3Q 2013 Market Insights
The Paradox of Profits
Michael Paciotti, CFA

Integrated|Capital|Management

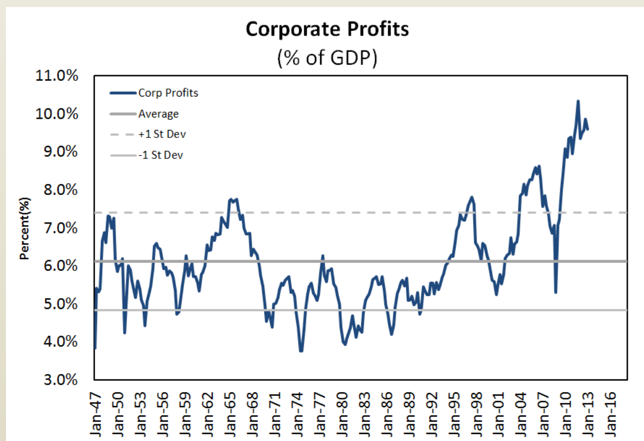
“Whenever you find yourself on the side of the majority, it is time to pause and reflect.”
– Mark Twain

Recently, corporate profits are the subject of much controversy. There is much debate about this topic. Do high profits lead to higher or lower equity returns? Do aggregate profits revert to their mean? Does either outcome have an economic justification or relevance or are the outcomes circumstantial? The topic of this quarter’s letter is to address this statement head on from an academic perspective. In doing so, we will not only address each of the aforementioned topics, but also illustrate why profits have been elevated.

<u>Profits are Mean Reverting, Really!</u>

The concept of mean reversion of aggregate profits comes as somewhat of a surprise to most. First, we must remember that we are referring to aggregate or total profits in an economy, not an individual business. An individual business may possess some unique attribute that is deserving of a greater share of the profit pie than a competitor. In aggregate, one company’s loss may be the other’s gain resulting in a total change of zero.

Chart 1



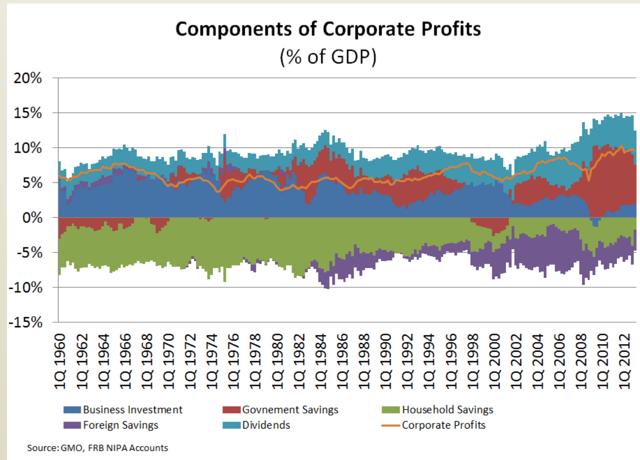
From 1947 through 1999 aggregate corporate profits averaged 5.75% of GDP with cyclical highs reaching about 8% in the mid 60’s and late 90’s and cyclical lows of 4% in the early 70’s and 80’s. For 50 years corporate profits would rise to a level where crowding out before falling back to and below average levels. Currently corporate profits remain stubbornly high at north of 10% of GDP. So what then if anything has changed to suddenly make this old reliable recipe suddenly invalid?

The simple logic that exists behind the concept of mean reversion of profits relates directly to Adam Smith’s Invisible Hand Theorem and that large profit opportunities in any market or business will tend to attract competition. This increase in competition will persist until profits are driven down to a normal level and equilibrium is restored, hence Smith’s Invisible Hand. Sell oranges on one corner and earn a large profit and it won’t be long until the apple retailer down the street decides that maybe he should sell oranges too.

Similarly, from an income perspective we must realize that both the business and the household sector share from the same economic pie. If business cuts wages to increase profits and consumes too much of the pie, there will be little left over for the consumer. At a certain point, consumption will decline and so too will the life-blood of business.

