Market Bulletin

February 14, 2020

Cash: it's what you do with it that matters

In brief

- Earnings are the main driver of stock market returns, but how earnings are used is also important
- Historically, companies favored capital spending (capex), but more recently have shown a preference for dividends and buybacks
- Companies with high buyback yields have outperformed this cycle, but the corresponding reduction in capex will matter in the long-run
- The rise of the capital-lite business has implications for how investors should think about growth vs. value
- Looking ahead, portfolios should balance shareholder returns and long-term growth

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Profits matter, but the devil is in the details

While multiple expansion was responsible for the majority of returns last year, over the long run, earnings growth tends to be the primary driver of stock market performance. As a result, equity investors spend a lot of their time looking for where earnings growth will be the strongest; what does not get as much attention is what happens to earnings after they are generated, and how this impacts future returns.

The clearest example of how earnings impact returns is through the shareholder channel – in other words, when a company returns cash through dividends or buybacks.

However, there are other ways that earnings are used to create value over longer periods of time. For example, when companies reinvest in themselves by purchasing new equipment or providing employees with additional training, this in theory should increase productivity, and therefore earnings, over the long-run. Even paying down debt has a positive effect on profits, as doing so reduces interest costs and allows more cash to fall to the bottom line.

Historically, companies demonstrated a preference for investing back into the business in an effort to drive future growth. While this came at the expense of returning cash to shareholders through dividends and stock buybacks, as shown in **Exhibit 1**, this dynamic has begun to shift. At the current juncture, 45% of cash is being returned to shareholders through dividends and buybacks, compared to just 26% in 1990.

While the implications of this change are yet to be fully realized, a shift in focus from investing for growth to returning cash to shareholders suggests that companies are increasingly focused on short-term earnings and stock performance.

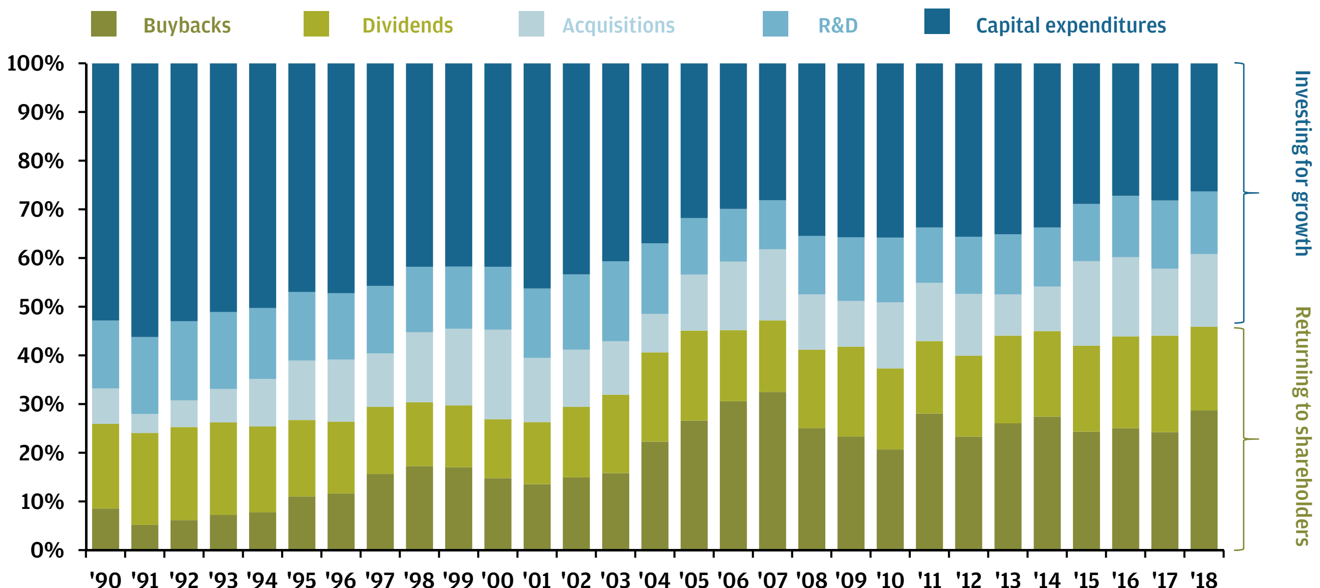
That said, this preference for dividends and buybacks also reflects an environment of lackluster nominal demand, which has characterized the global economy since the financial crisis.

To buyback or payout?

