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# *Journal of* APPLIED CORPORATE FINANCE

## In This Issue: Are U.S. Companies Underinvesting?



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# A Message from the Editor

During my 30-plus years as editor of this journal, I can't think of a time when U.S. public companies were not being widely criticized for "underinvesting," for failing to devote enough of today's profits to increasing tomorrow's earnings and value. American companies were charged with "short termism" throughout the 1980s, when article after article in the *Harvard Business Review* and strategy and management journals were holding up the "patience" of Japanese corporate managers as a model for emulation. In the 1990s, after hostile takeovers and LBOs were effectively shut down by regulatory curbs on leveraged transactions, U.S. companies were assailed for caving to pressure from institutional investors to adopt option-laden pay packages—packages that were said to focus management's attention on the bottom line and little else. And even the recent rise of China as a world economic power has served, along with the global financial crisis, as a pretext for chastising the shortsightedness of U.S. corporate financial management practices. In the popular mind, Chinese companies have been gaining valuable market share because of their willingness not just to defer profit, but perhaps to forgo it altogether. And if we want to regain some of this market share, as critics of corporate America have not been slow to suggest, perhaps the U.S. should consider abandoning its shareholder-centered model of management and governance.

But in the meantime, the stock returns of U.S. companies continue to outpace most of their overseas competitors' by a wide margin. As Floyd Norris recently pointed out in his *New York Times* column, the stock returns of U.S. companies during the 36-year period since 1978 have been the best in American history. By contrast, the main Japanese stock exchange, the Nikkei 225, continues to trade well below half of the peak it reached in 1989. And as for Chinese companies, their total average annual return—dividends plus stock price appreciation—to their shareholders during the roughly 20-year period since the Shanghai market was reopened on a large scale in 1993 has averaged close to a *negative* 5%.

So, if it's hard to find signs of U.S. corporate "short termism" in their long-run stock performance, why revisit the charge of underinvesting now? How are today's criticisms any different from, or more credible than, the perennial claims that U.S. companies systematically sacrifice their corporate future to concerns about current profitability?

In the "Capital Deployment Roundtable" that appears near the top of this issue, Michael Mauboussin, head of Global Financial Strategies at Credit Suisse, reports that in 2013 the average corporate return on invested capital for the largest 1,500 U.S. non-financial public companies reached its highest level in the last 60 years. But if corporate efficiency in using capital is today at record levels, growth in corporate capital investment and assets during the last ten years has been below average. As a consequence, U.S. companies are sitting on large stockpiles of cash, even after payouts in the form of dividends and stock repurchases that are also near record levels.

This combination of high returns on capital and large payouts with below-average growth raises the possibility, pointed out by a number of the roundtable participants, that many companies have been passing up value-adding growth opportunities in misguided efforts to keep raising their operating returns. Such efforts are "misguided" in the sense that the goal of financial management, as business schools have long taught their students, is to maximize not corporate returns on capital, but net present values. And the way to do that is to follow the NPV rule: take all projects that are expected to earn at least the "cost of capital," and walk away from the rest.

According to a number of the panelists, many U.S. companies when evaluating new investments appear to be using hurdle rates that are well above their cost of capital. (In fact, in an article that follows the roundtable, members of the JP Morgan corporate finance advisory team report that the median reported hurdle rate for S&P 100 companies is 18%—which, at a time when the 10-year Treasury rates are not much above 2%, seems stratospheric.) To the extent this is so, such companies are likely to be sacrificing valuable opportunities, whether for M&A or "organic growth."

In support of this argument, Mauboussin points to suggestive evidence of a recent shift in the market's view of corporate growth. During the past three decades, and thus starting in the 1980s, research published by academics as well as Credit Suisse shows a generally *negative* association between corporate growth rates in earnings (before interest and taxes) and stock returns; in other words, the companies with the best stock market performance have historically been those with relatively modest growth rates—and that have presumably focused more on increasing returns on capital. But in the last five years or so—roughly the post-crisis period—the companies that have achieved the highest stock market returns appear to have made conscious decisions to *reduce* their returns while increasing investment and growth.

