# [“Was Peter Lynch Right? – Does Earnings Performance Drive Stock Performance?”]

Jul 28, 2020
by GEOFF GANNON

I’m writing today’s Focused Compounding daily from a Best Western in Kansas. By the time you read this, I may already be back in Plano. Today will complete this short – only like four days total – research road trip by me and Andrew. We spent some time in New Mexico, Arizona, and Kansas basically.

While on this trip, I’ve been re-reading some books by a guy who did a lot of these sorts of trips: Peter Lynch. Lynch isn’t exactly a value investor. So, some of the things he says can be particularly interesting for a value investor to hear. One of the most interesting things he says repeatedly is that – in the long run – stock performance tracks earnings performance. So, you just find the stocks that are going to grow earnings a lot over the next 5, 10, 15 years. And then you make sure those stocks don’t have crazy high P/E ratios today. And then you buy them.

This part about how earnings performance drives stock performance tends to be true in the very long run. If you look at list of 100-bagger stocks, they are basically lists of 100-bagger businesses in terms of profits and even earnings per share. You don’t have many 100-baggers where earnings went up only 10 times but the stock went up 100 times. Usually, you need the two working together. So, yes, the multiple goes up 5 times, but the earnings go up 20 times. Or, the multiple triples and earnings increase 30-40 times. There aren’t a lot of pure value stocks on a list of 100-baggers. Nor, actually, are there as many pure growth stocks as you’d think. If a growth stock is something with a P/E of 50, or 75, or 100 – that’s not where hundred baggers usually come from. If it’s a very fast growing business with a P/E of 30 – then, yes, plenty of 100-baggers do come from stocks as expensive as that.

The problem for investors – even pretty long-term investors – is that, in some stocks, the tracking of earnings and price is very weak. In an earlier article, I mentioned FICO (FICO). Over the last 10 years, measures of things like sales per share, earnings per share, free cash flow per share, etc. have basically tripled. Meanwhile, the market cap of the stock has increased about 10 times. The P/E went from about 15 to about 50. Price-to-sales from like 1.5 to 7.5.

The risk for the investor is, of course, that he thinks of the multiple expansion the same way as the earnings growth. Investors rarely tell themselves I bought a stock that increased EPS at 15% a year for 10 years and I bought it at a pretty low starting price (let's say 15 times P/E). So, I've done well in this stock because I bought in at a P/E of 15 and it grew EPS at 15% a year for a long time. Instead, they have one other bit of information that can be dangerous: they know the combined result of multiple expansion and contraction with earnings growth or shrinkage. So, they know when a stock has compounded at 30% a year even when earnings have only compounded at 15% a year, and they give themselves credit for that.

Is this a bad way of thinking about stocks though?

I've talked about the "Davis Double Play". You buy a stock with a P/E that you expect to expand over time and with earnings that you expect to expand over time. This, in fact, is where 100-baggers tend to come from. I think it's a little aggressive to swing for a stock that returns 100 times your money in it. They are – outside of decades with a lot of inflation – pretty rare even over long holding periods. They're good subjects to study. Because, even if that 100-bagger had worked out pretty differently – it still would've worked out as an amazing stock. So, reverse engineering 100-baggers makes a lot of sense in terms of studying the past. In terms of aiming for future returns – I think aiming for 10-baggers over 15 years is actually a realistic target. You'll miss it a lot. But, it gives you something realistic and long-term to aim for. Ten baggers are also a lot less rare than 100-baggers. It isn't difficult to identify some stocks that might turn every $1 you put into them today into $10 by about 15 years from now. Aiming for a 10-bagger in fifteen years would be like aiming for returns of 16-17% a year. There are differences in actual returns based on whether it become a 10-bagger in year 14, 15, 16, etc. of course. Plus, there are pretty meaningful differences between trying to make 16-17% a year by turning over all your stocks (trading your entire portfolio) every year versus holding one stock for 15 years that compounds at 16-17%. But, this is a realistic target for someone applying a Peter Lynch or Warren Buffett or Phil Fisher or Shelby Davis type approach. Think 15 years out and think 15%+ annual returns.

The relationship between stock price and earnings over a 15-year period will not be perfect. In some stocks, it's not even all that strong.

