Smith Group
ASSET MANAGEMENT

The Next Leg

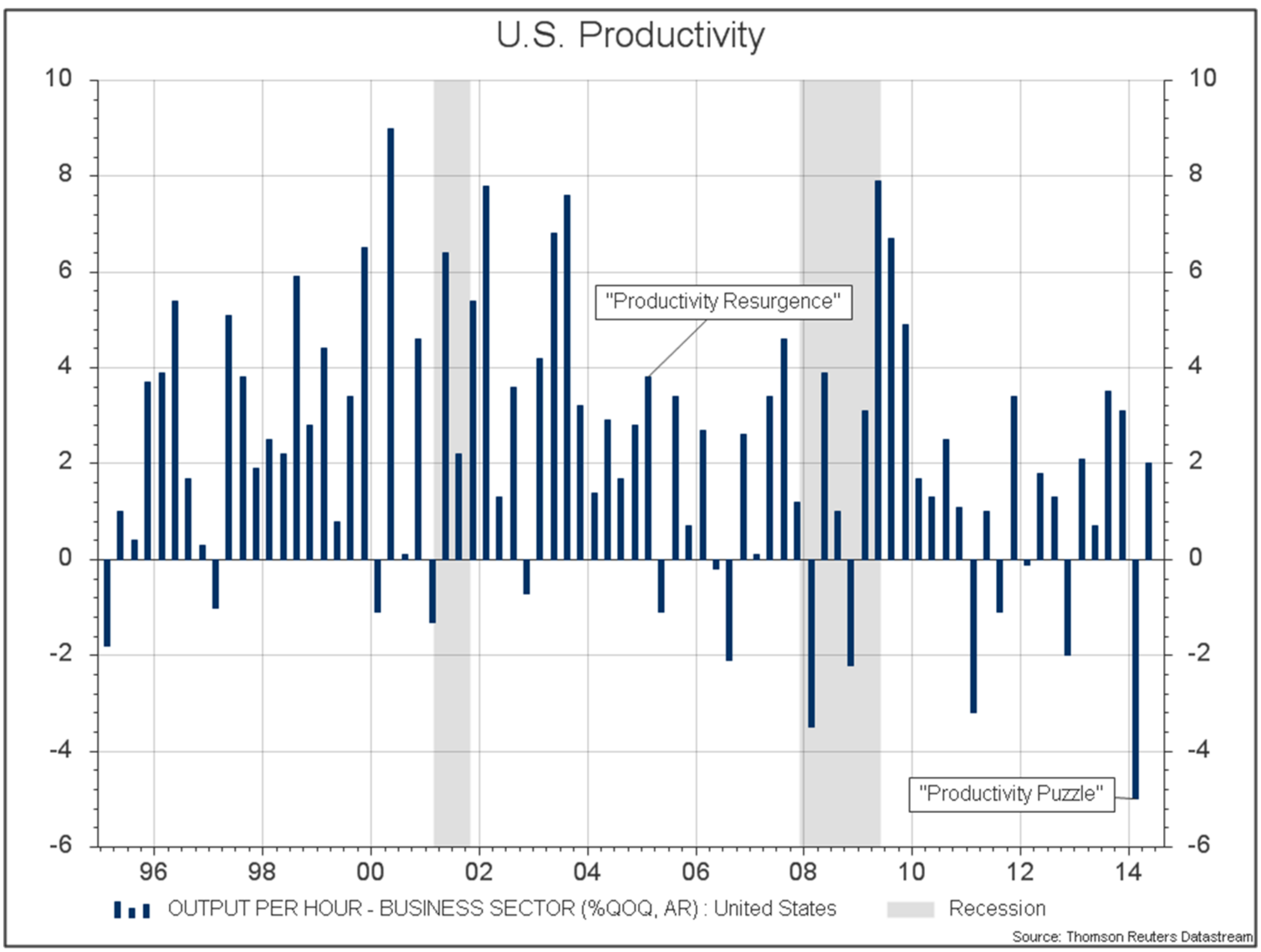
August 2014

Since the beginning of the current bull run, the S&P 500 has tripled in value. The increase has been due to an expansion in the market multiple (P/E) as well as record profit margins (E). But even a cursory examination of company financials suggests financial levers have been the primary mechanism used to boost earnings. With money so cheap due to a very accommodative Federal Reserve[0], an abundance of cheap labor that is either under – or un-employed, and factories operating well below capacity, "working the balance sheet" *was* a rational response and offered the fastest path to increased shareholder value (which also helped incentive based compensation that rewards short-term "value creation" but we will save that discussion for another day).

