical	3%	15%	-12%
Consumer, Non-cyclical	16%	18%	-2%
Energy	10%	6%	4%
Financial	18%	15%	3%
Industrial	6%	13%	-7%
Technology	14%	12%	2%
Utilities	9%	7%	2%
Sum	**100%**	**100%**	

What About Individual Companies?

Who is responsible for the huge difference between reported and operating earnings in the S&P 500? To find out, we compiled a study on the current list of S&P 500 companies. We subtracted a company's reported (GAAP) net income from operating net income (per Bloomberg definitions). **We then took this difference and divided it by the company's total sales in order to put these numbers into relative terms. By doing this, we are able to compare the much larger companies to smaller ones.**

After sorting the companies in the S&P 500 by this criterion, we constructed the tables shown in the appendix. It shows the 100 companies which had the largest earnings difference as a percentage of sales in the S&P 500. These 100 stocks account for roughly 19% of the S&P 500 on a market cap basis, so even by this measure they account for roughly one-fifth of the S&P 500.

Looking at this list, a couple of facts become evident. First, the communications sector is the largest component of the list. There are 20 different communications stocks in the "Top 100 Earnings Differences" of the S&P 500. This means that over 45% of **all** communications stocks in the S&P 500 are on this list.

The second largest component of this list is the financial sector. While it has 18 stocks in this list, that only makes up about 24% of **all** financial stocks in the S&P 500.

Based on percentages, the energy sector ranks second in number of stocks on this list. Roughly 35% of all energy stocks in the S&P 500 are in this list of 100.

On the opposite end of the spectrum, consumer cyclicals and industrial stocks are only seen sporadically throughout this list. Both sectors have under 10% of their entire weight in this list.

The table on this page sums up both the sector's weight in this list of the "Top 100 Earnings Differences" and the sector's weight in the S&P 500 overall. In essence, it helps to show which sectors are over-weighted or under-weighted in our index of the "Top 100 Earnings Differences."

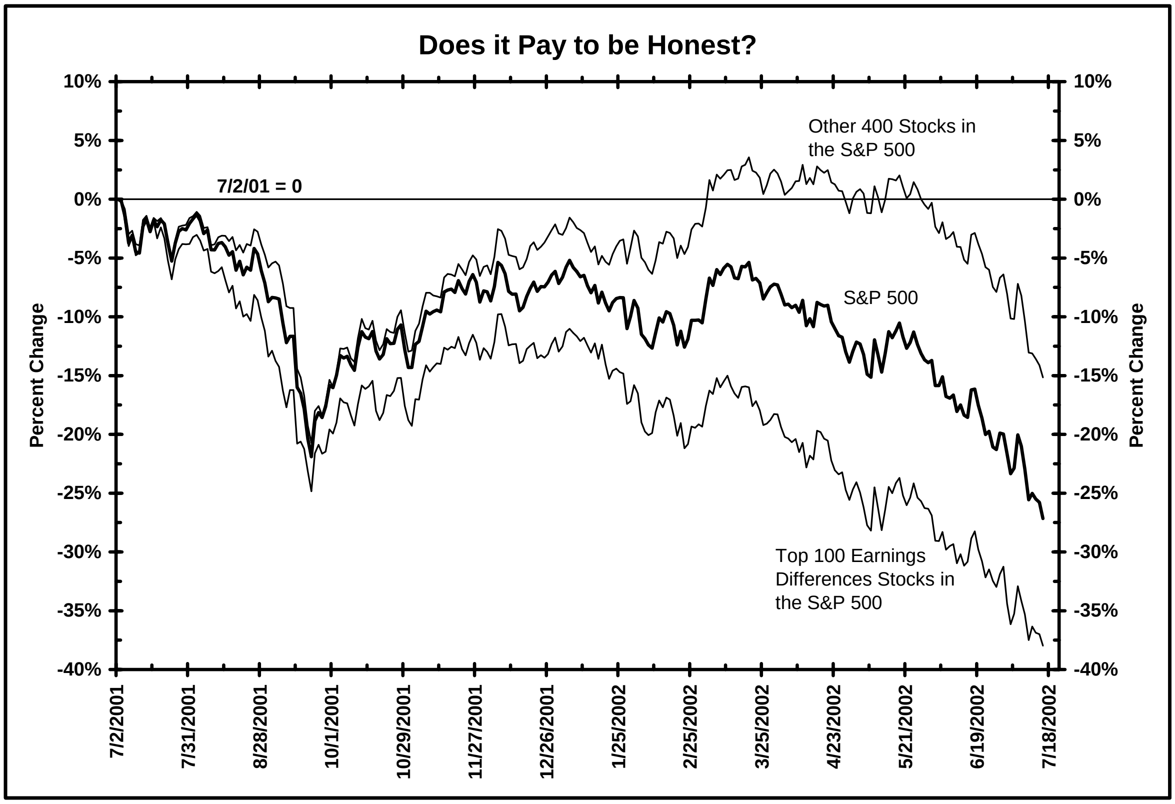
It appears as if the sectors that are under pressure by investors and the SEC for lackluster accounting standards (communications, financials, energy) are the most heavily represented on our list.