I've seen stocks where EPS grew about 11% a year and the multiple expanded about 6% a year for the result of a 10-bagger in about 15 years. Sometimes, the P/E starts out normal – like in the FICO case – and gets absurd by the end. Other times, the P/E starts out too low and gets more normal over time. There are stocks that used to trade around 5-7 times earnings year after year that suddenly start trading at 15-20 times a year and never look back. I've seen this a bunch of times in very small, very boring stocks. But, it seems to happen most often when the business is pretty predictable. When a very small stock graduates to being more of a medium sized stock, the predictability of its past earnings performance – like the fact it has grown sales, earnings per share, etc. every single year in a row – becomes very important in setting the P/E multiple. For whatever reason, this seems much less true of tiny stocks. Business quality seems to be rewarded with very high multiples among big stocks. But, business quality among tiny stocks doesn't seem to set the multiple at a higher level than among other tiny stocks. I don't know why this is. Maybe investors see all smaller stocks as more speculative and all bigger stocks as less speculative and they only look for quality among "investments" not among "speculations".

Sometimes, the relationship between a stock's earnings and price is much stronger. Let's take another business – I've mentioned this one before – that has some similarities on the surface to FICO. That stock is called Hingham (HIFS). It's a bank in

New England. I bring this stock up, because – over the last 10 years – many of its metrics have grown along the same sort of trend as FICO. The most basic number for a bank is stuff like deposits – not sales (revenue is skewed by

interest rate moves, so it's a less "pure" measure of business growth in banking than deposits). So, how fast has Hingham's balance sheet been growing? Stuff like deposits, loans (or "earning assets" in total), etc. have grown like 11-12% a year for the last decade. That means the underlying business has been growing faster than FICO. FICO's revenue – NOT revenue per share – has only grown in the single digits. However, FICO has bought back stock. And its margins have widened. And its multiple has expanded. The P/E multiple part is important there. FICO went from a P/E of like 15 to a P/E of like 50. Meanwhile, Hingham went from a P/E of like 9 to a P/E of like 12. This is a huge difference. And it brings up the potential problem with the Peter Lynch approach – which I don't think is much of a problem of all.

Wouldn't a BUSINESS analysis of both Hingham and FICO done in 2010 suggested – even if it was a very, very accurate business analysis – that the 10-year future for these two businesses would look very similar. I picked Hingham and FICO for a reason. Both have grown at meaningful but not unbelievable rates these past 10 years. Both are tied to credit expansions. Some of the growth was obviously very cyclical. But, they were both cheap in 2010. The question is: are the two stocks equally attractive now even if their futures are equally attractive.

I'd say no. Hingham's future as a stock looks more interesting to me. That's because the P/E there is 12 and the P/E on FICO is more like 54. If FICO's stock price fell 50% at the same time Hingham's stock price doubled – Hingham would still be a bit cheaper than FICO. So, I'd suggest investors focus on a stock like Hingham instead of a stock like FICO. In other words, I'd say the next 10 years could have a big divergence in the stock performance of FICO and Hingham even if there is not a big divergence in the business performance.

That isn't too troubling a thought if it happens one time, right? It's an anomaly. But, let's think for a second about why I believe Hingham and FICO could have very different stock performances over the next 10 years even if they end up having pretty similar business performances.

The reason is that they ALREADY have had really different stock price performances as compared to business performances. Let's pretend I am somehow clairvoyant over a period of ten years looking forward. FICO and Hingham both grow their business nicely and consistently and quickly (but by growth stock standards, kind of moderately) over the next 10 years. FICO stock vastly underperforms Hingham stock because FICO's P/E starts the decade of the 2020s so high and Hingham's stock starts the decade of the 2020s so low.

Okay. But, why is the P/E of Hingham low and the P/E of FICO high? It's because anyone making the same prediction in 2010 would've been wrong. Hingham and FICO would've had much closer business performances than stock performances. Now, if I'm right during the decade of the 2020s, that does mean that over the VERY long-run, someone making this projection that earnings growth drives stock price growth and applying it to FICO and Hingham would be proved right. But, they'd be proved right over the entire two decades of the 2010s and 2020s. They would actually be wrong for the decade of the 2010s alone. And wrong again for the decade of the 2020s. Any 10-year prediction they'd make based on stock price performance tracking a business's earnings performance wouldn't work. And it wouldn't work, because – in the case of FICO and Hingham – 10 years was too short a holding period to judge this strategy.

Now, that's pretty alarming. Most investors I know – no matter how long-term they consider themselves – don't have the patience to be right for 10 years on the facts and yet wrong on the outcome.

How can we deal with this problem?

