Earnings in aggregate, and what the index is priced against

> **AGGREGATE EARNINGS**
>
> The combined profits of an index's constituents, and the denominator most index valuation rests on. An index level divided by aggregate earnings gives a multiple, and almost every argument about whether a market is expensive is an argument about that number and what it should be.

An index is a price. Like any price it can be compared against what the underlying produces, and for a basket of companies that is profit.

The multiple

Index level over aggregate earnings per share gives a price-to-earnings multiple for the whole basket. It is the most quoted number in market commentary and the most casually misused.

Two versions circulate and they disagree, often materially. Trailing uses profits already reported and is a fact. Forward uses analysts' estimates and is a forecast wearing the same notation. A market can look cheap on forward earnings purely because estimates are optimistic.

Why the multiple moves without earnings moving

If the level rises and profits do not, the multiple rises: the same earnings cost more. That is not a valuation error by itself - it is a statement that buyers will pay more for the same profit, which is usually a statement about interest rates, and lesson 3.

Aggregation hides everything

A few very profitable companies can carry an index's earnings while most constituents stagnate.One large loss can drag aggregate earnings down while the median business is unaffected.Sector mix means two indices at the same multiple are not comparably priced.

So the multiple is a summary of a summary. It is a useful anchor and a poor argument on its own.

Earnings season as an event

Constituents report on a calendar. For a few weeks each quarter the index is repricing on company-specific news arriving in a queue, and the largest constituents' reports move the index more than the rest combined.

That is a reason to know when the biggest constituents report. Module 4's gap risk and this are the same fact seen from two sides: scheduled information that arrives when you cannot act.

The honest position

Aggregate earnings tell you what an index is priced against. They do not tell you what it will do, because the multiple people are willing to pay is not a constant and is not determined by earnings at all.

Check your understanding

1. Why can a market look cheap on forward earnings and not on trailing?

a. Forward earnings exclude the largest constituents
b. Forward earnings are estimates, and estimates can be optimistic
c. Trailing earnings include dividends

Answer: b. Trailing is a fact about reported profit; forward is a forecast in the same notation. The gap between them is analysts' optimism, not a valuation.

2. The index rises and aggregate earnings are flat. What has changed?

a. The multiple - buyers are paying more for the same profit
b. The index's composition
c. Nothing, the two always move together

Answer: a. Same earnings, higher price, higher multiple. What people will pay for a given profit is usually a statement about rates rather than about the businesses.