Does it Pay to be Honest?

After looking at this list in more depth, we began to wonder how these stocks were performing against the rest of the S&P 500. While we assumed they would be underperforming the rest of the index, the results we found surprised us.

In order to gauge how this list of stocks was performing on a relative basis, we created a couple of different indices. First we constructed a market capitalization weighted index of what we called the "Top 100 Earnings Differences Index" using the list of stocks shown in the appendix.

We then made an index of the "other 400 stocks" in the S&P 500. We did this simply so we could compare the "rest" of the S&P 500 to our "Top 100 Earnings Differences Index." The results are shown in the chart below.



On a year-to-date basis, the "Top 100 Earnings Differences Index" is down 28.73%. The other 400 stocks in the S&P 500 are only down 12.63%, while the S&P 500 is down 21.53%.

It appears as if the market is doing a fairly decent job of singling out the companies who have big gaps between reported and operating earnings.

Conclusion

The market appears to be acting rationally when it comes to the accounting scandals. Companies that have large differences between reported and operating earnings have been hit hard. These 100 stocks account for the bulk of the declines in the S&P 500 and are well below their September 2001 lows.

The other 400 stocks, while struggling, have only a fraction of the loss of the "Top 100 Earnings Differences Index." While these 400 stocks account for 80% of the names in the S&P 500, they have outperformed the rest by nearly 10%. Furthermore, these 400 stocks are still above their September 2001 lows. Should these stocks hold above this level, one could argue that the stock market, less the accounting scandal stocks, bottomed last year ahead of the expected recession end near January. This would be consistent with the stock market leading the economy.

Finally, the "Top 100 Earnings Difference" companies are having a big impact on the valuation of the S&P 500. As of Q1 2002, the P/E ratio (using reported income for the S&P 500) was an astronomical 52. When the "Top 100 Earnings Difference Index" is excluded, the reported earnings P/E ratio falls to 30. Currently, with the market down nearly 20% from its March 29 levels, the reported earnings P/E ratio is now 23. While 23 is still high, it is reasonable when compared to interest rates. Furthermore, should Q2 earnings "uptick" from Q1 levels, this P/E ratio could fall even further, making the "Other 400 Stocks" even more attractive buys.

Appendix

Top 100 "Earnings Differences" (as of Q1 2002)