The primary element that has been missing since the end of the Great Recession is the investment in the physical assets and productive capacity of corporate America. Now that the majority of the financial reengineering is done (maybe we should say "nearly" done since "inversions" are the financial strategy du jour), we believe the next leg of earnings growth will be fueled by companies investing in their business to drive top line growth through new products and services and the bottom line via improvements in productivity.

But for most companies, the next leg of the journey will not be as easy as the one just completed. While consultants and investment bankers can help any company optimize their financials, only the most skilled management teams know how to maximize return on invested capital.

In a 2005 speech[1], Ben Bernanke talked about a "productivity resurgence" that had emerged since the mid '90s and how it had not been derailed by the 2001 recession. The topic of productivity growth is important because, in Bernanke's words, the "rate of productivity growth is a primary determinant of economic perform-



ance" and is the "principle source of improvements in living standards." In the speech, Bernanke suggested productivity growth of 2 to 2.5% per year was a reasonable expectation and that the failure to achieve these levels would lead to higher inflation due to wage pressures with the likely reaction being less accommodative policies from the Fed.

During his "farewell" speech in early 2014[2], Bernanke noted a "productivity puzzle" that had emerged since the end of the Great Recession. Even worse than the period from the early 1970s until 1995 when productivity growth averaged 1.5% and was considered "disappointingly low", productivity was barely above 1% for the 16 quarters prior to the speech. While Bernanke put forth a number of theories on why productivity growth had been subpar up to that point, he also noted that resolution of the productivity puzzle was critical to determining the long-term growth potential of the economy.

Generally, companies can use their profits to: 1) directly reward shareholders via stock buybacks and dividends, 2) enhance their competitive position via mergers and acquisitions or 3) invest directly into the productive capacity of their firms through capital expenditures (capex). Given the lack of growth in productivity, it is not surprising to learn that companies have gravitated towards the first two options over the third.

