Corporate Risk Reduction

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Clients frequently ask what we expect the S&P 500 Index ("S&P 500") to return in a given year. Our answer is nothing if not consistent: we do not know (and are wary of those who claim they do). However, we have been building an analysis set for some time now that indicates that institutional biases increasingly emphasize liquidity needs for their enormous pools of capital over investment merit, all in the name of reducing volatility.

At the index level, this trend is reflected in the prevalence of the float-adjusted market capitalization weighted index construction methodology, the results of which include increasingly top-heavy indexes and the exclusion or under-representation of smaller or more closely-held companies, even of entire industry sectors. Unfortunately for index investors, the same large companies that dominate index returns also face the greatest challenge with respect to future growth. How can a company with a $100 billion sales base generate enough incremental sales each year to move the needle when it has already saturated its market? Complicating matters further, since investors wish to experience low volatility, the company with a $100 billion sales base is expected not only to increase its revenues and earnings materially, but to do so in a manner that does not result in a variable earnings stream or stock price.

In the face of these two seemingly antagonistic goals, the largest corporations appear to be favoring risk reduction over long-term value creation. One way of measuring this trend is to use the basic corporate liquidity measure, which is cash as a percentage of assets. The following table shows this measure for the 12 largest nonfinancial companies in the S&P 500; this discussion considers only nonfinancial companies because cash as a percentage of assets for Bank of America, for example, is not a meaningful figure. Note, too, that the top 12 nonfinancial companies in the S&P 500 happen to comprise 19.83% of the market value of the entire index, which is not a small number.

Cash as % of Assets for S&P 500's 12 Largest Nonfinancial Companies

Company	% of S&P 500		% of assets in cash/equiv.
Apple Inc.	2.86%		70.5%
Exxon Mobil Corp.	2.47%		1.3%
Google Inc.	1.99%		52.9%
Microsoft Corp.	1.74%		54.7%
Johnson & Johnson	1.59%		22.0%
Chevron Corp.	1.33%		6.5%
Procter & Gamble Corp.	1.30%		5.9%
Pfizer Inc.	1.23%		18.9%
Verizon Communications Inc.	1.16%		19.7%
IBM Corp.	1.13%		8.8%
AT&T Inc.	1.04%		1.2%
Merck & Co. Inc.	1.99%		16.6%
Total	*19.83%*	*Avg.*	*23.3%*

Source: Component weights for SPDR S&P 500 ETF from State Street as of 3/14/2013, % assets in cash/equivalents from Bloomberg as of December 2013. The SPDR S&P 500 ETF (SPY) is an investable product that seeks to provide investment results that, before expenses, correspond generally to the price and yield performance of the S&P 500 Index.

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Of course, the 12 companies—Apple, Exxon, Google, Microsoft, Johnson & Johnson, Chevron, Procter & Gamble, Pfizer, Verizon, IBM, AT&T, and Merck—are all very different businesses. On average, however, cash as a percent of total corporate assets is 23.3% for the group, and some companies, as one can see, are holding considerably more than that.

The 23.3% average is an interesting statistic. If portfolio managers were active and holding 23% cash in their portfolios, they would be considered reckless, at a minimum relative to their mandate to be invested in equities and to not assume other risks such as timing the market, and much worse than reckless, at a maximum. These companies, however, are holding cash at those levels. What is the difference, one might ask, if the companies hold a 23% cash balance and the managers hold a 23% cash balance? Is it not all the same? Actually, it is not, because the more cash on the balance sheet, the less volatile the equity is going to be. It is clear that the companies themselves are interested in reducing their volatility.

Another way to look at this question of liquidity is the current ratio, which is simply current assets divided by current liabilities. There are some interesting findings here for the same 12 companies:

Current Ratio	
Apple Inc.	1.49x
Exxon Mobil Corp.	0.83x
Google Inc.	4.58x
Microsoft Corp.	3.17x
Johnson & Johnson	2.20x
Chevron Corp.	1.52x
Procter & Gamble Corp.	0.89x
Pfizer Inc.	2.41x
Verizon Communications Inc.	2.62x
IBM Corp.	1.28x
AT&T Inc.	0.66x
Merck & Co. Inc.	2.00x

Source: Bloomberg as of December 2013.

Note that a well-capitalized company normally has a current ratio above 1.0. Of these companies, nine have a current ratio above 1. The three with a current ratio below 1 are AT&T, Exxon and Procter & Gamble. Does this mean that those three companies are poorly capitalized? No. They simply collect from their customers faster than they pay their vendors and, as a matter of fact, that is the secret—or one of the secrets—of a consistently high return on equity. For example, Procter & Gamble now pays vendors in 75 days, extended from the previous 45 days. *Supply Chain Digest,* an industry newspaper, wrote about that shift when it took place, because it was considered to be so surprising. A reduction in current assets simply makes it possible to employ less equity, and the same earnings on a smaller equity base implies a higher return on equity.

An even more elementary measure of risk and liquidity is the so-called quick ratio, which is current assets minus inventories, divided by current liabilities. This ratio is designed to envisage a circumstance in which either the inventory cannot be liquidated readily or, if it can be liquidated, that it will be done only at a loss.

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Quick Ratio	
Apple Inc.	1.02x
Exxon Mobil Corp.	0.53x
Google Inc.	4.25x
Microsoft Corp.	2.96x
Johnson & Johnson	1.59x
Chevron Corp.	1.15x
Procter & Gamble Corp.	0.50x
Pfizer Inc.	1.79x
Verizon Communications Inc.	2.46x
IBM Corp.	1.03x
AT&T Inc.	0.46x
Merck & Co. Inc.	1.38x

Source: Bloomberg as of December 2013.

Of these 12 companies, the same three have a quick ratio below 1.0 as have current ratios below 1 (Exxon, Procter & Gamble, and AT&T). Interestingly, all the companies have current ratios that are fairly close to their quick ratios. Apple carries virtually no inventory, which is also astonishing for a company of its size. Out of $80.3 billion in current assets as of December 28. 2013, only $2.1 billion was in inventory, and most of that was finished product.

Companies like these have come to dominate the S&P 500 in recent years. With such liquid balance sheets, their stocks are necessarily much less volatile than the stocks of market leaders of the previous generation. For example, companies in a prior era, like Ford, U.S. Steel and General Motors, did not maintain anything close to this level of liquidity. Their earnings were much more volatile than those of the companies that lead the S&P 500 today. What we might be looking at is an equity market that is less volatile than the historical average. Even the financial companies, which we did not include in these tables, have much less balance sheet risk than was the case prior to 2008.

In sum, portfolio managers are making portfolios less volatile, and managements of the companies are making the companies less volatile. Furthermore, orchestrators of indexes are making the indexes less volatile because their inclusion criteria tend to result in the exclusion of the most volatile stocks. These three trends are all occurring simultaneously.

For many of these companies, the priority placed on liquidity comes at the expense of investment. Along with other headwinds discussed in past commentaries, the unwillingness to deploy cash reserves seems likely to adversely impact earnings for the largest companies and indexes going forward, such that the companies and sectors with the most attractive predictive attributes will be found outside of the major stock indexes.

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