	Stock Symbol	Company Name	Net Income (Millions of Dollars) Reported	Net Income "Operating"	Difference	Sales	Difference as a % of Sales
1	AMCC	Applied Micro Circuits Corp	-3,605.69	-606.11	2,999.58	152.84	1962.56%
2	JDSU	JDS Uniphase Corp	-56,121.90	-5,998.10	50,123.80	3232.80	1550.48%
3	PMCS	PMC - Sierra Inc	-639.05	-191.11	447.94	322.74	138.79%
4	BRCM	Broadcom Corp	-2,742.05	-1,462.28	1,279.77	961.82	133.06%
5	CIEN	CIENA Corp	-1,794.06	34.47	1,828.53	1603.23	114.05%
6	NT	Nortel Networks Corp	-27,302.00	-9,939.00	17,363.00	17511.00	99.15%
7	GLW	Corning Inc	-5,498.00	-275.00	5,223.00	6272.00	83.27%
8	QCOM	Qualcomm Inc	-548.74	607.54	1,156.28	2679.79	43.15%
9	ADCT	ADC Telecommunications Inc	-1,287.70	-334.20	953.50	2402.80	39.68%
10	DVN	Devon Energy Corp	103.00	1,323.00	1,220.00	3075.00	39.67%
11	EIX	Edison International	1,149.00	5,450.00	4,301.00	11436.00	37.61%
12	NXTL	Nextel Communications Inc	-2,625.00	54.00	2,679.00	7689.00	34.84%
13	LU	Lucent Technologies Inc	-16,198.00	-8,872.00	7,326.00	21294.00	34.40%
14	CNXT	Conexant Systems Inc	-1,445.33	-1,083.48	361.85	1062.56	34.05%
15	Q	Qwest Communications International	-4,023.00	2,018.00	6,041.00	19695.00	30.67%
16	APC	Anadarko Petroleum Corp	-181.00	2,228.00	2,409.00	8369.00	28.78%
17	WMB	Williams Cos Inc	-477.70	2,590.90	3,068.60	10725.80	28.61%
18	PDG	Placer Dome Inc	-133.00	197.00	330.00	1223.00	26.98%
19	APA	Apache Corp	723.40	1,404.19	680.79	2790.69	24.40%
20	ABK	AMBAC Financial Group Inc	432.91	609.58	176.67	724.92	24.37%
21	MBI	MBIA Inc	570.09	847.43	277.34	1140.75	24.31%
22	CNC	Conseco Inc	-405.90	1,486.20	1,892.10	7915.70	23.90%
23	MTG	MGIC Investment Corp	639.14	962.53	323.39	1357.84	23.82%
24	MCO	Moody's Corp	212.20	398.50	186.30	796.70	23.38%
25	FCX	Freeport-McMoRan Copper & Gold	113.03	536.75	423.72	1838.87	23.04%
26	NOVL	Novell Inc	-272.87	-40.64	232.23	1040.10	22.33%
27	BR	Burlington Resources Inc	561.00	1,269.00	708.00	3326.00	21.29%
28	AW	Allied Waste Industries Inc	58.49	1,238.27	1,179.78	5565.26	21.20%
29	PNC	PNC Financial Services Group Inc	377.00	1,841.00	1,464.00	6956.00	21.05%
30	UST	UST Inc	491.60	833.03	341.43	1633.04	20.91%
31	AES	AES Corp/The	273.00	2,182.00	1,909.00	9327.00	20.47%
32	CEG	Constellation Energy Group Inc	104.10	890.40	786.30	3928.30	20.02%
33	PPL	PPL Corp	231.00	1,341.00	1,110.00	5725.00	19.39%
34	KLAC	Kla-Tencor Corp	66.68	456.46	389.78	2103.76	18.53%
35	IPG	Interpublic Group Cos Inc	-505.30	740.60	1,245.90	6726.80	18.52%
36	UVN	Univision Communications Inc	52.42	216.43	164.01	887.87	18.47%
37	KG	King Pharmaceuticals Inc	217.94	378.34	160.40	872.26	18.39%
38	SLM	SLM Corp	384.00	1,123.08	739.08	4020.84	18.38%
39	GENZ	Genzyme Corp-Genl Division	8.05	187.72	179.67	981.93	18.30%
40	MDT	Medtronic Inc	984.00	2,149.00	1,165.00	6410.80	18.17%
41	RX	IMS Health Inc	185.43	425.23	239.80	1332.92	17.99%
42	SV	Stilwell Financial Inc	302.30	578.30	276.00	1555.70	17.74%
43	GLK	Great Lakes Chemical Corp	-289.50	-10.20	279.30	1594.70	17.51%
44	MXIM	Maxim Integrated Products	334.94	608.62	273.68	1576.61	17.36%
45	MSFT	Microsoft Corp	7,346.00	11,720.00	4,374.00	25296.00	17.29%
46	BLS	BellSouth Corp	2,570.00	6,699.00	4,129.00	24130.00	17.11%
47	VZ	Verizon Communications Inc	389.00	11,882.00	11,493.00	67190.00	17.11%
48	LSI	LSI Logic Corp	-991.96	-689.37	302.59	1784.92	16.95%
49	EFX	Equifax Inc	122.50	314.20	191.70	1139.00	16.83%
50	PWER	Power-One Inc	-185.90	-124.98	60.92	363.73	16.75%

