MAKING THE NUMBERS

"There is no safety in numbers, or in anything else."

- James Thurber

Among the innumerable clichés littering the financial pages, few are as perversely ironic as the phrase "making the number." Anyone unfamiliar with investing would almost automatically take this as an explicit warning: "Beware! These numbers are *made.*" And yet the same declaration is almost universally received by the investment community as reassurance. It's a twisted, dangerous dynamic that only reinforces careless reliance on the most potentially manipulated of all available financial information.

Earnings are a metaphor, a misleadingly precise signifier of an amorphous, unknown economic reality.

Earnings results are only as relevant as their calculation is sound. This is why making investment decisions based on whether a company "makes" or "misses" its earnings estimate is like trying to understand a baseball game by watching the scoreboard instead of the field. Accounting, after all, is artifice – every financial statement is an act of principles-based interpretation, and GAAP leaves many gaps. Each line item is to some degree susceptible to interpretation, and therefore manipulation. Making the number is hence much less important than *how* the number is made.

By way of illustration, in late 2010 the shares of a number of large US banks leapt on the news that their quarterly earnings came in well above consensus expectations. This result was largely because they had reduced their estimates of future loan losses, and thus their reserves against them, thereby boosting their earnings by a corresponding amount. But how many individuals who bought the shares because they "beat their number" understood that math, or could explain why their prospective loan losses should be lower? Surely they weren't simply accepting the company's assessment; wildly inaccurate estimates of probable loan losses were what drove most of those institutions to the brink to begin with.

No one who esteems themselves a thoughtful investor would welcome characterization as a mindless speculator, yet most react to earnings announcements like a TV audience responding to canned laughter. It's a Pavlovian response borne of conditioning, not contemplation.

Given the consequences for disappointing, it's no surprise that many companies will engage in whatever accounting gymnastics are necessary to deliver or exceed the bottom line investors expect. For those companies loath to disappoint (read: most of them), accounting offers all manner of prosthetics for performance. If earnings are made, they can also be *made up*. Distilled to its essence, an income statement is nothing more than a summary translation of economic events, some actual and some – such as amortization and depreciation – imagined. Net income is ultimately the quasi-fictitious culmination of every decision impacting every line item that precedes it. If the validity and usefulness of earnings are thus entirely hostage to those constituent calculations, why are those computations safe to ignore?

With so many apparently professional investors fixated on earnings it's admittedly easy to follow their lead. But contrary to the vaunted wisdom of crowds, individual ignorance when multiplied does not magically transform into collective intelligence – any more than a hundred bad ideas culminate in one good one. The more people blindly relying on a conclusion rather than questioning its premises, the more dangerous that conclusion becomes. We don't need the benefit of hindsight to know that we should have been more skeptical of what were, by any measure of common sense, suspiciously regular earnings. The consistency of EPS demonstrated by the likes of GE and AIG wasn't an accomplishment; it was an *omen.*

The Devonshire artist and Platonist Sir Joshua Reynolds once observed, “There is no expedient to which a man will not resort to avoid the real labor of thinking.” It may also be the case that there is no expedient to which an investor will not resort to avoid the real labor of analysis. But they do so at their own peril. Earnings are at best a superficial shorthand for what’s really happening under the hood, and are not infrequently an utterly misleading indicator of a company’s economic reality.

With this knowledge, who but ourselves to blame when we unleash the devil by ignoring the details within which he resides?

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