From a corporate perspective, there are clear benefits that stem from returning cash to shareholders. For one, dividends reward investors for providing a company with capital, and allow them to share in a company's profits. Additionally, the payment of a dividend suggests that a company is financially sound, which may subsequently increase investor demand for shares of that company's stock.

However, there are also benefits from conducting share repurchases. For example, when a company buys back its own stock, it signals to the market that it believes its stock is undervalued. Furthermore, buybacks counteract any dilution from employee stock plans, the exercising of options or warrants, and the conversion of convertible bonds.

EXHIBIT 1: S&P 500 companies have seen a preference for shareholder return more recently
% of capital used for each outlay



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Data are as of February 14, 2020.

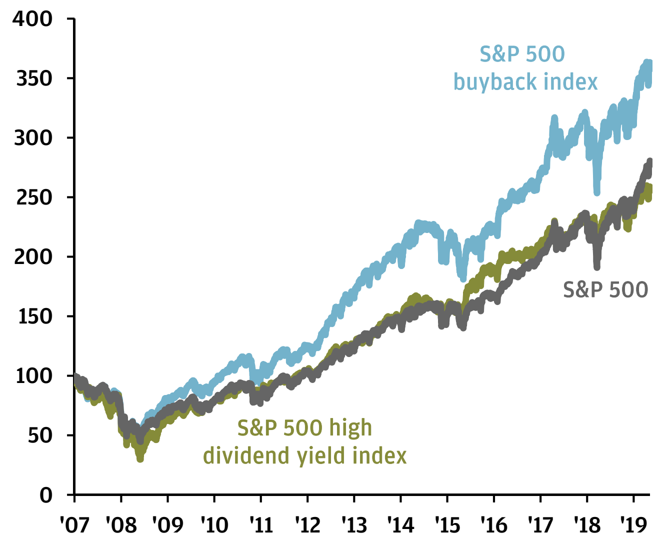
Additionally, in the case where a company is a net buyer of equity, buybacks increase each investor's ownership percentage in the company. Lastly, fewer outstanding shares provide support for financial metrics such as earnings per share (EPS), return on assets (ROA) and return on equity (ROE). In the case of EPS, a lower share count reduces the number of shares that net income is spread across. When it comes to ROA and ROE, a company's assets and equity will both be reduced by the amount of cash extended to buy back shares, shrinking the denominator and therefore improving these financial metrics.

Dividends have long been a hallmark for equity investors, but stock buybacks have gained in popularity over the course of this expansion. Since 2010, the S&P 500 has averaged a buyback yield of 3.0%, compared to a dividend yield of 2.1%. In addition to a belief on the part of management that shares were cheap – and therefore buybacks made sense – another explanation for this trend is that investors have rewarded companies with strong buyback activity. As shown in **Exhibit 2**, companies with the highest buyback ratios have significantly outperformed both high yielders and the broad market over this cycle. Part of this investor demand may be due to the tax advantages that buybacks have when compared to dividends. Investors pay no tax when their percentage ownership in a company is increased due to a stock buyback, but they would incur a capital gains tax if they received the cash as a dividend payment.

Both dividends and buybacks provide support for equities over the short-term, but do little to contribute to the long-term growth of a company. Another reason why returning cash to shareholders may have gained prominence over the last few years is the age old principal-agent problem.

EXHIBIT 2: Investors have rewarded companies that have bought back shares over this cycle

Rebased to 100 on the previous market peak on 10/7/2007



Source: Bloomberg, Standard & Poor's, J.P. Morgan Asset Management. Data are as of February 14, 2020.

Over time, more and more companies have aligned management compensation with stock performance, while simultaneously increasing the share of executive compensation paid in stock and stock options. With short-term stock performance tied directly to compensation, management is incentivized to do things that will have a positive impact on the share price. However, this comes at the expense of investing in structural growth projects, which should boost a company's output, and therefore stock price, over the long-run.

The migration to capital lite

A company can grow in two ways – organically or inorganically – but the bottom line is that in order for a company to grow, it has to invest. Traditionally, organic growth was dominated by capital expenditures (capex) such as the purchase of physical assets like property, buildings, equipment or hardware. More recently however, companies have shown a preference for research and development (R&D), as they work to develop in-house technologies.

While these investments certainly don't show benefits overnight, in the long-run, they boost employee productivity, can expand the company's footprint into new markets, and help to develop new products or services for the marketplace.

On the other hand, a company can grow inorganically by purchasing, acquiring or merging with another company. The benefits here are similar to those generated by organic growth, and they may even show up faster. That said, culture mismatches, a lack of synergies or cost savings, and the large up-front cost can all prove to be headwinds over time.