Sadly, and much to the dismay of many, profits are mean reverting. This can be seen in Chart 1. For fifty years, profits fluctuated in a rather reliable pattern between 4-8% of GDP. In the last ten years, there has been a rather seismic shift in this relationship with aggregate profits at or near 10% of GDP. Let us state clearly and without a shadow of a doubt that we are not of the belief that high profits can persist indefinitely. As with many other financial or economic relationships, elevated levels can persist for some time before an external catalyst causes a reversal.

Chart 2



In simple terms, business investment and dividends (received by consumers and spent) make a positive contribution to profits while savings of any sort remove dollars from circulation and reduce overall profits. Wages and consumption are both important pieces to the puzzle but are netted together to form savings. In this case, negative savings, or borrowing, is a positive contributor.

The Profit Puzzle

Aggregate corporate profits can be constructed from the Federal Reserve Board National Income & Production Accounts database. In essence, profits are comprised via the following formula:

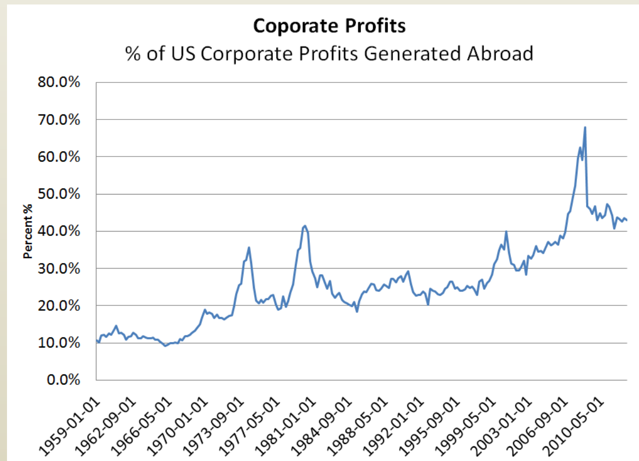
[1]Profits = Business Investment – Household Savings – Gov't Savings – Foreign Savings + Dividends

Previously we used the example of how profits mean revert via a crowding out effect whereby a business cuts wages only to result in reduced consumption. In reality, this relationship is somewhat elastic in that downward pressure on wages can be absorbed through reduced savings while holding consumption constant. It is only to the extent that wage cuts interfere with consumption that profits will be impinged. By observing Chart 2 we can demystify several of the opening questions. First, Business Investment has typically been the primary positive contributor to corporate profits. This occurs at the aggregate level because cash outlays for inventory, property, plant and equipment are not expensed, yet revenues received by the seller are recognized into income immediately. The second observation about business investment which may not be so surprising is that most dips in corporate profits correspond with the initial dip in business investment at the downturn of the business cycle. In 2008, business investment declined so substantially that it actually turned negative and has remained low since then. So why haven't profits followed? It has been met by two equally powerful forces. First, wages as a percentage of GDP have declined but not so much as to disrupt consumption. The slack has been absorbed by reduced savings at both the personal and government levels. Government savings in particular has actually turned negative or said differently the government has engaged in deficit spending. This can be seen in the red, shaded area and has come in the form of direct government spending as well as government spending on social programs. Spending on social programs in particular has increased from 4% of GDP in 1947 to 15% of GDP recently (in the last 10 years this ratio increased from 10% to 15%) and has been a direct boost to consumption.

[1] What Goes Up Must Come Down! James Montier, GMO 2012

The other factor contributing to elevated profits as a percentage of GDP relates to data discrepancies between the corporate profit numerator and the GDP denominator. In our opinion, this discrepancy does not lead to an erroneous conclusion but rather is rather telling as to the external environment that has led to our current conundrum. The corporate profit data point used in Chart 1 includes profits garnered from US companies' operations abroad while GDP, the denominator, only recognizes economic activity within US borders[2]. From Chart 3 we can see that the percentage of US profits generated from abroad has steadily risen from 10% of total profits in the late 50's to a peak of nearly 70% in 2008 before falling to approximately 40% current day. While much of the early gains can be attributed to the globalization of US business, from 1985 through current day the US has seen a massive secular decline in interest rates and corresponding weakening of the dollar. Profits from this source have undoubtedly been enhanced through revenues being earned in local currency terms before being converted back to a weaker US dollar and earning a profit on the conversion trade.

