Smith Group
ASSET MANAGEMENT

At The Margin

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MARKET PERSPECTIVES EXCERPT

Despite the overall economic gloom which hung over 2011, corporate earnings are expected to grow by 16% for the year. This growth continues a trend that has been in place since the second quarter of 2009. A large proportion of that absolute increase was due to expanding profit margins as opposed to top line growth, as companies benefitted from operating leverage coming out of the recession. Many investors are wondering, how long can this trend continue? Have margins reached a peak?

To put current margin levels in perspective, the chart at right shows both gross (minus direct costs) and operating (minus indirect costs) margins. Net margins are not as useful for comparison due to distortion from differing capital structures and tax rates.

Interestingly, while operating margins are indeed at their peak, gross margins are not. That high water mark (40.3%) was reached in Q3 2000. Financial margins have weighed heavily on this measure in recent years. In addition, many companies have faced headwinds due to rising input costs and the challenge of passing increases on to customers in the form of higher prices during a recession.

The chart illustrates the extreme pressure companies were under in 2009 as the gap between gross margins and operating margins narrowed to its lowest point over the 25 year period. The fact that gross margins dropped much more sharply than operating margins showed that in general companies were effective at finding ways to squeeze out costs and increase productivity over this time.

Operating margins for a typical Russell 1000 company have increased from around 15% to 20% over the past 25 in 1990/1991, 2001/2002 and 2008/2009.

Has the increase in margins been broad based or driven by a few sectors? As illustrated below, sectors with less cyclical businesses such as Information Technology and Staples, have generally realized steadily increasing margins, while margins for cyclical sectors such as Energy have been highly volatile. In the case of Information Technology, innovation drives both the top and bottom lines, with new product concepts like the iPad demanding premium pricing while costs are controlled using technological advances. Similarly, Staples companies are tapping into automation and innovation to manage costs lower.

On the other end of the spectrum, Energy companies are saddled with volatile commodity prices at the top line and high fixed costs from a capital intensive business model. And while there certainly have been technological innovations (e.g., 3-D seismic, enhanced recovery techniques) these have not been enough to counteract the cyclical nature of margins in this commodity sensitive sector.

So will margins in 2012 prove secular or cyclical? Most likely, it will be a bit of both. Cyclical sectors are apt to see some rollover in margins depending largely on selling prices, which in turn are sensitive to economic strength. But innovation continues to provide opportunities for new, higher margin products and more productive ways to make or deliver them. If you look beneath the aggregates, you find a wealth of businesses that are not in as precarious a situation as the margin bears would have us believe. With current expectations having moderated so dramatically, we may even see an upside surprise.