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Corporate investment: A mysterious divergence

By Robin Harding

Experts are struggling to explain a great puzzle of the US economy, writes Robin Harding

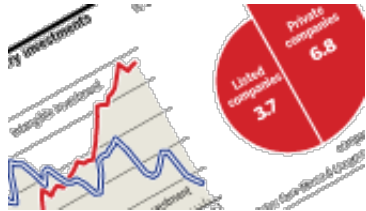
Robert Grant made a solid career out of Botox and breast implants. With a broad smile, he looks like Hollywood's version of a US corporate executive, perhaps because he admits to using some of the rejuvenating products he sold.

Treatments to tauten an ageing population are the quintessential – and highly profitable – products of the US economy in the 21st century. Mr Grant has flown high at some of the industry's top companies, such as Allergan and Bausch & Lomb, which have operations, together with their most ardent customers, in California's Orange County.

But Mr Grant grew frustrated, even in this healthiest of industries. "It has become less about blue

skies, less about true innovation. It has become more a world about efficiency, cost-cutting and debt," he says of large US corporations. "Nobody wants to take a risk on something that could fail."

He overcame his frustration by founding Strathspey Crown, an investment company that aims to back new technologies in "lifestyle healthcare" for consumers who will pay to look better.



Mr Grant's experience reflects a broader mystery about the US economy, one that dates back to the late 1980s, but has become ever more pressing as a fifth year of sluggish recovery begins. Profits in the US are at an all-time high but, perversely, investment is stagnant.

According to GMO, the asset manager, profits and overall net investment in the US tracked each other closely until the late 1980s, with both about 9 per cent of gross domestic product. Then the relationship began to break down. After the recession, from 2009, it went haywire. Pre-tax corporate profits are now at record highs – more than 12 per cent of GDP – while net investment is barely 4 per cent of output. The pattern is similar, although less stark, when looking at corporate investment specifically.

This change is profoundly odd. Economic theory says investment is driven by profitable opportunities on one side and the cost of capital on the other. High profits suggest there are decent opportunities to make money; historic lows in interest rates and highs in the stock market mean that capital is dirt cheap. Yet investment does not follow.

"We have this strange thing that the return on capital really does seem to be high, the cost of equity capital is low, and yet we're getting a lot of share buybacks and not much investment," says Ben Inker, co-head of asset allocation at GMO. "It just feels a bit weird."

For workers, this weirdness is mirrored by a falling share of GDP for wages, so it contributes to rising inequality; for investors, if the extraordinary strength of profits turns out to be unsustainable, then the US stock market must fall; and for everyone, investment today is what leads to a better standard of living tomorrow.

Explaining the disconnect between profits and investment may help solve some of the US economy's biggest problems. Theories include everything from the financial crisis, to the hidden side effects of computer technology, and the perverse incentives of corporate executives.

The most obvious place to start is with the financial crisis and recession. Its extremity helps explain the trough in overall investment: no one built houses for five years. To an extent, it can also explain why corporations do not invest despite high profits.

"You had to recover all the ground that was lost in the dip before you needed to add more capacity," says Joseph Kasputys, founder of IHS Global Insight, which provides economic advice to US companies. "Secondly, there's the fact that the growth prospects for the future have been very anaemic and continue to be very anaemic."

The policy implication is simple: heal the economy and investment will take care of itself. Profits will fall, wages will recover. But the recession alone cannot explain why profits should reach record highs nor why their relationship with investment has changed so much over the past 25 years.

Similar objections apply to the theory – beloved of US business – that rampant regulation, taxation and political uncertainty are stifling investment. Mr Grant argues that the government's focus on controlling healthcare costs discourages innovation. He points to the 2.3 per cent tax on medical devices that helped pay for the Affordable Care Act.

"Innovation is normally only born amid freedom," he says. "In general, you're seeing – particularly in the United States – a model that is probably more regulated than it has been in the past."

Regulation may lower productivity but it is most likely to hurt investment by making it less profitable – and yet profits are up. Moreover, recent rules such as the Dodd-Frank financial reform and the Affordable Care Act cannot explain a trend that spans deregulation during the Clinton and Bush administrations.

That leaves deeper shifts in the economy and one of the most profound is the rise of information technology, which gathered pace as the pattern of investment and profits began to change in the 1980s.

IT is often cited as a cause of rising inequality because computers favour skilled employees who can use them, but Loukas Karabarbounis and Brent Neiman of the Chicago Booth business school suggest they boosted profits as well. Their argument revolves around the cheapness of computers compared with traditional investment: it costs less to raise output via a new version of Windows than a new production line.

As IT made investment cheaper, companies used computers to replace staff. That led to a rise in profits relative to wages. The cheaper investment became in a country, find Mr Karabarbounis and Mr Neiman, the more the share of profits in GDP went up.

There were times when we wanted to acquire early stage

But there is a problem with this theory: it predicts higher investment along with higher profits as companies plough money into computing power. "It is the case that our baseline calibrations predict more

> technologies but we couldn't because it would put too much burn on the P&L
>
> - Robert Grant, former US corporate executive

investment spending than we have typically seen," Mr Nieman says.

