

Investor Insight

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The Corporate Profit Margin Debate

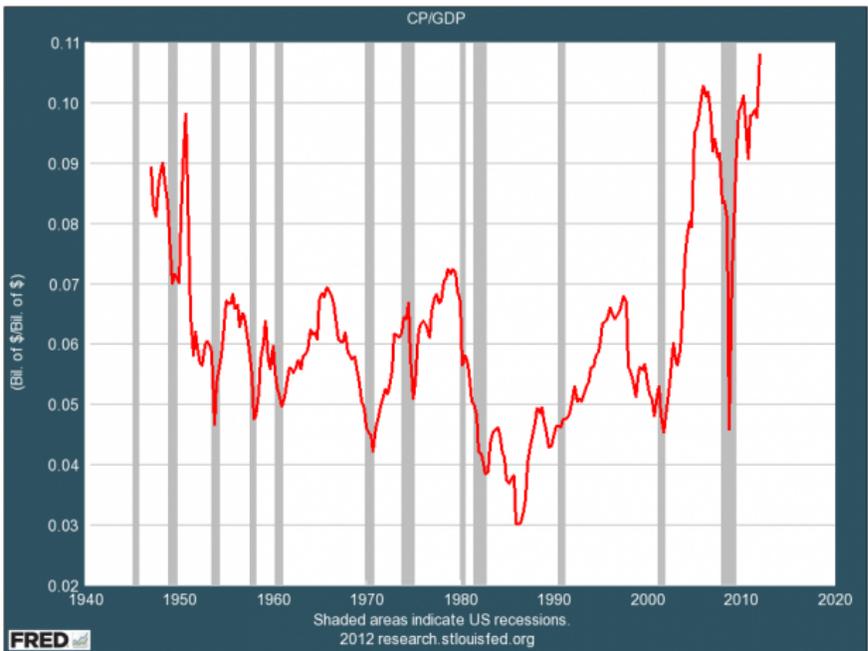
Can profitability be sustained?

Morningstar Investment Services
Commentary

The sustainability of corporate profit margins is a hotly debated issue among investment strategists – and rightfully so. In this commentary, we briefly summarize the views of the bears and bulls, add our voice to the debate, and discuss the potential implications for investors.

Why are profit margins so closely watched right now? It's because if the current level of profitability cannot be maintained, then corporate earnings would likely come under pressure-- and the S&P 500 would be vulnerable to a correction or even a bear market. If profitability can be sustained, then a secular bull market may well be under way. So, we think this debate warrants attention.

The bears, most notably GMO's Jeremy Grantham, point to the fact that U.S. corporate profits as a percentage of gross domestic product (GDP) are at record highs (see chart) and they believe that they will ultimately revert to their mean, as they've done consistently throughout history.



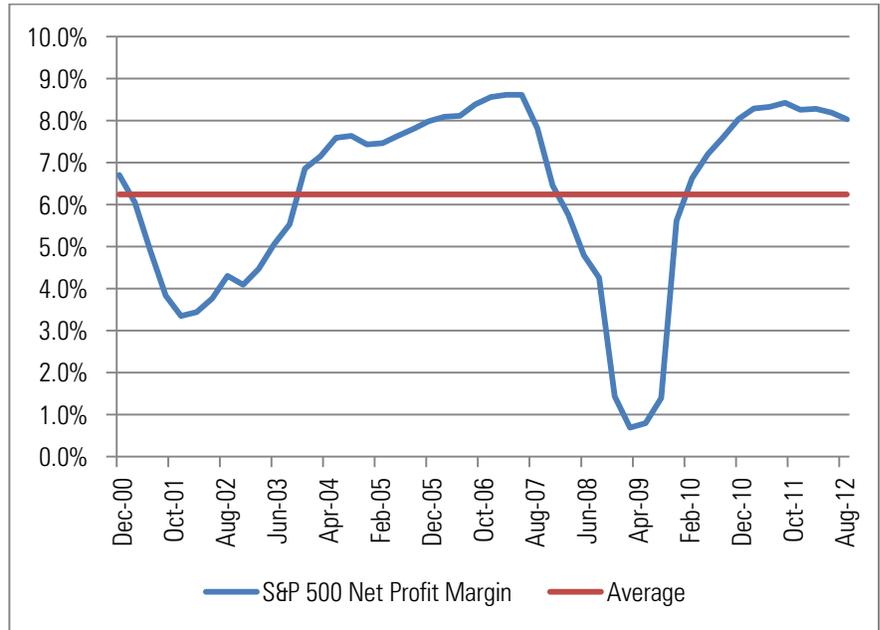
Source: Business Insider, St. Louis Fed

Bulls, including Schwab's Liz Ann Sounders and Deutsche Bank's David Bianco, have countered that lower effective tax rates, lower interest expense, and more profitable foreign operations have driven most of the expansion in profit margins. Wharton professor Jeremy Siegel has also noted that more firms are now being classified in the corporate sector and less in proprietors' income or private income, which boosts the corporate profit as a percentage of GDP ratio. So, in their view, comparing the current ratio of corporate profits/GDP to those of decades past is not an apples-to-apples comparison. The bulls believe that corporate profit margins are sustainable.

