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EQUITY EARNINGS

The unique advantage of equity investment

Compounding effect is attractive — if a company has a source of growth says Terry Smith

ADVICE & COMMENT

Terry Smith

Investment in stocks and shares — equities — has a unique advantage over other asset classes which in my experience is rarely understood and almost never discussed.

Equities can compound in value in a way that investments in other asset classes, such as bonds and real estate, cannot. The reason for this is quite simple: companies retain a portion of the profits they generate to reinvest in the business.

If you look at companies in the major indices, such as the S&P 500 or the FTSE 100, you will find that on average companies pay out about half of their earnings in dividends. The earnings that are not paid out are invested in the business. No other asset class provides this. If you own bonds, you receive an interest payment but it is not automatically reinvested in the bonds. The only exception to this is so-called payment-in-kind bonds issued by highly leveraged companies, which provide the option for them to issue more bonds if they are unable to pay the cash coupon. So you get more bonds but only at a moment when the last thing you want is for your interest payment to be invested in more of this junk.

Similarly, if you own real estate, you will receive rental income but none of it will be reinvested in property for you.

As well as being a unique feature of equity investment, this can also be a valuable source of compounding in the value of your investments. For example, if you owned the average company in the S&P 500 it earned a return on equity capital employed of 13 per cent last year. If it can retain half the earnings which are attributable to you as an investor and it can continue to invest at its current rate of return as its business grows, that half should also earn 13 per cent.

What makes it even more attractive is that on average the companies in the S&P 500 trade on three times book value, so for every dollar of earnings they retain, they currently create $3 of market value, although of course this — the valuation — can change.

This is not the same as the frequently uttered mantra that the majority of the return on equities comes from reinvestment of the dividends paid. Dividends which are reinvested have to be used to purchase shares at market value — at three times book value currently in the S&P — whereas each $1 of retained earnings gets reinvested at book value. It is the reinvestment of retained earnings, not dividends, which provide the majority of the growth in the value of equities.

Of course, what is even more attractive is if instead of simply owning the index and seeing the companies reinvest your retained earnings at an average rate of return, you own only companies which can achieve a high return on capital and which can as a result manage to translate each $1 of retained earnings into a market value which is a much higher multiple of book value.

If you follow this reasoning you would conclude that if a company is able to invest retained earnings at a high rate of return then the last thing you would want it to do is pay you a dividend. This is perhaps best illustrated by Warren Buffett's Berkshire Hathaway, which has not paid a dividend in over half a century.

Of course this needs to be pursued with care. There is a reasonably sound piece of economic theory called mean reversion which suggests that companies which generate high returns should attract competition, which will eventually reduce their returns to the average, or worse. The very small group of companies that manage to avoid this economic law of gravity have some kind of defence which enables them to fend off the competition. This is the oft-quoted concept of the "moat" popularised by Mr Buffett.

In this article I have described the benefit of equity investment purely in financial terms, but the company has to have a source of growth to enable it to reinvest retained earnings and furthermore, the growth has to provide an opportunity for it to reinvest at a good rate. There are plenty of examples of companies which start with good rates of return but then invest retained earnings at much lower rates and destroy value for shareholders. For an illustration of this, read my article on what went wrong at Tesco.

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