One possible answer is that economic statistics do not pick up all this investment. For example, they may not fully capture the falling price of computing power and investment may be shifting towards intangible assets such as research, branding and better business organisation.

According to Carol Corrado of The Conference Board, the business group, intangible investment has doubled as a share of GDP over the past 40 years. Once you account for it, investment looks stronger. "It changes the pattern enormously," she says.

If computers are the main influence then profits are sustainable, there is less fear for future growth and workers are out of luck until another technology comes along to create demand for their labour.

There are still many doubts, however, about whether intangibles really are a form of investment. If one company invests in a brand to boost profits, does that not mean another company will lose profits, with no change for the economy overall?

Paul Krugman, the Princeton economist and New York Times columnist, has a more sinister explanation for the missing investment. He suggests there has been a general increase in monopoly power. "The most significant answer, I'd suggest, is the growing importance of monopoly rents: profits that don't represent returns on investment but instead reflect the value of market dominance," he wrote.

More monopolies would explain higher profits with less investment, but there is modest evidence that monopoly power has risen, and capital expenditures are low in competitive industries as well. The share of value added by the top 20 software publishers in the US rose from 46 per cent in 1997 to 58 per cent in 2007, for example, which is noteworthy but hardly a new Standard Oil.

That leaves one more theory, which goes back to Mr Grant, and the large public companies that have fuelled rising profits in America.

Corporate America went through a revolution in the 1980s with the arrival of leveraged buyouts, shareholder value, executive stock options and their like. The nature of public companies changed.

"There's just this focus we have on Wall Street around quarterly numbers," says Mr Grant of his years working for public companies. "There were times when we wanted to acquire early stage technologies but we couldn't because it would put too much burn on the P&L.

"Over time, the pressure for earnings per share becomes so strong." That leads to a focus on cost-cutting and efficiency, rather than risky investments that take time to pay off, he says. "If you're gaining market share then you win, even if the market contracts. If you grow the market but lose share then you could lose your job."

Andrew Smithers, of London-based asset allocation adviser Smithers & Co, claims this change in the culture of large corporations can explain the divergence between investment and profits. In particular, he argues that stock options encourage executives to boost short-term profits, while curtailing investment in favour of buybacks that push up earnings per share.

The idea that a myopic stock market may lead companies to underinvest dates back to research done in the late 1980s by Jeremy Stein, then a Harvard economist and now a governor of the Federal Reserve. The question, however, is whether executive pay can have such drastic effects on the broader economy. There is no certainty – but some suggestive evidence.

In a piece of theoretical research published recently by the New York Fed, economists John Donaldson, Natalia Gershun and Marc Giannoni find that executive pay contracts may have "dramatic, adverse business cycle consequences".

But perhaps the most remarkable result comes from newly available data on private companies studied by Alexander Ljungqvist and colleagues at Harvard and New York University. They find that, keeping company size and industry constant, private US companies invest nearly twice as much as those listed on the stock market: 6.8 per cent of total assets versus just 3.7 per cent.

Private companies are four times more responsive to new investment opportunities and, when a private company goes public, it changes its behaviour.

Mr Ljungqvist says he has not examined the effect of this difference on overall investment in the economy. Given the size of the S&P 500, however, investment might be percentage points of GDP higher if its members invested like private companies.

Each theory may hold part of the truth about profits and investment. But if corporate behaviour is to blame, there are policy levers to pull. It would be time to stop thinking about corporate governance and executive pay as matters of equity and to regard them instead as a macroeconomic problem of the first rank.

"All the discussion has been about unfairness," says Mr Smithers. "The economic damage has been totally ignored."

Amazon bucks the trend

If there is an exception that proves the rule about US corporate investment it is the internet retailer Amazon. Whenever the company has a dollar to spare, Jeff Bezos, chief executive and dominant shareholder, ploughs it into a new service.

“Our heavy investments in Prime, Kindle, digital media and customer experience in general strike some as too generous, shareholder indifferent or even at odds with being a for-profit company,” wrote Mr Bezos in his shareholder letter this year.

“But I don’t think so . . . Proactively delighting customers earns trust, which earns more business from those customers, even in new business arenas. Take a long-term view and the interests of customers and shareholders align.”

In 2012 Amazon was one of very few US technology companies to invest more cash than it earned. It generated $4.2bn in cash from operations, spent $3.8bn on equipment and paid $745m to acquire a warehouse automation company.

Apple is more typical. It takes risks on innovations such as the iPhone but usually within existing product categories. Last year Apple managed to reinvest only about 20 per cent of its cash generation within the company and recently announced a $50bn share buyback.

Perhaps it is impossible for a company as big as Apple to invest that money. But consider Amgen, the world’s biggest biotechnology company.
Amgen has less capital equipment than it did in 2006 and spends only a fraction more on R&D. Last year it earned $5.9bn in cash from operations, spent $2.4bn on acquisitions and returned a net $4.4bn to shareholders via buybacks and dividends.

This need not be bad for companies or their shareholders. It is surely better to return capital than waste it. The question for the US economy, however, is this: if growth companies such as Apple and Amgen cannot or will not deploy capital, then who on earth will?

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