As Mauboussin reflects on this finding,

*I've spent much of my career criticizing companies for an excessive focus on growth and too little attention to returns. But with our latest report, I now find myself in this weird situation where I might begin arguing the opposite… [T]he market may be saying that it's no longer high returns on capital, but rather growth, that is the scarce commodity investors are willing to pay up for.*

But if this is indeed evidence of a major underinvestment problem, many U.S. companies now seem to be responding to the market's signals. For, as Mauboussin and others observe, U.S. corporate capital spending, particularly on M&A, now appears to be taking off. And corporate spending on R&D, despite popular claims to the contrary, has risen steadily in the last 30 years. As Mauboussin and Dan Callahan point out in their article that follows the roundtable, total R&D spending by the largest 1,500 U.S companies has increased from 1.4% of sales in 1980 to its current level of about 2.3%, an increase that reflects the growing role in the U.S. economy of R&D-intensive sectors like technology and healthcare.

The second major focus of the roundtable, clearly related to the first, is the widespread complaint that many U.S. companies are shortchanging the corporate future by paying out excessive amounts of their capital to investors as dividends and stock buybacks. There are two main versions of this story. In the more popular one, companies like IBM are said to be attempting to compensate for their loss of growth prospects by buying back shares primarily to maintain their reported EPS. In this account, share repurchases—and dividends too—are viewed as corporate admissions of failure to find promising growth opportunities and so fulfill their primary social mission of creating jobs.

The other version of the story—one that is premised on value maximation and not full employment as the corporate goal—focuses partly on the underinvestment problem. In particular, Greg Milano, the panel's moderator, cites his own research that shows that, at least in recent years, companies with the largest buyback programs also tend to have below-average stock-price and operating performance. But Milano's greatest concern about buybacks appears to be the growing evidence of a tendency for companies to buy back their shares at the worst possible time—that is, when their prices turn out to be close to peak levels. By so doing, companies could not only find themselves short of capital when opportunities materialize; but in some ways even worse, they could effectively be rewarding those shareholders who choose to sell—the short-term holders, if you will—at the expense of those who choose to stay.

But others on the panel are less troubled by this possibility of "transfers of value" between departing and existing shareholders. As Mauboussin suggests, even stock buybacks undertaken when prices are near their highs are likely to have net benefits for the economy as a whole. The inclination of U.S. companies, sometimes with prodding from activist investors, to pay out their excess capital is in most ways a reflection of an effective governance system. And as the two activist investors on the panel—one representing Pershing Square and the other Jana Partners—were quick to point out, such payouts have generally functioned as a demonstration of U.S. corporate managers' commitment to investing and operating with the optimal, or value-maximizing, level of capital—neither too much nor too little. Getting those decisions right is the main goal of financial management.

And to judge from our lead article, Conrad Ciccotello's assessment of "The State of the Public Corporation," U.S. companies have done pretty well on this score. Although there are far fewer publicly traded U.S. companies today than there were 20 or 30 years ago—as Harvard's Michael Jensen suggested there might be in a much-cited *Harvard Business Review* article in 1989—the companies that have survived are on the whole larger, more productive, and more valuable than their predecessors. And the main reason for this development, as Ciccotello argues, is a vigorous market for corporate control in which U.S. public companies are continuously monitored by what Jensen called "active investors"—a group that includes other public companies, private equity firms, and even hedge funds. What's more, many readers of the roundtable may be surprised to learn that the average holding period of Pershing Square is "four years," a time horizon considerably longer than that of most actively managed U.S. mutual funds. And for those of us still troubled by the possibility of a large and persistent U.S. corporate underinvestment problem, the news that investment by both private equity firms and hedge funds is on the rise should actually be reassuring.

The next four issues of this journal will be devoted to the following: (1) corporate risk management; (2) sustainability and shareholder value; (3) activist investors; and (4) German capital markets and corporate governance. Manuscripts should be sent to me at *don.chewnyc@gmail.com*. —DHC

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