	Stock Symbol	Company Name	Net Income Reported (Millions of Dollars)	Net Income "Operating" (Millions of Dollars)	Difference (Millions of Dollars)	Sales (Millions of Dollars)	Difference as a % of Sales
51	WPI	Watson Pharmaceuticals Inc	116.36	302.75	186.39	1160.68	16.06%
52	CZN	Citizens Communications Co	-83.47	294.95	378.42	2456.99	15.40%
53	AMGN	Amgen Inc	1119.7	1737	617.30	4015.70	15.37%
54	HLT	Hilton Hotels Corp	166	632	466.00	3050.00	15.28%
55	KMI	Kinder Morgan Inc	225.07	384.32	159.25	1054.92	15.10%
56	ADBE	Adobe Systems Inc	205.64	390.52	184.88	1229.72	15.03%
57	CD	Cendant Corp	385	1703	1,318.00	8950.00	14.73%
58	AOL	AOL Time Warner Inc	-4921	703	5,624.00	38234.00	14.71%
59	CMA	Comerica Inc	709.58	1323.12	613.54	4232.65	14.50%
60	AIG	American International Group	5363	13833	8,470.00	58944.00	14.37%
61	HRC	Healthsouth Corp	202.39	825.09	622.70	4380.48	14.22%
62	HRB	H&R Block Inc	281.16	707.62	426.46	3001.57	14.21%
63	FITB	Fifth Third Bancorp	1093.77	1994.41	900.64	6463.64	13.93%
64	BK	Bank of New York Co Inc/The	1343	2315	972.00	7091.00	13.71%
65	MIL	Millipore Corp	31.12	119.11	87.99	656.90	13.39%
66	USB	US Bancorp	1706.5	3900.6	2,194.10	16380.80	13.39%
67	TRB	Tribune Co	111.14	802.23	691.09	5253.37	13.16%
68	SAFC	Safeco Corp	-989.2	-89.2	900.00	6862.50	13.11%
69	TROW	T Rowe Price Group Inc	195.87	330.59	134.72	1027.50	13.11%
70	HOT	Starwood Hotels & Resorts Worldwide	145	665	520.00	3967.00	13.11%
71	FBF	FleetBoston Financial Corp	931	3409	2,478.00	19087.00	12.98%
72	WAT	Waters Corp	114.54	224.53	109.99	859.21	12.80%
73	GDT	Guidant Corp	484	828.5	344.50	2707.60	12.72%
74	EOG	EOG Resources Inc	398.62	595.08	196.46	1556.20	12.62%
75	HPC	Hercules Inc	-58	270	328.00	2620.00	12.52%
76	EXC	Exelon Corp	1477	3362	1,885.00	15140.00	12.45%
77	PBI	Pitney Bowes Inc	488.34	996.9	508.56	4122.47	12.34%
78	LLTC	Linear Technology Corp	427.46	546.28	118.82	972.62	12.22%
79	NE	Noble Corp	262.92	384.29	121.37	1002.33	12.11%
80	FE	FirstEnergy Corp	718.51	1685.12	966.61	7999.36	12.08%
81	GCI	Gannett Co Inc	831.2	1589.84	758.64	6344.24	11.96%
82	MMC	Marsh & McLennan Cos Inc	974	2159	1,185.00	9943.00	11.92%
83	KMG	Kerr-McGee Corp	486.4	917.3	430.90	3638.00	11.84%
84	DIS	Walt Disney Co	-158	2832	2,990.00	25269.00	11.83%
85	D	Dominion Resources Inc/VA	642	1890	1,248.00	10558.00	11.82%
86	GDW	Golden West Financial Corp	812.8	1332	519.20	4446.35	11.68%
87	BMET	Biomet Inc	197.55	316.79	119.24	1030.66	11.57%
88	BAX	Baxter International Inc	612	1493	881.00	7663.00	11.50%
89	CEFT	Concord EFS Inc	216.41	412.66	196.25	1707.00	11.50%
90	FON	Sprint Corp-FON Group	-147	1789	1,936.00	16924.00	11.44%
91	ORCL	Oracle Corp	2561.1	3777.09	1,215.99	10859.67	11.20%
92	BNI	Burlington Northern Santa Fe Corp	731	1755	1,024.00	9208.00	11.12%
93	AWE	AT&T Wireless Services Inc	-887	598	1,485.00	13610.00	10.91%
94	OXY	Occidental Petroleum Corp	1154	2667	1,513.00	13985.00	10.82%
95	LMT	Lockheed Martin Corp	-1046	1543	2,589.00	23990.00	10.79%
96	AEE	Ameren Corp	480.99	965.04	484.05	4505.87	10.74%
97	HET	Harrah's Entertainment Inc	208.97	605.84	396.87	3709.04	10.70%
98	PEG	Public Service Enterprise Group Inc	842	1892	1,050.00	9815.00	10.70%
99	TMK	Torchmark Corp	356.51	645.93	289.42	2707.04	10.69%
100	ABT	Abbott Laboratories	1550.39	3224.44	1,674.05	16285.25	10.28%

Top 100 "Earnings Differences" (as of Q1 2002)

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