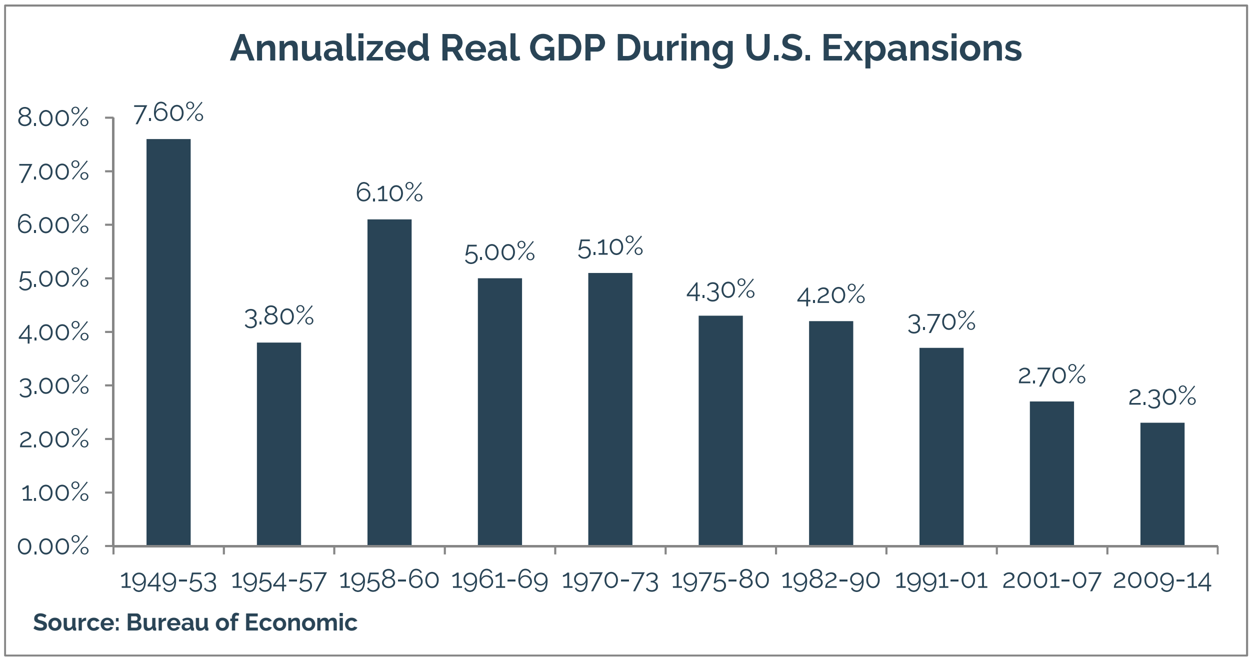
The Extinction of Capex & the Rise of Buybacks

What if? It's a question I found myself asking a lot this month. What if the Fed raised rates today? What if they raised rates 2 years ago? What if they never introduced quantitative easing (QE) to the world? There are just so many questions and so many answers we'll never know. What we do know is that financial assets in the form of stocks and bonds are trading at multi-year highs, if not at record levels, around the world. The Fed's policies implemented during the darkest hours of the financial crisis clearly had an impact and got us to where we are today. If their policies were measured by the performance of the stock market, they more than exceeded everyone's expectations. If they were measured by economic activity, I could argue they've come up quite a bit short. After more than 6 years of maintaining a zero interest rate policy and expanding their balance sheet to $4.5 trillion, you will clearly see we have been rewarded with one of the slowest recoveries in history.



