The profits prophet

A new book explains why business investment has been low

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PROFITS have been booming in America, reaching the highest proportion of GDP since the second world war. Given such buoyant conditions, you might imagine that businesses are investing like crazy to take advantage of all those great opportunities.

Not a bit of it. The ratio of business investment to GDP has picked up since the depths of the financial crisis, but is still close to the lows of previous cycles. Instead, businesses are handing cash back to shareholders, a tactic once reserved for executives who had run out of ideas. In 2011 the value of American share buy-backs was equal to 2.7% of GDP; in Britain, the figure was 3.1%.

In the early 1970s American companies invested 15 times as much cash as they distributed to shareholders; in recent years the ratio has dropped back to below two (see chart). What has driven this change? In his new book, “The Road to Recovery: How and Why Economic Policy Must Change”, Andrew Smithers, an economist, argues that the main cause has been management incentives.

Executives are now paid largely in the form of bonuses rather than salary. These bonuses are often tied to the share price, which in turn depends on the ability of the company to meet its quarterly earnings-per-share target. Buy-backs tend to boost earnings per share; investment plans may dent them. Mr Smithers writes that “The result of the increased importance of bonuses and the use of these measures of performance is that managements are now less inclined to take short-term risks, such as cutting profit margins, and more inclined to take the longer-term risks involved in lower investment
and the possible loss of market share that will result from higher margins.”

There is other evidence for his assertion. A 2004 academic survey (http://www.nber.org/papers/w10550) found that the majority of managers questioned would not proceed with a profitable long-term project if it meant that the company would miss the consensus forecast of profits in the current quarter. A 2013 study (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1603484) found that publicly quoted companies where executive compensation is linked to the stockmarket invest considerably less than private firms and are less responsive to new investment opportunities. The authors state that “our results are most consistent with the view that public firms’ investment decisions are affected by managerial short-termism.”

Many executives are rewarded in the form of share options for meeting targets. Options are more valuable when they are linked to a volatile asset (the more the asset price moves, the more likely it is that the option will be exercised). Since share prices are affected by trends in profits, executives have an incentive to pursue strategies that make profits more volatile. Sure enough, Mr Smithers finds that profits of quoted companies have become much more volatile in recent years. Until 2000 profits in the national-accounts data had very similar volatility to the reported profits of S&P 500 companies; since then, the latter have been four times as volatile.

The change seems to be driven by mark-to-market accounting. Firms mark up the value of their assets during good times, and then write them down in the bad. There is no equivalent to this in the national accounts. In Mr Smithers’s view, that means American profits are overstated, particularly at the moment. Indeed, according to the national accounts, American companies have been paying out in cash more than 100% of their domestic profits to shareholders.

If profits have been overstated, so therefore has the net worth of companies. For all the talk of deleveraging, there is barely a sign in the national accounts of a fall in the ratio of non-financial corporate debt to GDP. As a result, the dangers of high debt are underestimated. A collapse in asset prices could still provoke a crisis.

The lack of corporate investment has also had broader effects. Companies have preferred to increase output by adding labour rather than capital. In Mr Smithers’s view, this explains why the productivity numbers in America and Britain have been unusually poor in recent years.

Mr Smithers is something of a maverick in financial and economic circles but he makes a powerful case—just as he did in 2000, when his book, “Valuing Wall Street”, pointed to the excesses of the dotcom bubble. Few listened to him then. More should do so now.

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