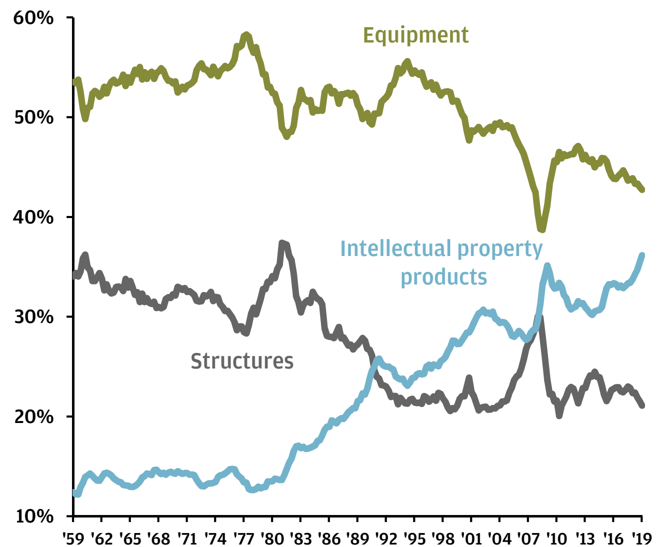
Thinking about this cycle specifically, merger and acquisition (M&A) activity has been robust, while capex has been missing in action. One of the reasons for this has been the collapse in oil prices, which hit capital spending in the energy sector particularly hard. Looking more broadly, however, there has been a hesitancy to invest, despite favorable financing costs, as elevated policy uncertainty, mediocre end-demand, and questions around the longevity of the expansion have kept traditional capex on the sidelines. That said, as shown in both **Exhibit 1** and **Exhibit 3**, companies have not hesitated to invest in R&D and intellectual property products at the expense of traditional fixed investment.

This behavior seems to represent a broader shift toward operating with fewer assets and employing capital-lite business models. Capital-lite businesses typically have lower overhead and fixed costs, and spend more on research and development. Over time, this tends to lead to higher margins, return on assets (ROA) and return on equity (ROE).

For investors, this shift has significant implications for how a company should be evaluated. Traditional capex is capitalized, rather than expensed, and therefore shows up on as an asset on the balance sheet. This leads to higher asset and book values, which has implications for how investors determine whether a company's stock looks cheap or expensive. Research and development however, is typically accounted for as an expense, and therefore does not show up as an asset on the balance sheet. As a result, companies that expense R&D tend to have lower book values.

EXHIBIT 3: Outside of intellectual property products capex has been weak

% of gross private domestic nonresidential fixed investment



Source: BEA, FactSet, J.P. Morgan Asset Management. Data are as of February 14, 2020.

It seems likely that the book value of these capital-lite businesses is understated, which has clear implications for how investors think about valuing securities and investing across different styles. Traditionally, index providers have built value indices by screening companies based on their price-to-book ratio (P/B), with those companies that have a low P/B ratio characterized as "value". This has left growth indices full of capital-lite businesses, while value indices have been inundated with capital intensive companies plagued by higher operating costs. When viewed from this angle, the outperformance of growth relative to value over the course of this cycle begins to make a bit more sense.

Investment implications

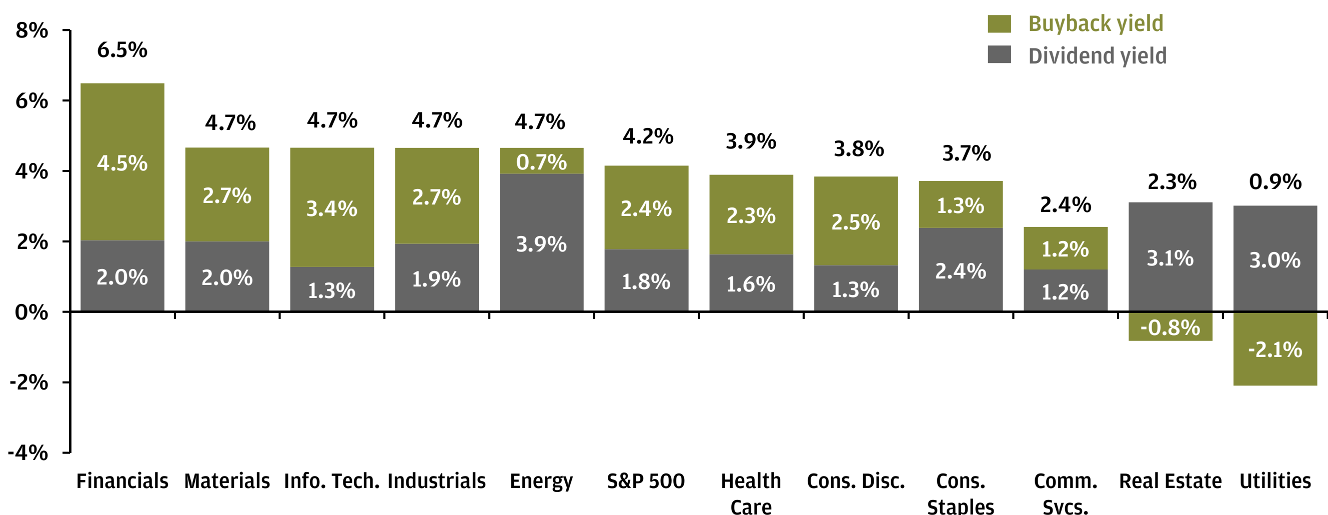
At the end of the day, companies need to balance returning cash to shareholders to support stock prices in the near term, and investing for long-term growth. That said, investors have the opportunity to take advantage of both the short-term and long-term uses of corporate cash within their portfolios.

