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EARNINGS GROWTH DRIVES STOCK PRICES

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Simply put, the stock market goes up as the economy grows. When the economy grows, corporate profits grow. When corporate profits grow, so do stock prices.

Two studies that were done many years ago support this premise. First, Henry Latane and Donald Tuttle randomly selected 48 stocks in the Value Line Survey to study during 1950-1963. The study focused on two factors; earnings growth and price change. They found that the 8 stocks with the fastest earnings growth averaged a gain in price of 30% each year, whereas the stocks with the lowest earnings growth gained just 1% each year.

Manown Kisor and Van Messner came up with similar findings in their study of 800 stocks during the 1962-1965 period. In the first year of study, the upper half of companies ranked in descending order of earnings growth returned 4 percentage points more than the S&P 500 return, whereas the lower half returned 12% less than the S&P 500. In subsequent years, this correlation held as companies with above average earnings growth sharply outperformed those in the slower growing group.

Target QR Strategies recently ran a study on the S&P 500 Index looking for a correlation between price and earnings. Since taking point to point comparisons in performance data can be misleading, we took as the initial starting point the five-year average of S&P 500 earnings per share and the yearend index starting in 1926 and ending in 2018 in order to gauge their correlation. We found that S&P earnings per share grew 117x while the Index advanced 135x. Adjusting for the differential in P/Es (starting P/E of 14.6 in 1926 and ending P/E of 16.9 in 2018) elevated the earnings growth rate from 117x to 135X. Thus, both earnings and the index moved in lockstep over the entire period.

Target QR Strategies conducted a similar study on the Top 10 Stocks during the 2006-2015. These results are shown in the following table.

Top 10 Stocks over 10 years ending 2015

Stock	Gain	EPS Growth
Priceline	5,345%	17x
Regeneron	2,670	49x rev. (neg. EPS)
Alexion	2,490	47x rev. (neg. EPS)
Netflix	1,970	8x
Amazon	1,576	6x
Apple	920	14x
Under Armor	910	6x
E.W. Edwards	855	5x
CF Industries	850	2x
Dollar Tree	845	5x
S&P 500	**126%**	**0.4x**

Note that each of the Top 10 Stocks over the 10-year period was accompanied by earnings growth that far exceeded the growth rate in S&P earnings.

William O'Neill studied 30 stock variables during the period 1959-1982. Variables included earnings growth, price strength, industry strength, return on equity, etc. Earnings growth proved to be key variable of the 30, so he then built a database and an investment system which used earnings as the focal point. His IBD 50 Growth Stock Index, published each week in Investor's Business Daily, has far outperformed the S&P 500 Index since its inception in 2003.

The evidence is quite compelling that earnings growth plays a dominant role in stock price behavior. Most of the top performing mutual funds over the past 40 years are growth funds that follow the simple strategy that "price follows earnings". Pursuing fast growing companies has always been a sensible investment strategy and one way to beat the stock market.

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