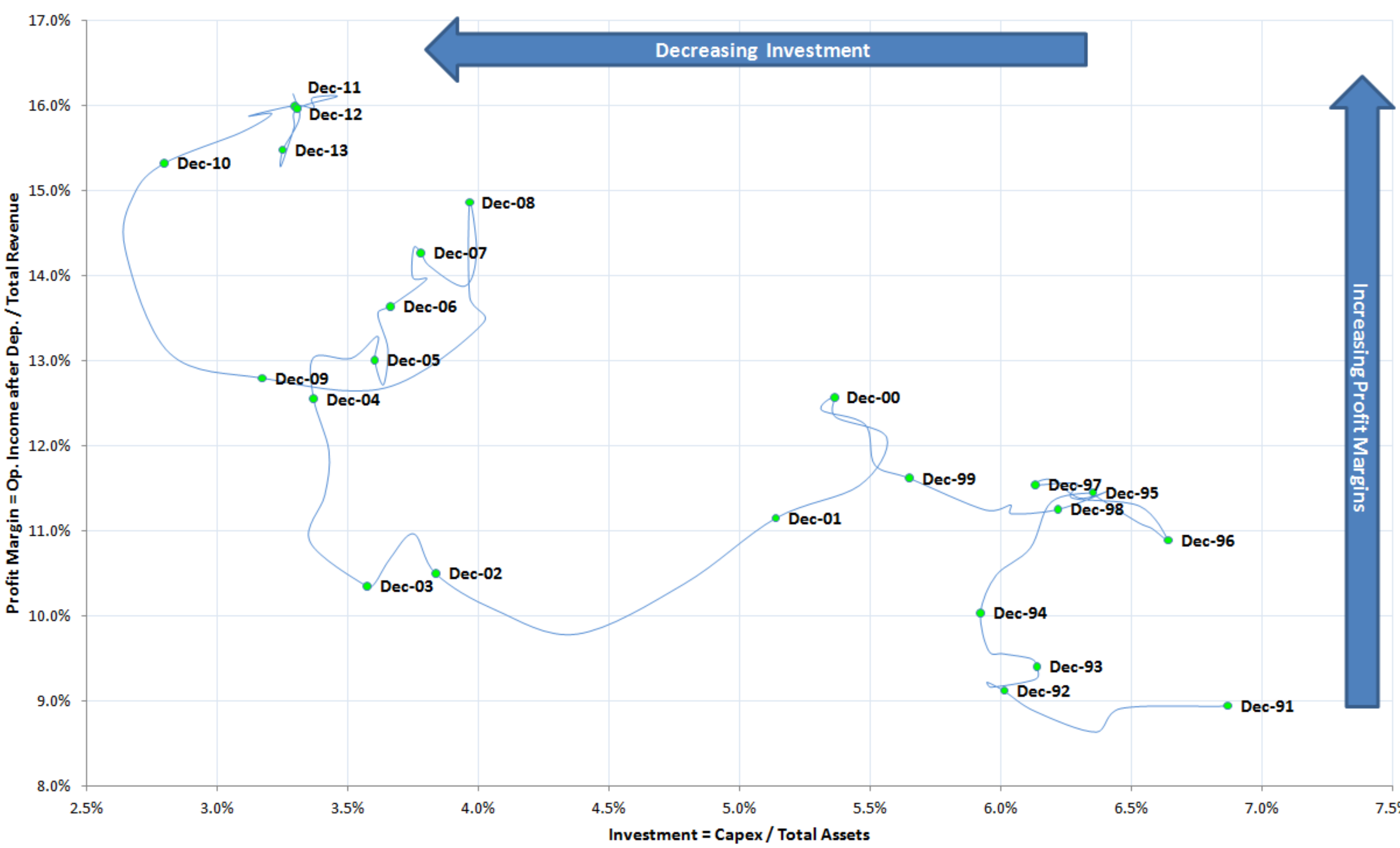
According to Factset, buybacks are up 50% year-over year and are now near pre-recession highs[3]. Technology companies increased share repurchases the most year-over-year, increasing share buybacks by 175%.

While not creating outright monopolies, the recent increase in mega-deals is producing a number of notable duopolies. Assuming approval, the two largest tobacco companies will control 90% of the cigarette market and a combined Time Warner and Comcast will control a third of the cable market. As a result of a number of shotgun marriages following the financial crisis, the four largest banks in the country control 40% of the consumer banking market[4]. But the motivation for M&A activity is not limited to capturing market share alone with a number of smaller companies pursing cost saving acquisitions and numerous health care companies merging for tax reasons.

The following chart looks at the final alternative for profits, capital expenditures[5]. The vertical axis shows aggregate profit margins for the S&P 500 excluding Financials while the horizontal axis shows the level of investment for these companies.

Consistent with the high levels of productivity growth noted by Bernanke in his 2005 speech, the absolute level of investment from 1991 through 2001 was very high. Over the course of the decade, margins steadily improved as the benefits of the heavy spending dropped to the bottom line. Not coincidentally, productivity growth during this period was 3% - far above the "disappointingly low" average noted previously. As is typical, investment dropped with the 2001 recession.

Beginning 2004, capital investment increased each of the next

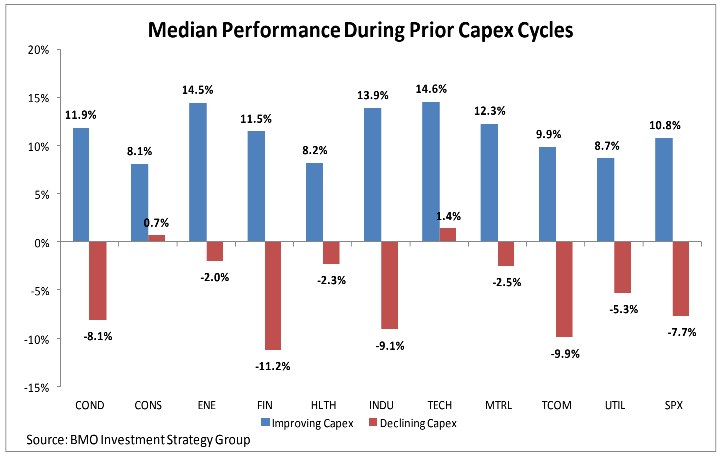


five years. As a percentage of Total Assets, however, capex was starting from a much lower base and never recovered to the levels of the previous period. Productivity growth during the period between recessions was lower than the pre-2001 period but still in excess of 2%.