In addition to record equity and bond prices and an anemic recovery, we've been blessed with a lot of confusing data points. As regular readers of this column, you will recall the numerous times I have brought up the disconnect between fundamentals and valuations. This point was validated once again on April 24th when the March Durable Goods report was released. The headline Durable Goods number has historically been extremely volatile and not a great indicator of the economy. However, when you dig deeper into the report, there is a vital piece of information directly related to future growth of the economy and business in general. It is the Durable Goods New Orders (non-defense, ex-aircraft) number. This specific data point is a good indicator of business investment spending (i.e. capital expenditures). Capital expenditures are important because they represent business investment with the expectation of generating future growth. Well, it was most recently reported to have fallen for the seventh straight month. To put this in context, this number has never fallen for this long without a recession. Think about it for a second, it makes complete sense. You invest today for future gains. If businesses stop investing and innovating, job growth slows, consumption screeches to a halt, and the economy eventually contracts.

Some would argue businesses have never been in better shape than they are today. If this is the case, then tell me why they are not using their cash to invest in themselves. Most of the cash generated is getting returned to shareholders in the form of stock buybacks and dividends rather than trying to grow the underlying business. Don't get me wrong, returning cash to shareholders is not a bad thing. However, doing it at the expense of potential future growth is not a wise business decision. Take IBM for example. IBM generated $16.87 billion in cash from operations in 2014. Management decided to use $13.68 billion to buy back stock and paid out another $4.27 billion in dividends. Now, you don't have to be a mathematician to realize IBM paid out more cash to shareholders than they generated from operations. How is this possible? Thanks to the Fed's zero interest rate policy, debt is so cheap that a business like IBM can tap the credit market to make up the difference. As I mentioned, returning cash to shareholders is not in and of itself a bad thing, except when your business has stopped growing. The table below shows IBM's revenue, net income and earnings per share since 2011.

	2011	**2012**	**2013**	**2014**
Revenue (billions)	$106.92	$104.51	$99.75	$92.79
Net income (billions)	$15.86	$16.60	$16.48	$15.75
Earnings per share	$13.06	$14.37	$14.94	$15.60

What stands out like a sore thumb is the difference in direction between revenues and earnings per share. Revenue has consistently declined since 2011, while EPS has been increasing. If you looked at just the top line, you would conclude IBM's business is in decline. If you just looked at EPS, you would conclude IBM was growing. Which is right? IBM 's business is contracting. It is extremely hard to financially engineer sales. You either sold a product or service or you didn't. However, it is much easier to financially engineer EPS. A few examples include cost cutting, "one-time" write-offs and of course, buying back stock. When a company buys back their stock they can make a declining company appear to be growing. In the case of IBM, it would behoove them to use their cash to invest in their business to hopefully one day grow revenues again. A growing business who has the ability to buy back their stock is ideal. However, it is a total misallocation of capital to ignore future growth in favor of the immediate benefits of reducing shares outstanding today. The ability to lever up and buy back shares has a finite life. Whereas, continually investing in future growth opportunities theoretically could provide infinite growth in the business going forward.

So, what if the Fed would've ended their zero interest rate policy and raised rates a couple of years ago? Many people would argue the equity markets would not be where they are today and the economy may even be worse off. I am not totally convinced of this argument. In fact, I think we would've been better off today with higher rates. Fundamentals and valuations would probably be more aligned. It is my belief that the Fed's zero interest rate policy is actually holding growth back and encouraging a misallocation of capital. Look no further to the recent Durable Goods New Orders report and IBM's capital allocation strategy. Low interest rates have encouraged companies to use their cash, whether it is generated through operations and/or debt, to buy back stock because executives believe they can get a higher return through an increasing share price rather than making capital investments in their business. In order for the economy to really grow again, capital investments must become the preferred use of capital over stock buybacks. Investing in the long term prospects of a business will spur job growth, which in turn will increase demand and consumption. The economy will grow and companies can plow those earnings back into further investment. It ends up becoming a self fulfilling prophecy. Until then, we will remain in a world where stock buybacks trump everything else. The economy will continue to grow at a meager pace and we'll always wonder... what if it could've been different?

--Billy Little, CFA

"It requires a great deal of boldness and a great deal of caution to make a great fortune, and when you have it, it requires ten times as much skill to keep it." ~ Ralph Waldo Emerson