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FAIR GAME

Why All Earnings Are Not Equal

By GRETCHEN MORGENSON

AFTER a rip-roaring performance in 2009, the stock market has continued its upward climb. A reason to celebrate? Sure. But also a good time to check whether a company in which you have a stake keeps its books in a way that reflects reality.

When the market is roaring and the economy isn't, executives come under increased pressure to make sure that their companies' results justify higher valuations. That's why smart investors keep an eye on them, by scrutinizing how their profits are figured.

Such is the view of Robert A. Olstein, a veteran money manager who dissects financial statements to uncover stocks he thinks other investors are valuing improperly. Since 1995 he has overseen the Olstein All-Cap Value fund, and although he had a horrific 2008 (down 43 percent), his 14-year results exceed the Standard & Poor's 500-stock index by an average of 3.25 percent annualized, net of fees.

Mr. Olstein's 2008 troubles have made him more determined than ever to scrub companies' results. "As the market goes higher, it becomes more important to measure the quality of corporate earnings," he said. "You have to look behind the numbers."

Adjustments that investors need to make now, in Mr. Olstein's view, are a result of disparities between a company's reported earnings and its excess cash flow. Earnings are what investors focus on, but because these figures include noncash items, based on management estimates, the bottom line may not tell the whole story.

Cash flow, on the other hand, is actual money that a company generates and that its managers can use to invest in the business or pay out to shareholders.

SOME of the widest gulfs between earnings and cash flows, Mr. Olstein said, are showing up the ways companies account for capital expenditures.

To ensure growth, companies invest in things like new facilities or additional equipment. As time goes on, plants and equipment lose value — the way a car does the moment you drive it away from the dealer — and companies are allowed to write off a portion of these values each year based on management estimates of how long they will generate revenue.

Minding the gap between profits and cash flow.

The write-offs are known as depreciation, and the more a company chooses to write off, the greater its earnings are reduced. So managers interested in plumping their profits may depreciate less than they otherwise would or should. Conversely, heavy depreciation amounts can make earnings appear more depressed than the company's cash flows indicate.

"It's an investor's job to determine the economic realism of management's assumptions," Mr. Olstein said. "There is nothing illegal here, but maybe their depreciation assumptions are unrealistic."

One way to assess the accuracy of management's estimates is to compare, over time, how much a company spends on new plant and equipment and how much it deducts in depreciation each year. Some of the discrepancies that emerge can be temporary, caused by the lag time between an initial investment and subsequent write-downs for depreciation.

Companies in a growth phase, for instance, will show greater capital expenditures than depreciation as they increase investments in plant and equipment.

But that should be only temporary. If such discrepancies appear on a company's books year in and out, then investors might well question the depreciation assumptions. Investors confronted by large disparities should discount those companies' earnings by the amount of excess capital expenditures. Such an exercise reveals how much free cash flow is available to stockholders.

Conversely, if depreciation exceeds capital expenditures, Mr. Olstein says that the earnings at these companies are actually better than they appear — and that this shows up in the cash flows.

Mr. Olstein has spotted several companies whose depreciation and capital expenditures have shown significant discrepancies in recent years. For some, heavy depreciation schedules are punishing earnings temporarily. At other companies, modest depreciation means earnings look better than cash flows.

The performance data quoted represents past performance and does not guarantee future results. The Olstein All Cap Value Fund's Class C average annual return for the ten-year, five-year, and one-year periods ended 12/31/09, assuming reinvestment of dividends and capital gain distributions and deduction of the Olstein All Cap Value Fund's maximum CDSC during the one-year period, was 3.52%, -2.64%, and 36.01%, respectively. As of 10/31/09, the expense ratio for the Olstein All Cap Value Fund Class C was 2.33%. Expense ratios for other share classes will vary. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than performance quoted. To obtain performance data current to the most recent month end please go to our website at www.olsteinfunds.com. Performance for other share classes will vary due to differences in sales charge structure and class expenses.

Two retailing companies provide examples of how depreciation can hurt earnings but mask solid cash flows. They are Macy's and Home Depot, and both are coming off recent expansion programs that are still being felt in the financials, Mr. Olstein said. He owns both in his fund.

Macy's earned just a penny a share in the first nine months of 2009 but generated per-share cash flow of $1.41. Home Depot posted per-share profits of $1.40 for the period, while its cash flow reached $1.87 a share.

The flipside is represented by companies like railroads where depreciation is not keeping up with spending. Railroad operations are capital intensive, to be sure, but for the last four years, some companies' expenditures have exceeded their write-downs by significant margins.

For instance, Union Pacific put $3.64 a share into capital expenditures in the first nine months of 2009. But its depreciation during that period totaled just $2.12 a share. In 2008, the company spent $5.40 a per share in capital expenditures compared with $2.69 in depreciation. Since 2005, Union Pacific has recorded $17.81 a share in capital spending but has depreciated about half that much — just $9.54 a share.

"The railroads are not bad businesses, but their stocks are overpriced when you look at what their cash flows are," Mr. Olstein said. For the first nine months of last year, Union Pacific's free cash flow was 99 cents a share; earnings were $2.51.

Another company with a sizable gap between depreciation and capital expenditures is the Carnival Corporation, the cruise ship company. Over the last four years, it has spent $16.48 a share on assets but it has written down just $6.01 a share.

Donna Kush, a Union Pacific spokeswoman, said it's common for capital spending to exceed depreciation in her industry. "When you have long-life assets, you will have a mismatch," she said, "because we need to constantly upgrade for safety and to serve our customers."

And David Bernstein, chief financial officer of Carnival, said that at some point his company's growth would wind down and its capital expenditures and depreciation would be more aligned. But in the meantime, he said, it is "simplistic" to expect the two figures to match up.

Still, Mr. Olstein said consistent gulfs between capital spending and depreciation should concern investors. "If it keeps on deviating then you have to look at why," he said. "You have to reconcile the differences or the market will do it for you."

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