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Equity Investments

The Adjusted Earnings Yield

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Abstract

The earr... frequently
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level. The research reported here identified an adjusted earnings yield as an intuitively appealing approach to estimating real expected return.

An accounting adjustment and a debt adjustment are both necessary to convert reported earnings into a measure of real profitability. The accounting adjustment converts reported earnings into a current-cost (or replacement-cost) accounting system. The debt adjustment corrects for the impact that inflation has on the real value of creditor claims. Adjusted earnings are, then, the sum of reported earnings, the accounting adjustment, and the debt adjustment. The adjusted earnings yield, determined as the ratio of adjusted earnings to equity value, ensures that real return is determined as a ratio of current-period prices.

Using freely accessible and publicly disseminated data, I created an adjusted-earnings-yield series for the U.S. equity market. I used a predictive regression model to test the hypothesis that this valuation measure is superior to other commonly used valuation measures as a predictor of future real equity returns. Statistical tests confirm that it is, indeed, a better measure, particularly when the goal is to forecast near-term real returns.

The article also provides evidence that the accounting and debt adjustments made to reported earnings are each important considerations if the goal is to accurately forecast real equity returns. Results of the predictive regression models indicate that the coefficie— —ignificant for all the ti— —djustment variable— —ession results s— —tment, the debt adj— —with future real retu— —horizon.

An e— —the high real retur— —ionally. The results o— —explanation of why r— —recognized that trac— —ield, were misstati— —o be somewh— —sidered.

The adjusted earnings yield suffices as a stand-alone measure of real expected return, and investors should be most concerned with its level. As of the third quarter of 2006, the adjusted-earnings-yield series developed for the U.S. equity market was predicting a real return of 6.1 percent. But forecasts change quarterly with the arrival of new data, and the current economy raises some concerns. Recent trends in fixed capital investment and borrowing suggest a slowing of the U.S. economy, which may adversely affect share prices.

Notes

[1] In his 1984 annual letter to investors in Berkshire Hathaway, Warren Buffett wrote that for companies with outstanding businesses, solid financials, and an undervalued stock, "no alternative action can benefit shareholders as surely as share repurchases." (Available online at http://www.berkshirehathaway.com/letters/1984.html.)

[2] Mauboussin cited corporate reports, Empirical Research Partners, Bernstein Research, FactSet Research Systems, and Legg Mason Capital Management estimates as sources for these data.

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[4] Credit   ). They identifie   the importa   tions. The prese   thematical simp   rate assump   ohn debt adjustm   ), as noted in the pr

[5] Becaus   the BEA uses the   ods.

6 An important benefit of using tax-accounting earnings data is that companies have an obvious incentive to be conservative in reporting their taxable income. Therefore, to assume these types of earnings estimates are of higher quality than reported earnings is reasonable. Desai (2003) found substantial differences between book income and tax income.

7 The match between the BEA and Federal Reserve data appears to be good but not perfect. I assumed that any differences between BEA and Federal Reserve data are minor and can be ignored.

8 The BEA switched from a fixed-base-year method to simplified chain weighting in 1995, primarily because of a dramatic fall in computer prices. The BEA calculates growth for a year itself and for the preceding year. The chain-weighted growth for a year is an average of the two.
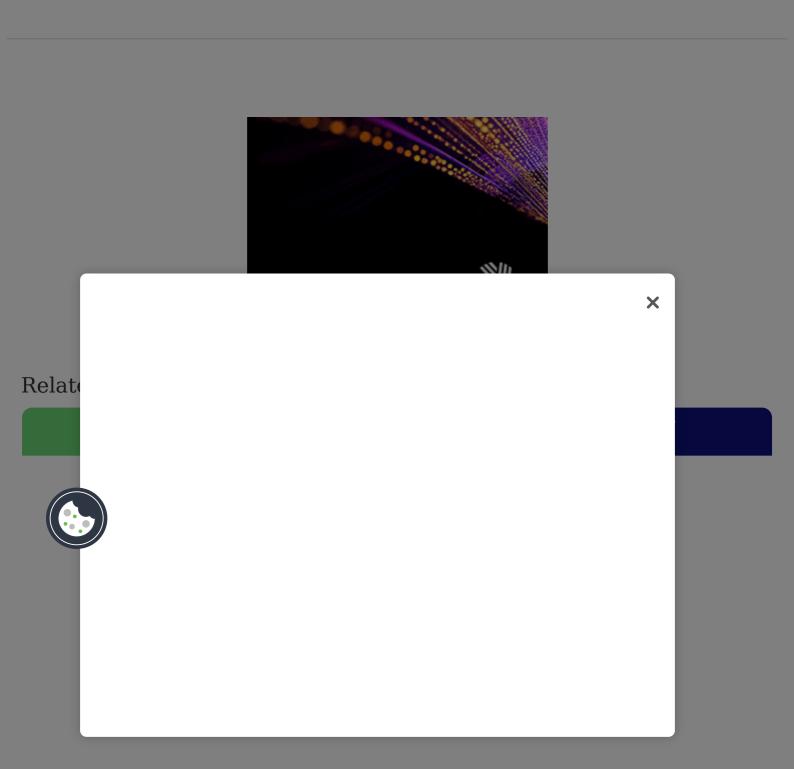
9 All the regressions in this section were also carried out with real returns for the S&P 500 used as the dependent variable, with results that are substantially the same as those reported for the CRSP value-weighted index.

10 Comparisons with Shiller's work in this study were included primarily at the request of an anonymous referee. No criticism is intended, and all readers should understand that I view Shiller's contributions as very valuable and timely. My views are similar for the cont

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[13] The real return computation used the chain-weighted GDP price index to deflate the quarterly values of the CRSP value-weighted index. Siegel used various indices to determine returns and the CPI to adjust for inflation.

[14] Accelerated depreciation methods for tax accounting have been in place since 1954. The current Modified Accelerated Cost Recovery System has been in place since 1986 (with some revisions). Following the terrorist attacks of 11 September 2001, the U.S. Congress enacted the Job Creation and Worker Assistance Act of 2002, which temporarily changed how depreciation is charged for property acquired after 10 September 2001 and before 11 September 2004 and was put in service before 1 January 2005. The act gave companies the option of charging an additional 30 percent of their original basis to Year 1 depreciation.

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