As frequently noted in the financial press, profit margins have soared since the end of the Great Recession. Unfortunately, spending on capital equipment has barely increased from the recession lows[6]. This could be due to the lack of wage pressure as the un- and under-employed find their way back to work, inadequate demand as households continue to repair their balance sheets or the simple fact that companies don't need to expand capacity when their factories are still operating below capacity[7]. Not surprisingly, since 2010 there has been almost no improvement in productivity. In fact, the average quarter-over-quarter growth in productivity for the past 17 quarters is a miserable 0.90%.

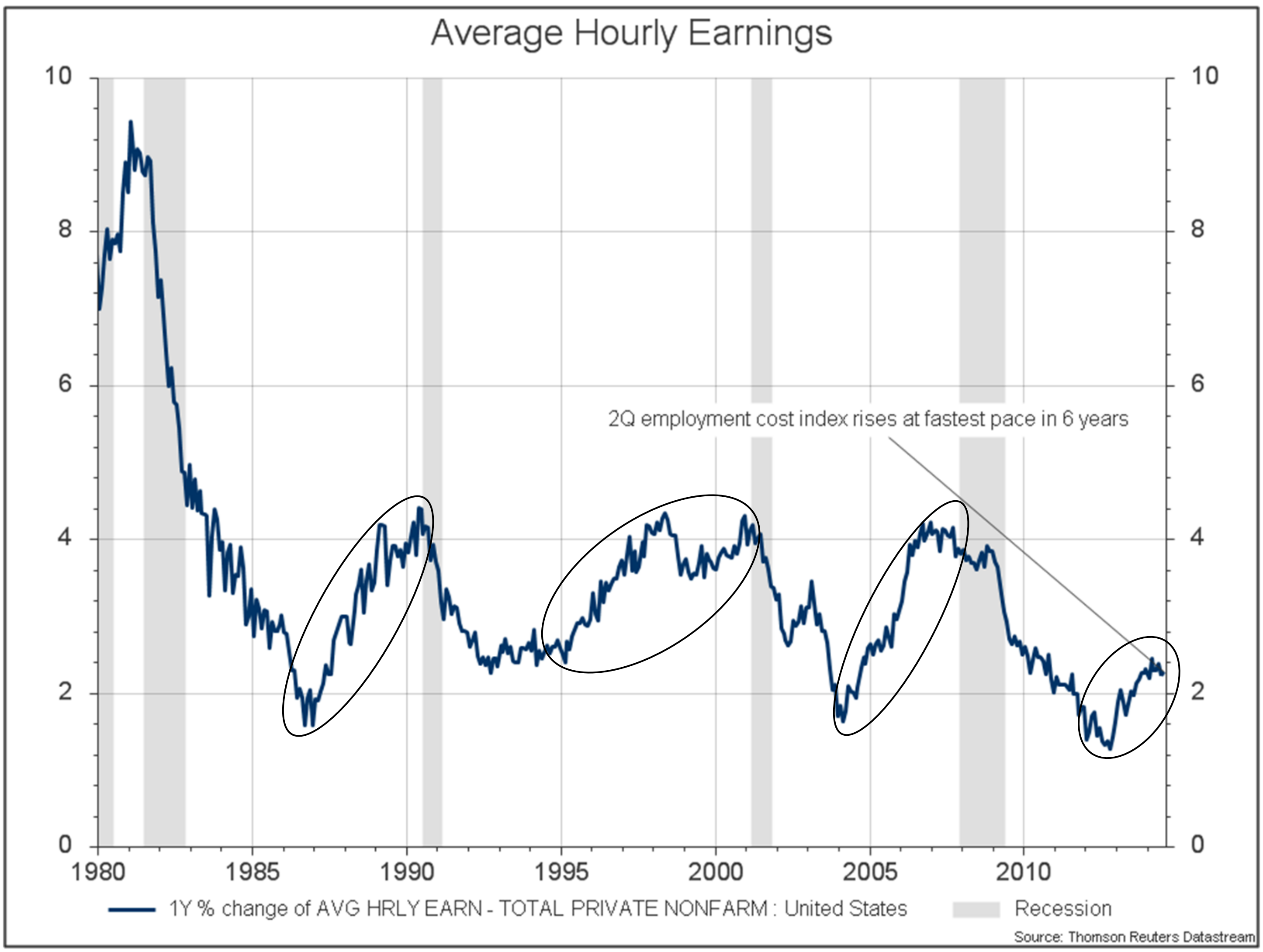
Understanding productivity and its impact on capex budgets is important for investors since market returns tend to be better during periods of increasing capex as seen in the upper chart -