Our View

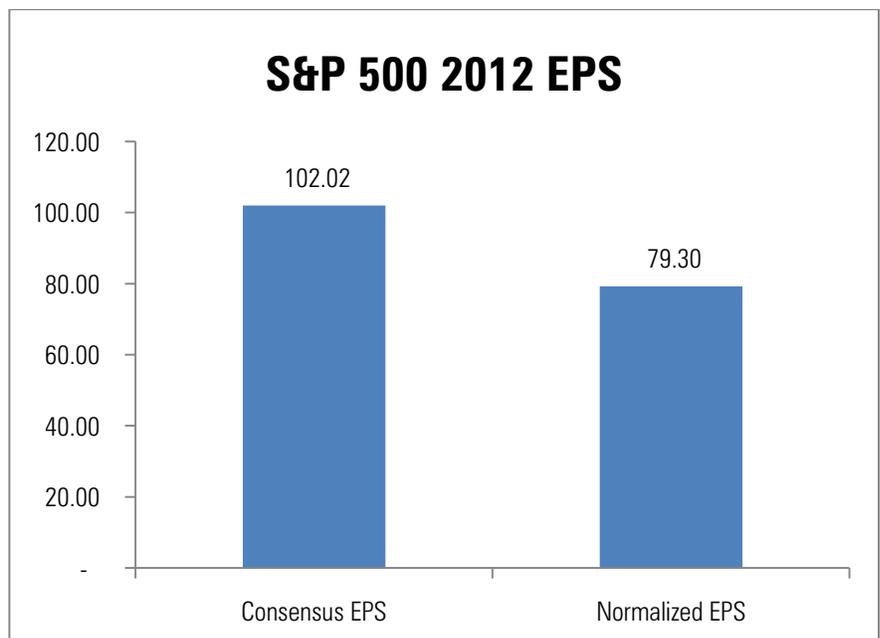
We think that the answer likely lies between these two sets of divergent views. Given the comparability issues with the government data over the past several decades, we decided to examine the S&P 500 after-tax profits as a percentage of sales since December 2000. We believe this data is more relevant to investors in stocks of publicly traded firms.

On this basis, corporate profit margins appear elevated, slightly below the peak levels of the prior economic expansion, but nowhere near the all-time highs noted in the corporate profit/GDP graph.



Sources: Morningstar Investment Services, Standard and Poor's

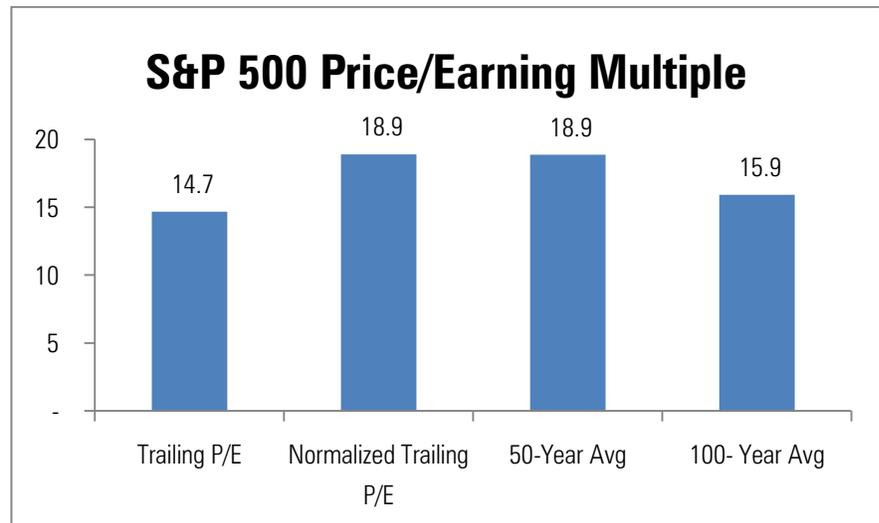
Nevertheless, a reversion to the mean could still weigh on corporate profits. If we assume that the S&P 500 net margin declined from 8.0% to the 12-year average of 6.2%, then its earnings per share would decline to a 'normalized' level of approximately \$79 per share, down from \$102 based on 2012 consensus estimates according to Reuters. That represents a 22% drop.



Sources: Morningstar Investment Services, Reuters

Market Implications

Still, it does not appear that the market is giving full credit to the earnings delivered by S&P 500 firms. As of January 31, 2012, the S&P 500 traded for 14.7 times trailing earnings, which is well below the long-term historical averages. Even if you haircut trailing earnings by 22%, you'd get a price/earnings multiple of 18.9, which is in line with the 50-year historical average and modestly above the 100-year average.



Sources: Morningstar Investment Services, Reuters

So, a reversion to mean in corporate profitability may be partly or even fully priced into the market's current valuation. Of course, the market does not have to stop at fair value and can certainly overshoot to the downside, especially if another recession is in the pipeline.

But, it is by no means certain that a reversion to mean is imminent and even so a decline in earnings would likely be temporary. Furthermore, the bulls could be proven right. U.S. corporations could continue to benefit from low effective tax rates, reduced interest expense, and more robust foreign profits, which could drive extended growth in corporate profits.

In conclusion, a decline in corporate profitability is a serious risk, but given the market's current valuation (not to mention lack of compelling alternatives), it may be a risk worth taking for patient and risk tolerant investors. We also believe that active portfolio management can help achieve a more favorable risk/reward proposition, by focusing on undervalued firms with durable competitive advantages, which could maintain or possibly grow their corporate profit margins.

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P/B Multiple Compares a stock's market value to the value of total assets less total liabilities (book value). Determined by dividing current stock price by common stockholder equity per share (book value), adjusted for stock splits.

The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

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