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“In free enterprise nations, the earnings on stockmarket indexes fluctuate around the replacement book value of the shares of the index”

John Templeton

It is with some trepidation that we enter the debate on the Tobin's Q ratio. This measure compares a firm's stock market value with the replacement cost of its net worth. Using numbers presented by the Federal Reserve Board, bearish commentators have seized on the current elevated level of this ratio (1.7 times at the end of last year for the S&P industrials) as compelling evidence that the U.S. market must duly correct sharply. For those who have not followed this debate closely it has seen two Wall Street rivals in opposing corners: Morgan Stanley are warning of imminent collapse whilst Goldman Sachs argue that the current level of this measure is both inflated and irrelevant. Much ammunition has therefore been provided to both bulls and bears alike. It has been a classic example of the 1979 study by the American Central Intelligence Agency, the main conclusion of which was that the more information available the greater the conviction with which previous views are held!* Regardless of the outcome, and the market will surely pronounce on this in due course, the case for using this ratio is compelling. The financial markets are the mechanism by which investors price companies from day to day, whereas replacement asset value is clearly a stable measure of intrinsic worth. It would be rational to suggest a clear relationship between the two, and intuitive to suggest that the best investment returns are achieved when shares sell at a material discount. Whether the current premium is a cause for concern is one thing, but it is certainly a valid subject for discussion. What follows are Marathon's observations on the subject.

First, in a sense this debate is the age old one between growth and value investors, but applied to a whole market rather than individual stocks. At individual company level the growth investor argues that asset value per se is irrelevant, as the company is worth a discounted value of the cashflows generated by those assets. The value investor argues that a share is particularly attractive if there is a discount between market capitalisation and “intrinsic” value. In the latter approach shares select themselves on the basis of price which is why the approach is particularly amenable to quantitative methods. A recent visit to the Mexican blue chip company, Cemex, confirmed that the differences between the two approaches can be stark. Despite its enormous stock price decline, Cemex's market capitalisation, adjusted for debt, is still at a premium to the cost of building new plant. On the contrary, argue Cemex's management, assets are so well managed that they generate cashflows which are worth, in aggregate and after discounting, a value well in excess of their cost. Under this methodology, which may seem to some to be even more ‘through the looking glass’ than most of the arguments presented here, assets are worth more than their value.

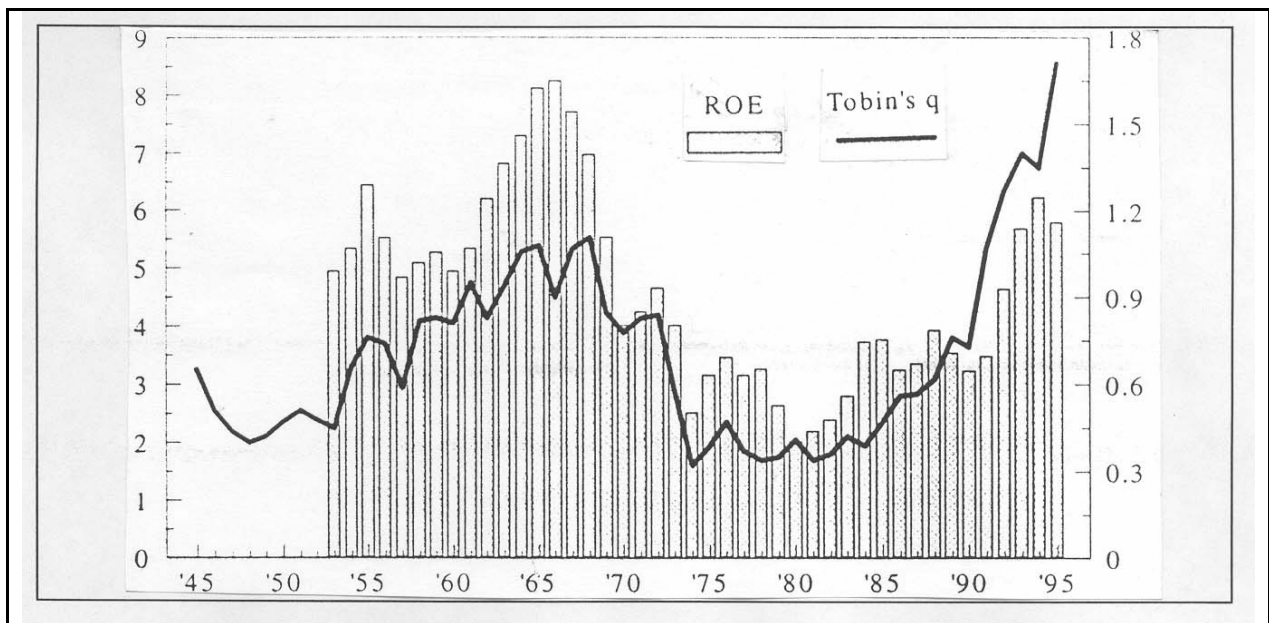
Implausible though it may sound, stockmarket overvaluation of assets is probably one of the key drivers of the capitalist process. Economic wealth is clearly about capital goods, and companies (providing of course they are acting rationally) should only convert shareholders cash into assets if they think they are going to make something on the deal. In short a Tobin's Q ratio in excess of one (or overvaluation) should act as the major catalyst for capacity growth. All too often of course the

*“Do you really need more information?” by Richards J. Heuer, Jr 1979

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process of undisciplined expansion leads to excess capacity and falling profitability, inevitably undermining shareholder values. Thus the process is one of the key drivers behind regression to the mean, and shares individually should in theory trade toward their replacement values. The data for whole markets, however, does not support this view. In the case of the United States for example this overall market measure, unlike that for individual company cyclicality, does not appear to be “mean reverting” except in the very long run (see chart 1 below). For more than a 15 year period shares sold well below replacement value, and investors who recognised this early (such as the buyout funds) performed especially well. This phenomenon means that the measure may have limited value to a portfolio manager over 3 year rolling periods. The current phase of full (or over) valuation could last for an extended period.

