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Strategist's Corner
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Spotting Unseen Risks in Portfolios

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In brief:

- Like health crises, downside risks to portfolios can come with little warning.
- The divide between Generally Accepted Accounting Principles (GAAP) and non-GAAP earnings often grows as the business cycle matures. At this stage of the cycle, every earnings adjustment must be critically evaluated by a trained and well-resourced investor.
- Whether in our bodies or in our portfolios, true downside risk is hard to spot. Just like for hard-to-detect diseases, we think a prudent approach is to take preventive measures.

Hard-to-detect risk

Neurodegenerative diseases and cancers are among the leading causes of death worldwide. Unfortunately, they range from being hard to detect to completely lacking biomarkers altogether. While progress has been made, detection still comes too late for too many.

Investment professionals typically frame risk around volatility. Volatility is an observable metric and offers a window into the potential range of future outcomes, making it an appropriate and easy-to-use measure. However, as with certain health risks, true downside risk can occur without warning and without the prospect of recovery. This was seen recently in two large corporate bankruptcies in the United States. While the media covered the fraudulent activities and destruction of capital extensively, these episodes offer a reminder to investors that we want to highlight.

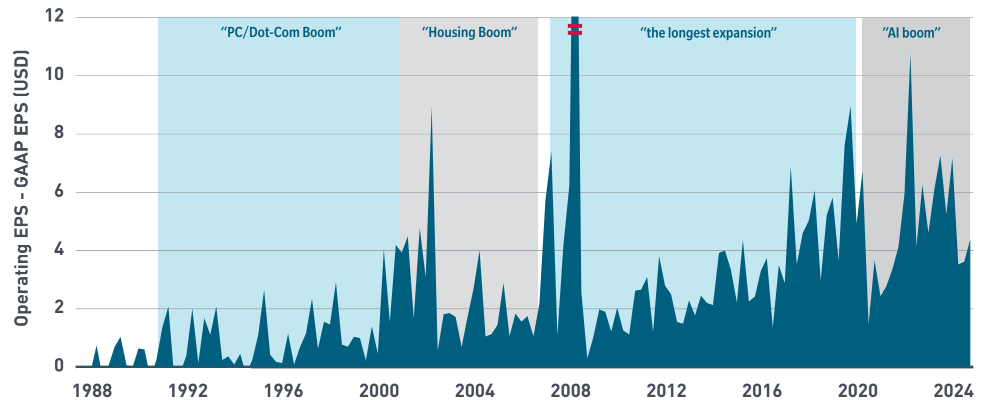
Accounting adjustments increase with the business cycle

In the US, public companies are required by the Securities and Exchange Commission to report earnings according to GAAP, which are standardized accounting rules that include all expenses, whether non-cash or irregular. Outside the US, many countries adhere to International Financial Reporting Standards (IFRS), a similar framework.

Of course, a management team can supplement GAAP and IFRS financials with their own adjusted results to provide investors with what they believe is a more accurate representation of the company's operational health.

As is often the case, adjusted earnings are typically higher than those reported under standardized methods. As the graph below illustrates, using readily available US data, the difference between non-GAAP and GAAP earnings ebbs and flows but generally increases as the business cycle matures.

Exhibit 1: Mind the gap: The difference between GAAP and non-GAAP earnings grows late cycle



Source: Haver Analytics. Quarterly data from 31 March 1988 to 30 June 2025 (latest available). Operating Earnings per Share (EPS) are earnings after taxes that exclude restructuring charges that are part of ongoing operations. GAAP EPS are after-tax, as-reported earnings from continuing operations, calculated using generally accepted accounting principles (GAAP).

Early in an expansion, input costs and investor expectations are low. As the economy grows, demand for capital, labor and goods rises, driving increased revenues but also higher expenses. Profit comparisons become more difficult, particularly for businesses facing fresh competition or an inability to raise prices in line with cost inflation.

With equity valuations on the rise later in the cycle, professional investors look for any evidence of fundamental weakness. This incentivizes management teams to present optimistic results by adding back charges they deem "one-time" or "non-recurring" to bolster financial performance.

While investors understandably rely on non-GAAP earnings, greater attention should be paid to businesses with an elevated level of adjustments.

The period from 2009, after the global financial crisis, through 2021, during the post-pandemic rebound, was unique. Capital costs were artificially suppressed to the lowest in recorded history, which drove a capital cycle focused on balance sheet financialization at the expense of tangible fixed investment — resulting in stagnant economic growth. Companies issued debt and recycled that capital to shareholders via dividends and buybacks, and they also used it for acquisitions to compensate for a lack of organic revenue growth.

In 2022, this dynamic shifted dramatically. The capital cycle transitioned from shareholder enrichment to capital expenditures to build artificial intelligence (AI), reorient supply chains and acquire other long-term assets.

Management teams are quick to tout the hoped-for savings from AI. While these efficiencies may prove real in the short term, they often get competed away over time. The same technology that drives savings often lowers the barriers to entry, paving the way for new entrepreneurs. This can lead to increased competition, price wars and a reversion of margins to previous levels — or worse.

If AI proves as transformative to society as was the steam engine, electricity or the internet, it will create new industries and vectors of competition that we cannot yet imagine. When Amazon sold its first book online in 1995, few could have envisioned that, over the next 30 years, we would be able to order taxis, food or media from our phones. These innovations have brought consumers more choice, convenience, and lower prices, and is evidence that technology has been a long-term deflationary force.

Given today's elevated input costs and soft growth, combined with the disruptive force of emerging technology, the context has shifted. Assets acquired during the era of scarce revenue growth and cheap money may have made sense at the time, or perhaps not. Now, every earnings adjustment must be critically evaluated by a trained and well-resourced investor.

Conclusion

Whether in our bodies or in our portfolios, true downside risk is hard to spot. Just like for hard-to-detect diseases, we think a prudent approach is to take preventive measures.

As fundamental investors, this preventive strategy comes in the form of questioning everything and thinking critically. In short, we believe businesses with optimistically-adjusted earnings, or those whose value proposition are vulnerable to competition, should be avoided. On the contrary, consider focusing on companies with durable competitive advantages. This is easier said than done, but it defines both the risk and opportunity as we transition from an equity environment driven by "survival of the least fit" to one that more closely resembles "survival of the fittest."

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