There are a couple ways. One is diversification. The reason the example of Hingham and FICO doesn't work has more to do with FICO than Hingham (FICO's P/E went from "normal" to 50+ in under a decade). It actually has a LITTLE to do with Hingham as a bank. So, it's a somewhat unfair comparison. I knew that FICO fits the kind of stocks that are popular right now. And I knew that the industry that has the widest divergence between its business performance and its stock performance has been banks. So, I unfairly picked something I knew to be very in favor (high quality, asset light, leader in the field, etc.) FICO vs. a true bank stock. It would be harder to find examples of "growth companies" with P/Es of 10, 11, or 12 outside of banks. Banks are, right now, the only place I know of where you can consistently find cheap growth stock. There are industries with cheap stocks out there. But, they're not growing. And there are industries with growth stocks. But, they're not cheap. Banking is about the only area where you are just finding buckets of growing businesses trading at low P/Es. It's an anomaly compared to all the other industries in the public markets today. That means picking a stock in an industry that ends up way out of favor – banks are very out of favor right now as stocks – will skew multiples so much that you could have strong business performance lead to underperformance as a stock even over a 10-year holding period.

So, Lynch's approach won't work if the end of your holding period happens to be when the stocks in the industry you've picked to invest in are particularly out of favor.

Of course, one solution to this problem is that if business performance has continued to be strong while stock price performance has weakened – you just don't sell during those times. That would suggest not selling banks right now. And I'd agree with that. It's commonsense. If you own a bank that is safe and solid – don't sell it now. Now is not the right time to sell a bank. They are too unpopular as stocks. So, don't sell a good business into a bad market for the stock. That's common sense. And you can apply it just fine. But, it doesn't solve all the problems here.

There's still a problem with the difference between individual investment results and a theory that works diversified over a lot of stocks and a lot of years.

There really could be people who bought BOTH Hingham and FICO in 2010 and held them till today and have now been taught that buying FICO was right in a way that buying Hingham was wrong.

This particular problem has shown up in the emails I'm getting from people these days. They talk a lot about the price performance of what stocks have worked and haven't worked without thinking about how much of this return comes from multiple expansion and how much from earnings growth. I'd be very, very carefuly with this kind of thinking. Honestly, based on what you could've known at the time and what was reasonable to assume might happen and so on – I do think that you could've decided in 2010 that it was a smart idea to buy Hingham and it was a smart idea to buy FICO. I think you could've imagined a day when Hingham's P/E expanded from 9 to 18 and

FICO's from 15 to 30. I don't think you should kick yourself now for not imaging FICO's P/E wouldn't stop at 25 – but zoom right past 50. That's the kind of "resulting" you need to be careful about. Even if you made a ton of money in FICO these past 10 years, I don't think you should count all that mney as being a valid profit on your part. Skill might explain half your return from holding FICO these past 10 years. But, I really think luck explains the other half. There's nothing wrong with profiting from some luck. But, there would be something wrong with learning from this experience that you should be biased more toward stocks like FICO and less toward stocks like Hingham because stock's with P/Es of 9 only go to P/Es of 12 while stocks with P/Es of 15 sometimes go on to become stocks with P/Es of 55. I think that's the wrong lesson to learn. It worked for this cycle. But, it won't work over all cycles at all times. And yet this is the lesson I hear about from most people who email me. They've learned to pay up for stocks in a way that could be potentially dangerous. It's fine to pay up for a business that will grow its earnings faster for loner. It's not fine to pay up for a stock because it has a higher chance of abnormal recognition from the market resulting in a rapidly accelerating multiple without rapidly accelerating earnings growth.

So, what does this mean for investors on the other side of things? Instead of getting lucky through wild multiple expansion on a stock you were right to buy in the first place – but has now zoomed higher in price than you ever imagined – you are staring at a portfolio that has lagged the market.

Okay.

Has your stock portfolio lagged the market in terms of stock price performance? Or: has your stock portfolio lagged the market in terms of underlying business performance? Or is it both?

If you own a basket of stocks that have been increasing their earnings each year as fast or faster than the S&P 500, but have been underperforming the S&P 500 for a couple years now – that's not something to be deeply worried about. If the stocks you own have seen their earnings contract, or have failed to match the EPS growth of the market, that is something to worry about.

So, should you be concerned if your stocks are really underperforming the market right now?

Maybe.

Are the businesses really underperforming too? Or, are the business performing as well as the market – while the prices of the stocks you own are not.

Poor stock performance combined with poor earnings performance is the thing to watch for. Poor price performance alone is what cycles in sentiment look like. You just have to learn to live with those.