SHAREHOLDER VALUE

Loose arguments about capital returns

January 2, 2020

Comment on today's story in The Australian that companies returning capital through dividends and buybacks are missing high return projects and contributing to a lack of investment and innovation. There are two loose arguments. First, that executives are driven to focus on short-term performance by a narrow share market focus on immediate results – share price responses to earnings announcements show that the market places just the right emphasis on short term results. Second, that retaining more earnings for investment boosts return on capital – reverse causality is clear, companies with opportunities take advantage; mature businesses return cash. Spot loose arguments by asking if there is anything objectionable? Anything to debate? If the answer is no, chances are that the idea is simply a response to a straw person argument that no-one is making.

Comment on today's story in The Australian that "the over-distribution of capital through dividends or share buybacks can be a drain on corporate performance over the longer term." Examples of loose arguments and how to spot them.

The first loose argument is that the share market over-emphasizes short-term performance. It's true that many executives believe that the share market places undue emphasis on short-term performance (hitting earnings targets, increasing dividends). Survey evidence bears this out – the researchers correctly state that many executives would reject a positive net present value project if it meant missing a quarterly earnings per share target. The evidence also shows a cluster of earnings per share announcements just above zero, and just above expectations.

However, the perception amongst some executives that this is due to the share market's undue focus on short term profits does not reflect reality. The share market places just the right emphasis on short-term performance. If the market consistently over-emphasized short-term outcomes we would have a simple trading strategy – sell stocks that had a positive price response to good earnings news, and buy stocks that had a negative price response to bad earnings news. The persistent over-reaction would lead to stock price reversals and substantial profits for our strategy. However, this strategy doesn't generate positive risk-adjusted returns, which rebuts the loose argument that investors can't see past the next quarter's earnings.

The second loose argument in the research referred to by The Australian is that companies with high distributions are leaving money on the table. The argument is that companies that invest more generate higher returns on capital on the long term – of course they do. Companies which have good opportunities for investment take on those opportunities. It's not the case that companies with mature businesses can suddenly create value or boost their research productivity by just deciding to invest more.

Loose arguments are exposed by asking, "is there anything at all objectionable about them?" If the answer is no, you can bet that the argument is a loose rebuttal of a straw person case that no-one else is making.

For example, can anyone object to the idea that executives should consider long-term outcomes in making investment decisions? No. For decades in business schools we have taught executives to accept positive net present value projects – these projects generate returns above the cost of funds after fulling accounting for the timing, magnitude and risk of expected cash flows. Can anyone object to the argument that high research productivity is better than low research productivity? Or that companies that retain earnings for investment will grow more than companies that invest less?

The point is that no-one in the investment community is making the argument that rejecting projects that earn returns above the cost of funds, and instead returning cash to shareholders, is a worthwhile use of funds. This might be the perception amongst some executives, motivated by the idea that investors just don't understand long-term horizons. But the market evidence suggests otherwise. Investors calling for the return of capital via dividends and share repurchases do so with respect to companies sitting on idle cash. They aren't making an in-principle objection to investment. But they want executives to come to the debt and equity markets for new capital if there is a good opportunity, rather than sit on cash, or spend money on research or expansion, simply to grow a mature business.