Chart 3



Declining interest rates and a corresponding weakening of the dollar have certainly contributed to a rise in the percentage of US profits derived from foreign operations.

Chart 2

<u>Conclusion</u>

Over the course of the last few paragraphs we've covered a wide array of topics and some fairly complex relationships. We've identified that profits have historically been a very reliable mean reverting relationship and that the economic justification for mean reversion ranges from simple competitive principles to crowding out that occurs if businesses squeeze wages to the point that consumption declines. We've also gone into great detail to discuss the components of aggregate profit margins, identifying that business investment has been the primary positive contributor to historical profits while savings have typically detracted from profits. In recent years as business investment has fallen, profits have remained elevated. This is due to deficit government spending with a large increase in social programs allowing consumption and profits to remain elevated even as wages fell. Finally, we identified the increased contribution of profits from US companies' foreign operations. While globalization accounted for much of the early gains, a persistent reduction in domestic interest rates and corresponding weakening of the dollar undoubtedly added to these results.

Going forward, we are confident that the reliable mean reverting nature of profits will persist. Rising interest rates and a strengthening dollar would reduce the amount earned from foreign operations. Likewise, domestic austerity measures and improvement in labor markets will positively impact savings (from the government perspective this is through less negative savings or reduced deficits). All of these look to be a headwind to future profits and potential causes to

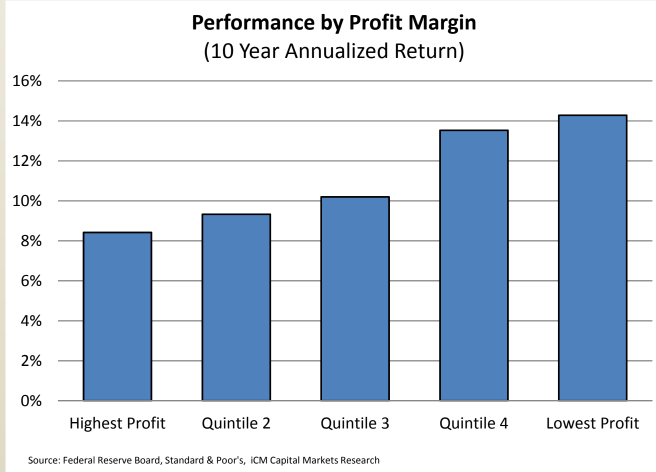
---

[2] Profiting From Foreign Profits: Are Corporate Profit Margins Abnormally Elevated or Sustainable? May 1, 2013 by Tobias Carlisle(contributions from Raj Yerasi)

return to normal levels. Ironically, an increase in business investment from virtually non-existent levels will certainly soften the fall some and perhaps help to sustain high profits temporarily. We are confident though, that the mean reverting relationship of corporate profitability is alive and well.

Lastly, and as the final piece to our profit puzzle, we need to answer the million dollar question; what does this mean to equity results? Despite the feel good nature of investing in what is obvious, the results don't often feel that good; in fact, quite the contrary. Chart 4 demonstrates that over the following 10 year period after achieving profit margins ranging from very high to low, high corporate profits have historically led to the worst results. What's more, as the current profit environment was less rosy, the following 10 year period tended to yield better results. This is undoubtedly due their mean reverting nature. Remember, markets are exceptionally efficient at pricing in current high or low profits. It's only to the extent that information changes that causes prices to move higher. Record high profit margins are more difficult to overachieve than record low profits. This leaves fewer reasons for advances and as a result lower returns. We opened this letter with the intent of tackling a complicated concept that has gotten a fair amount of press in recent months including the idea that some new macroeconomic variable has disrupted the mean reverting nature of profits. Remember, the four most dangerous words in investing…"it's different this time"…..it rarely ever is. Thank you for your trust and confidence.

Chart 4



Despite the seemingly logical belief that high current profits lead to or are an indicator of future success in equity market returns, our research indicates the opposite. In fact, the top quintile profit margin environments since 1947 have produced returns in the subsequent 10 year period of 8.42% vs. an annual rate of return of 14.28% following the weakest profit environments.

Integrated|Capital|Management

410 Spruce Street, 4th Floor, Scranton, PA 18503

Phone: (570)344-0100, Email: info@icm-invest.com

www.icm-invest.com