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The myth of smooth earnings

Many executives strive for stable earnings growth, but research shows that investors don't worry about variability.

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Executives like their earnings smooth—even in normal times, they will go to great lengths to achieve steady growth in earnings per share quarter after quarter. As the economy emerges slowly from recession, we encounter even more deference to the conventional wisdom that investors prefer smooth earnings growth and shun earnings volatility. Those who make such claims have long cited stable earnings growth as a rationale for strategic actions. In 2002, for example, the CEO of Conoco justified that company's then pending merger with Phillips Petroleum in part by asserting that the deal would provide greater earnings stability throughout the commodity price cycle.

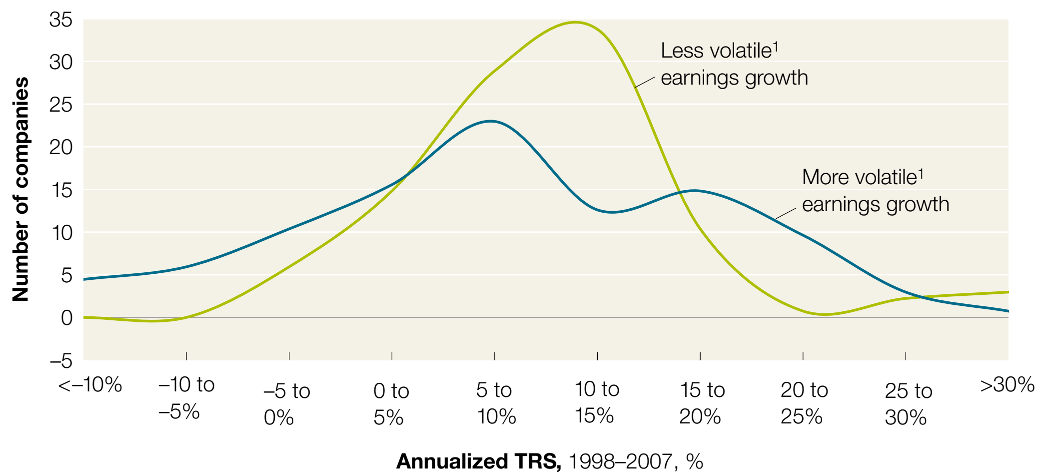
Our research shows that these efforts aren't worthwhile and may actually hurt companies pursuing them. If investors really preferred smooth earnings, you would expect companies that achieve them to generate higher total returns to shareholders (TRS) and to have higher valuation multiples, everything else being equal. Yet using different techniques, company samples, and time frames, all the studies we examined[1] reached the same conclusion: there is no meaningful relationship between earnings variability and TRS or valuation multiples.

To illustrate these findings, we compared the TRS of 135 companies with above-average earnings volatility and the TRS of 135 companies with below-average volatility (Exhibit 1). While the median return of the low-volatility companies is higher, the statistical significance

Exhibit 1

Earnings volatility and TRS are not linked.

Distribution of large, nonfinancial US companies by total returns to shareholders (TRS)



[1] Based on difference between each company's second-highest and second-lowest levels of growth during the 10-year period; 135 companies in each category.

of the disparity vanishes when we factor in growth and returns on capital. More interesting, however, is the fact that plenty of low-volatility companies have low TRS, just as plenty of high-volatility companies have high returns. You can also see that the very volatile companies have more extreme TRS results.

Investors, we believe, realize that the world isn't smooth. How could a company with five different businesses in ten different countries achieve a smooth 10 percent annual earnings growth for years? The chances of unexpected positive results in one area exactly offsetting unexpected negative results are slim. The chances that each business performs exactly as planned are even slimmer. In fact, sophisticated investors tell us they get suspicious when earnings growth is too stable, since they know that isn't how the world works.

Part of the explanation for the results of our research is that smooth earnings growth is a myth; almost no companies have it. Exhibit 2 shows five that were among the least volatile 10 percent of all large companies by earnings growth from 1998 to 2007. The one with the most stable earnings was Walgreens, with annual earnings growth between 14 and 17 percent from 2001 to 2007. But after Walgreens, we quickly ran out of companies to compare. We looked at 500 others and couldn't find any with seven such years of steady earnings growth. In fact, we could find only a handful of cases where it held steady for at least four years.

Most low-volatility companies follow a similar pattern. Anheuser-Busch, for example, had four years of steady growth, around 12 percent, from 1999 to 2002. Then, after 7 and 8 percent growth in 2003 and 2004, respectively, the company's earnings dropped by 18 percent in 2005. This pattern is common. Of the 500 companies we examined, 460 experienced at least one year of earnings decline during the period.

Investors expect the natural volatility associated with industries in which companies participate. In some cases, such as gold-mining companies, investors actually want exposure to changing prices. Companies therefore shouldn't try to reduce natural volatility, especially if it means reducing expenses like marketing and product development.

Nor should they try to reduce volatility through more diversified corporate portfolios. The argument for them is that different businesses have different business cycles, so earnings at the peak of one business's cycle will offset the lean years of other businesses, thereby stabilizing a company's consolidated earnings. If earnings and cash flows are smoothed in this way, the reasoning goes, investors will pay higher prices for the company's stock.

Exhibit 2

Even among the least volatile companies, earnings growth is rarely smooth.

Earnings growth of the 5 least volatile companies,[1] 1998–2007, %

	Walgreens	Anheuser-Busch	Colgate-Palmolive	Cisco	PepsiCo
1998	23	5	13	7	31
1999	16	13	9	12	1
2000	24	11	12	25	4
2001	14	12	7	32	22
2002	15	11	7	14	22
2003	15	7	10	14	8
2004	16	8	–6	17	16
2005	16	–18	2	7	–2
2006	14	7	0	–12	37
2007	17	8	28	18	–2

[1] Among the 500 largest, nonfinancial US companies; earnings defined as net income before extraordinary items, adjusted for goodwill impairment.

The facts refute this argument, however. First, we haven't found any evidence that diversified companies actually generate smoother cash flows. When we examined the 50 companies from the S&P 500 with the lowest earnings volatility from 1997 to 2007, we found fewer than 10 that could be considered diversified, in the sense of owning businesses in more than two distinct industries. Second, and just as important, we found no evidence that investors pay higher prices for less volatile companies. In our regular analyses for our clients, we almost never find that the summed values of the business units of a diversified company differ substantially from its market value.

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Investors expect the natural volatility associated with the industry in which a company participates. Instead of trying to manage volatility, senior executives should spend their time making decisions that fundamentally increase a company's revenues or its returns on capital.

[1] See Brian Rountree, James P. Weston, and George Allayannis, "Do investors value smooth performance?" *Journal of Financial Economics*, December 2008, Volume 90, Number 3, pp. 237–51; John M. McInnis, "Earnings smoothness, average returns, and implied cost of equity capital," *Accounting Review*, January 2010, Volume 85, Number 1, pp. 315–42; and Ronnie Barnes, "Earnings volatility and market valuation: An empirical investigation," LBS Accounting Subject Area working paper, ACCT019, November 2002.

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