Chart 1: Return on Replacement Cost of Equity vs Tobin's Q.

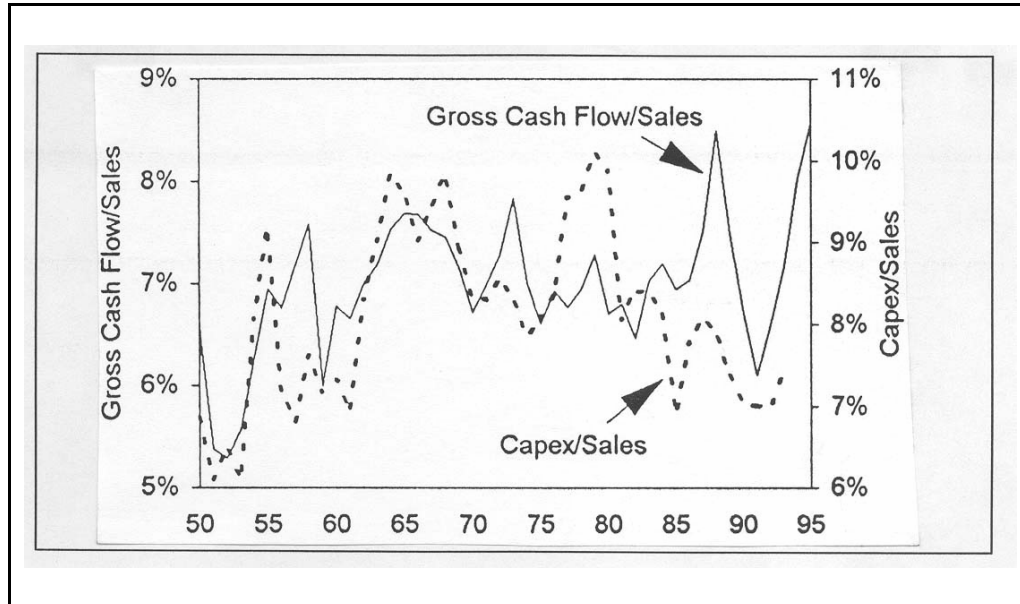


Source: Morgan Stanley

Clearly there are several important relationships to flesh out between stockmarket valuation and capital expenditures, both for individual companies and in aggregate. In theory Marathon expects U.S. capital spending to run at materially higher levels than historically for the foreseeable future. To the extent that the valuation premium is extended so will be the capital spending boom. One of the most interesting features of the current investment environment is the apparent disinterest shown by corporations in rapid expansion, preferring share repurchase and acquisitions to more normal corporate pursuits. The chart below, courtesy of Sanford Bernstein shows how although cash flow as a percent of sales is high, capital spending appears somewhat depressed. Evidence that this has not seriously inhibited capacity growth, as companies appear to be getting more capacity for less spending, does not detract from this anomaly since the evidence is overwhelming that all companies, even US ones, tend to spend their cash flows. That they are restraining themselves, however modestly, is both unusual and lends some support to the notion of an extended business cycle, as it will sustain profitability and cash flows for longer.

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Chart 2: Cash Flow and Capital Spending for S&P as a Percent of Sales.



Source: Sanford Bernstein

It is noticeable that much of the debate around Tobin's Q and replacement cost measures has revolved around the U.S. market. This may reflect available data, but is more likely symptomatic of the enthusiasm of investment professionals to call the top in the U.S. bull market. But America is by no means alone: in emerging markets valuations are extremely high on this measure. Indocement, Indonesia's largest cement producer sells at three times the replacement cost of assets. Unsurprisingly the firm has succumbed to temptation and has announced significant expansion plans. Morgan Stanley, in particular, seems to be able to maintain a negative stance based on replacement cost in the United States, with a positive one in the emerging world, a stance which to our way of thinking is somewhat inconsistent. Moreover profitability in emerging markets is under pressure not just from undisciplined asset expansion, but from the systematic deregulation and tariff reductions (per WTO/GATT etc. etc.) which have supported profits in the past. Material discounts to replacement cost are prevalent in Continental Europe and Japan, and there remains a strong traditional value argument for investments in these more mature economies on this basis.

We can therefore tentatively conclude the following. First, that replacement cost should be a powerful tool both for assessing markets and individual companies. Second, based on historical data, it is unlikely to be 'mean reverting' within the context of a single market cycle. Third, the high net present values implied by Q ratios above imply above normal profitability and this is usually competed away by rapid asset expansion or foreign competition, and so should lead to a continued capital spending boom. Fourth, in the U.S. dollar, or dollar linked block, it is values in the emerging market world that are most exposed, rather than those in the domestic U.S.. Moreover corporate profitability there appears more vulnerable to disappointment because asset expansion is higher and because margin supports like import

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tariffs are being progressively removed. The growing popularity of replacement cost measures is to be welcomed and will produce much better insights into the sustainability of corporate profitability. To the extent that Marathon's clients are underweighted in the U.S.A. and cautious on emerging markets, the conclusions of this policy are already reflected in client portfolios.

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