Stock Market Performance is Much Stronger When Capex Improves



this is fairly obvious since the biggest threat to capex budgets and equity returns is a recession.

But beyond the obvious correlation to overall market returns, we believe periods of high or increasing capex are the most



conducive environments for traditional active managers to produce meaningful excess returns (the word "traditional" is used to differentiate the majority of the industry from "activist" shareholders which are dominant in today's press). And while the true source of the quote "the business of business is business" is debatable[8], we subscribe to the adage and are looking forward to the days when the primary focus of business is increasing organic growth and creating new industries and not merely maximizing existing resources and optimizing existing industries[9].

So what is the signpost that will portend the next era of capex spending? We believe Average Hourly Earnings, which is the divisor used to calculate productivity, is a good leading indicator to the capex cycle. As wage pressure grows, the balance between labor and equipment tilts towards the cost saving advantage of capital equipment. Companies that have the financial wherewithal and vision to know how to maximize these investments will differentiate themselves for fundamental reasons (as opposed to engineered financial reasons) which is the bailiwick of active management. As highlighted in the chart entitled “Average Hourly Earnings”, we find the slow but positive trend in average hourly earnings encouraging[10].

If the ability to differentiate based on financial reengineering is reaching its limits, as we believe, the next leg up in the market can only be driven by productivity enhancing and revenue generating investments. It will be these decisions that drive a wedge between the winners and losers. This will create copious opportunities for investors to separate their portfolios from the benchmarks as they identify and invest in management teams that know how to maximize the allocation of capital.

Endnotes

[0] In Smith Group’s December 2013 quarterly newsletter, Chris Zogg wrote an article entitled, “At the Margin.” Chris’ research revealed that the recent expansion in profit margins is primarily due to a reduction in corporate interest expense as opposed to lower COGS or SG&A. Given the current interest rate environment, this is rational but not likely to be sustainable and supports our thesis regarding the return of capex.

[1] http://www.federalreserve.gov/BoardDocs/Speeches/2005/20050119/default.htm

[2] http://www.federalreserve.gov/newsevents/speech/bernanke20140103a.htm

[3] http://www.factset.com/websitefiles/PDFs/buyback/buyback_6.18.14

[4] http://dealbook.nytimes.com/2014/07/22/changing-old-antitrust-thinking-for-a-new-gilded-age/

[5] There was a lengthy discussion regarding how to account for the domestic shift from manufacturing to services, factoryless goods producers (yes, “factoryless” is a real word created by the government) and globalization. In the end, we kept it simple and focused only on capex. While the “squiggle” chart, as some despairingly called it, was confusing to some, others found it inspirational. The chart is merely a simple representation of the trade off between investment (horizontal axis) and profits (vertical axis). It is also interesting because it clearly shows three distinct periods of investment.

[6] According to the BEA, the average age of private non-residential fixed assets is at a near 50 year high.

[7] http://www.nytimes.com/2014/07/22/upshot/businesses-need-to-spend-more-the-future-of-the-economy-depends-on-it.html

[8] http://en.wikiquote.org/wiki/Milton_Friedman

[9] A recent survey by BofAML showed 58% of investors wanting capex over dividends or buybacks. This was a record high number since the start of the survey (2002).

[10] As noted, labor costs have implications for the capex cycle. The other important consideration is the influence labor costs will have on inflation expectation and the Fed’s attitude towards interest rates. If rates increase as some expect, weaker companies that have been dependent on cheap financing will likely become less competitive versus their more healthy competitors. This too should play into the wheelhouse of active management.
http://online.wsj.com/articles/employment-costs-rise-0-7-in-second-quarter-1406810233

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