To take advantage of these shorter-term themes, an investor should look to companies returning an increasing amount of cash to shareholders. More recently, this has entailed a preference for buybacks over dividends, and has led us to look to sectors that are offering a total shareholder yield (buybacks dividends) in excess of the broad market. This allows an investor to mitigate some volatility in this late cycle environment, but given that these sectors tend to be more cyclical than defensive **(Exhibit 4),** participate as the market broadly trends higher.

However, we also believe that a part of one's portfolio should be focused on long-term structural growth. For that, we look to how profits are being used, and believe that capital-lite companies will continue to outperform their more capital intensive peers. **Exhibit 5** highlights the industries that have exhibited strong R&D spending over the last few years. Perhaps unsurprisingly, many of these industries sit within the technology, health care and consumer discretionary sectors, suggesting these may be the best access points for investors looking to take advantage of these secular growth trends.

EXHIBIT 4: Total shareholder yield by sector

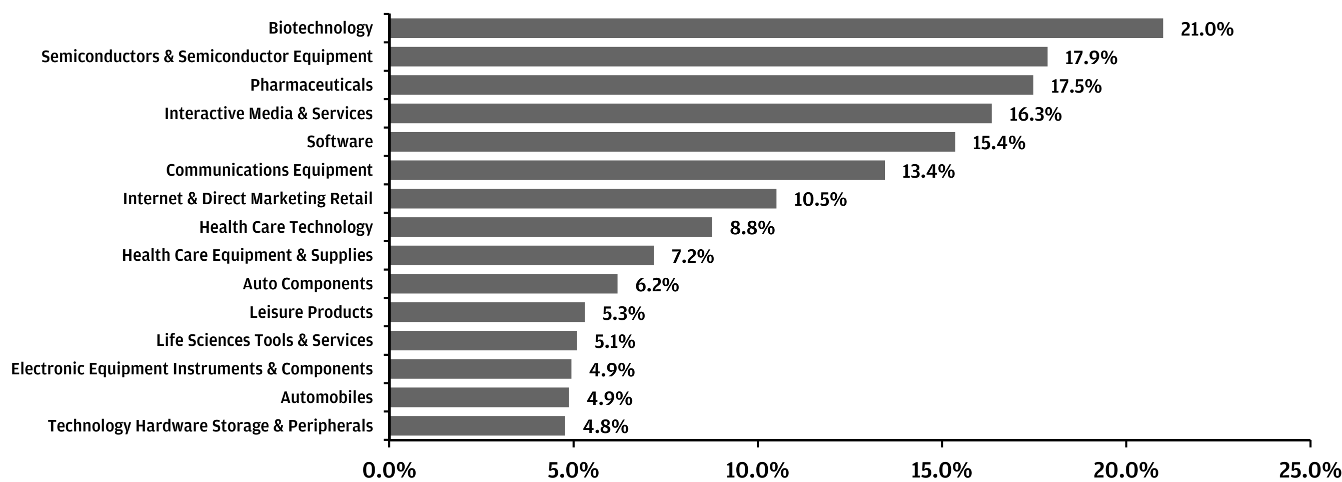
Last 12-months dividends and net buybacks divided by market cap



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Data are as of February 14, 2020.

EXHIBIT 5: Research and development expenses by industry

Research and development spending as a % of sales, average from 2014-2018



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Data are as of February 14, 2020.

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