Markets

**Investors Rewire Stock Trades to Find Trillions in Hidden Assets**

By Justina Lee  
October 22, 2020, 7:54 AM EDT

- Systematic managers spar on whether to incorporate intangibles
- Research spending may justify high valuations for tech firms

Ask Moderna Inc. bulls how the money-losing biotech firm has just become a $28 billion stock, and they’ll play up its status as a frontrunner to deliver a drug that ends the pandemic.

While the company holds equipment and cash, what makes investors so willing to shell out is its promise in research and development. Yet under rules established since 1975, accountants treat R&D not as an asset of identifiable value on the balance sheet, but as an expense that reduces corporate earnings.

Now, big Wall Street names are pushing back. From MFS Investment Management to Wellington Management, they’re shaking up their investing models to make it easier to evaluate a Corporate America built on intangible assets -- brands and patents -- rather than physical items like factories and commodities.

“We're now in a more service- and technology-oriented economy so it's more important today to actually incorporate these measures of intangibles,” said Campbell Harvey, a senior adviser at quant firm Research Affiliates and professor at Duke University, on a recent webinar.

Incorporating intangibles to book values leads to superior performance for systematic investors, according to Harvey.

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That’s a big deal. If the idea catches on, it could transform financial analysis, rewrite quant models and reclassify hundreds of securities for investors of all stripes. With listed American firms excluding real estate and financial services spending an estimated $2 trillion last year on intangibles, more than double capital expenditure, the debate is firing up diverse constituents of the marketplace.

**Forgotten Assets**
Capitalizing intangibles makes the tech giants look less overpriced

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Source: Research Affiliates; data as of Sept. 30

Capitalizing things like trademarks and human talent on the balance sheet would make valuations for tech firms look somewhat more reasonable relative to their earnings or book value. Among America’s famously pricey tech giants, for instance, Research Affiliate’s calculations show the change would lower Amazon.com Inc.’s premium over the average large-cap from 982% to 340%, and Netflix Inc.’s from 1,138% to 759% as of Sept. 30.

No wonder traditionalists see a ruse to justify frothy tech shares. They fear that valuing intangibles is a guessing game, given the inherent uncertainty about their future worth.

Proponents say it’s all rooted in a larger mission: Reflecting an economy that’s less about the physical stuff and more about intellectual capital. After all, intangibles are now worth nearly 80% of tangibles in the U.S. market, compared to less than half before the 1980s. For growth shares, the former are now roughly 180% of the latter, according to Research Affiliates.

Read more about intangible assets in the stock market
Heeding this trend has paid off for MFS Investment. Capitalizing R&D in tech and health care has been one of the top-performing value signals in recent years, says Noah Rumpf, director of quant equity research at the $548 billion firm. His team is now studying what expenses can proxy for intangible investments in other sectors.

The $1 trillion Wellington Management has also advocated the approach recently, while strategists at banks from JPMorgan Chase & Co. to Morgan Stanley are coaching clients on how to do it. Some firms have turned to alternative data such as patent registrations to refine their measurements.

“If R&D capitalization is instead taken into consideration in an assessment of value, the denominator in multiples gets bigger -- and a broader range of companies can show that they have value,” a Wellington team led by Gregg Thomas wrote in a report.

**Knowledge Economy**

Intangible assets are an increasingly large portion of U.S. corporate capital

Source: Research Affiliates

To complicate matters, when a firm buys another, the intangibles of the target company end up listed on the acquirer’s balance sheet in modern accounting. When the latter develops such assets on its own, however, the book value stays the same. To fix this, analysts typically turn a firm’s R&D as well as a fraction of selling, general and administrative expenses into an asset on the balance sheet that is then amortized, as if it is buying a building.

The thinking goes that just like regular capital investments, such intangible spending brings future benefits and shouldn’t be treated as expenses for that period.

With that tweak, Microsoft Inc.’s 2020 after-tax profits, for instance, would be 17% higher and its investments 70% greater, according to an analysis adapted from academic research by Morgan Stanley Investment Management’s Michael Mauboussin.

While discretionary stock pickers are free to adjust their math, these changes can be momentous for quants who invest based on factors like how cheap a share is relative to fundamentals. An academic paper found that in a 929-stock value portfolio, more than a quarter dropped off the list after incorporating intangibles into book value.

“This factor is extraordinarily important to our assessment,” said Lauren Goodwin, a strategist at New York Life Investments. “The inadequacy of our traditional financial statements to give us
that information as investors has meant that some of these style calls -- value versus growth is just a great example -- are less straightforward."

**No Tangible Benefits**
DFA says capitalizing intangibles doesn't improve strategies much

Source: Dimensional Fund Advisors

Dimensional Fund Advisors, a $527 billion quant, is resisting the newfangled approach. In a recent study, it showed value portfolios that capitalized intangibles would still have lost money over the past decade and any edge disappears once the firm’s profitability is taken into account.

“You would not have been saved from the underperformance of value stocks,” head of research Savina Rizova said. “There is a lot of noise in the estimation of intangibles.”

Yet for a large swath of the asset-management world watching tech stocks tear higher every year, it’s at least worth a shot.

“Is looking at R&D just a way to justify how expensive stocks are? I don’t think that’s an issue,” said Rumpf at MFS. “It’s important to be aware of places like this where the accounting system doesn’t do a great job of capturing firm value.”

– *With assistance by Sarah Ponczek*

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**In this article**

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