Smith Group
ASSET MANAGEMENT

Market Perspectives Excerpt

Is Underinvestment a Problem?

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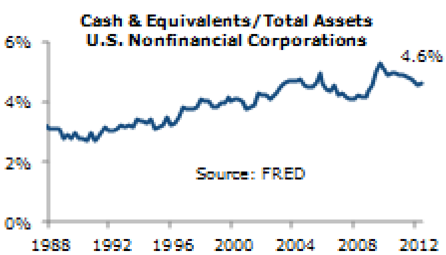
DECEMBER 2012

U.S. companies were holding on to $1.74 trillion in cash and equivalents at the end of the third quarter, an increase of $44 billion over the prior quarter. The ratio of cash and equivalents as a percent of total assets is down from its peak of 5.3% in 2009, but far higher than in the previous two and a half decades.



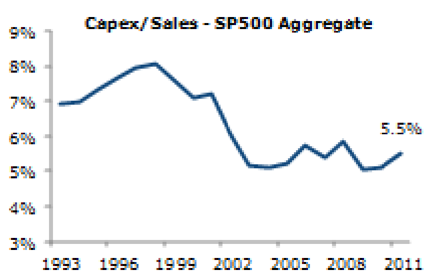
Corporate debt levels also continue to swell, fueled by low borrowing costs, and now stand at $8.4 trillion, almost half a trillion dollars higher than a year ago.

Companies can claim numerous justifications for stockpiling cash, including potential changes in tax and other regulations, recession in Europe, slower growth in China, and to provide a buffer against general economic and market turmoil. But more cash parked on the balance sheet means less to put to work growing the business. Companies are hoarding cash instead of spending it on capital equipment or increased hiring, both of which are vital drivers of growth.

> *"... more cash parked on the balance sheet means less to put to work growing the business."*

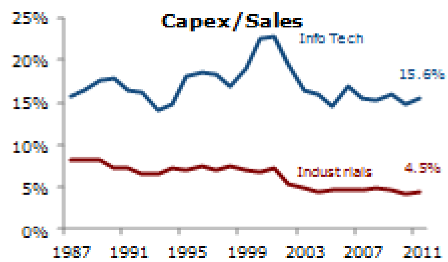
As management waits out economic uncertainty, other uses of cash are on the rise. Both the number of companies paying dividends and the overall amount paid has increased significantly over the last few years. Likewise, the level of stock buybacks has dramatically increased, with the aggregate value of Treasury stock more than doubling since 2005.

The graph below shows the decline in corporate investment over the past 20 years. The rate of investment slid from 8.1% in 1998 to 5.5% in the most recent full year. During the recession, capital expenditures fell at a faster rate than revenues. Capital expenditure has rebounded off 2009 lows. But the effects of muted investment in past years may already be effecting revenue growth that ultimately supports earnings expansion. For the two most recent quarters, more than half of the S&P 500 companies fell short of sales expectations. Even with the recent uptick the current level of investment appears quite tepid.



At a sector level, the drop in capital spending is most pronounced in the Industrial sector (see graph next column), which showed a decrease from just over 8% to around 4.5% of sales since 1987. Interestingly, the investment rate in the Information Technology sector has stayed fairly stable over the past 25 years, with the exception of the spike during the dot-com boom and Y2K refresh of equipment.

Lower investment rates have implications for margins and productivity. In the short run, margins are enhanced but at the cost to future productivity and growth. Companies are expected to earn a return on their assets. These assets depreciate over time, and in some cases become obsolete fairly quickly. Outdated assets can lead to lower productivity and a loss of competitiveness, which in turn lead to lower margins and lower earnings growth.



What will encourage companies to start investing more of their cash? Some argue that a tax holiday on the repatriation of foreign profits will provide the needed carrot, since over half of U.S companies' cash is held overseas. This strategy was tried in 2004 and failed to produce the desired outcome, as almost all of the repatriated funds were spent on dividends and stock repurchases instead of the desired hiring or other growth initiatives. There is a hoard of cash locked out of the U.S., but on shore cash is also plentiful. The tax holiday argument probably has some validity but is not the primary driver of underinvestment.

Investors have been fairly patient as companies hoard cash in the face of uncertainty, but that patience may be wearing thin. Management's reluctance to invest for the future may even be playing a role in the multiples investors are willing to pay for stocks in the current environment. Eventually investors will again demand top line growth, which may be challenging for those too far down the path of deferred investment. Capital stock, both physical and intellectual, is something you build over time rather than overnight.