

Interview: A New Era of Growth for the U.S. Economy

Charles G. Callard

Charles Callard is Founder and President of [Callard Asset Management](#), a leader in the practical application of cutting-edge academic theory to real-world financial management. A recognized authority in the investment management field, Chuck has written and lectured extensively on valuation methods and performance measurement.

Virtual Strategist: Your latest research suggests that profitability is becoming less important for corporations than it's been in the past. What exactly do you mean by that?

CC: It's all about the Cost of Capital.

The cost of equity capital over the next decade and beyond will be something like half what it's been for the last 80 years. Major US corporations have historically faced a 7-8% Cost of Capital, in real terms. Today that number's more like 4%. In this kind of

environment, the stock price is more affected by a company's ability to expand its investments - R&D, employees, and so forth. Hitting the old accounting targets, like ROE (Return on Equity) and ROI (Return on Investment) becomes less important, especially if it means turning down attractive investments just to keep the ROE numbers up. You're going to see a period in which the firms which have historically delivered high ROE's will continue to attract new capital, but their ROE's will drop as they invest in projects which they wouldn't have done back when the Cost of Capital was higher.

VS: How did you make that prediction?

CC: The real question is, how do you measure the Cost of Capital. You start by asking what level of return must investors earn in order to keep funding economic growth. That number, around 2½% real (after-tax), has been stable for over a century. Then you do the arithmetic to figure out what the investor must earn pre-tax to achieve it. (The investor's pre-tax return is equivalent to the corporation's after-tax earnings.) The calculations are a bit complicated, but there's nothing magical about them. You need to factor in marginal tax rates, capital gains rates, inflation expectations, and so forth. That's where the basic numbers come from.

That's all well and good, but it isn't worth much unless it works. This is where things start to get interesting. Finance 101 teaches that the value of a stock is the present value of anticipated earnings, discounted at the appropriate Cost of Capital. Applying this to individual companies is tricky - there's just too much uncertainty in the forecasts. Applying it to the equity market in general, let's use the S&P 500, is much easier. The earnings forecast for the S&P doesn't really fluctuate all that much. Even in a recession, the good results tend to offset the bad. The equation has three elements: price, earnings, and Cost of Capital. As long as you know two of them, you can solve for the third.



Interview: A New Era of Growth for the U.S. Economy

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

When you go back and apply this, you find that all the ups and downs in historical stock prices are accounted for by changes in the cost of capital. You have a relatively simple model, and yet it permits accounting for achieved shareholder returns over any holding period, whether three months or twenty years, during most of the past two centuries.

VS: This approach doesn't sound very much like the Capital Asset Pricing Model (CAPM)...

CC: No. It's fundamentally different because it's a forward-looking model. CAPM looks at what past returns have been, and assumes that those returns will continue into the future. It doesn't really address the question of why those numbers are what they are, or what might cause them to change. The S&P returned around 13% a year from the 1950's through 1965, then it was basically flat for the next fifteen years, then it returned around 12½% per year from 1980 through 1999. Do you really want to just average everything together and call that your Cost of Capital?

VS: What about debt?

CC: CAPM treats the debt and equity rates as two independent numbers. One problem is that the debt (interest) rate is a forward-looking number, and as we've seen, the equity rate is a historical number. When you look at the data, you find that the two rates are correlated and that the equity rate actually leads the debt rate. Interest rate forecasts are a whole other interview. The bottom line, is that debt rates are falling as well, for many of the same reasons as equity rates.

VS: So why is all this important?

CC: When the Cost of Capital is high, as it was during the 1930's and the 1970's, most companies have difficulty expanding, corporate earnings shrink, and stock prices get marked down. When the Cost of Capital is lower the opposite happens. More companies can afford to expand, and the economy benefits as profits rise. A difference of even a few percentage points in the Cost of Capital makes a tremendous difference in the number of firms that can afford to expand.

VS: You did some interesting research ten or fifteen years ago...

CC: Yes, back then the Japanese firms were going gangbusters, and US firms were in the doldrums. Everyone thought the Japanese walked on water. It turned out it was simply that Japan was enjoying the benefits of a lower Cost of Capital. US firms were actually outperforming the Japanese, but since the US cost of capital was so high, it felt like we were losing. We were shutting plants, laying off workers, and losing market share. The Japanese firms, with their lower cost of capital, had an incentive to expand, and that's what they

Interview: A New Era of Growth for the U.S. Economy

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

did. Even though from an operational standpoint, they weren't doing nearly as well as the US firms that were shrinking.

The Japanese had a 2.5% cost of capital then, but they changed their tax policies, their cost of capital rose, and all of that flip-flopped. That accounts for most of their enormous decline. Now Japan is where the US was in the late 1970's.

VS: If the cost of capital was 8% or 9% for most of the past 80 years, but 4% going forward, what does that mean for corporate managers making strategic decisions?

CC: The corporate world will have to realize that the faster they can grow, the better off they'll be. They can accept lower return projects in order to grow at a greater rate. Whereas in the past, when the cost of capital was high, the proper emphasis was to get corporate profits up, ROE's and ROI's up. To do that, they'd have to grow typically at a lower rate. Now there's more capital available to finance new projects that may return less, but provide greater rewards for later. And with a lower cost of capital, a larger share of total output goes to wages and employees.

VS: Are today's managers intellectually ready to accept a world where they increase their stock price by going after lower-return projects? Or paying a greater proportion of their revenues to employees? This sounds very different from today's situation where companies are cutting headcount and shrinking their business in pursuit of higher returns?

CC: There you come back to the market puts pressure on them to realize those opportunities. Some will, some won't. We're seeing more and more small firms thriving in this environment, at the expense of larger firms. The larger firms have a larger adjustment to make in their thinking. The smaller firms are able to respond.

VS: So the strategies that worked in the 70's, 80's and early 90's are very much the wrong strategies going forward...

CC: That's right. Companies will ultimately hurt their shareholder value by trying to follow those strategies today.

VS: How does this kind of advice address the technology bubble? Many are saying that those kinds of high-growth modest-profit strategies are what led to the current slump in the first place?

CC: First, the case we're building isn't based on technology at all. We'd be making the same case if no one

Interview: A New Era of Growth for the U.S. Economy

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

had ever heard about the internet or the PC. . Everything here is based on fundamental economics and finance. This framework has its roots in academic research that's been broadly accepted, with work by Merton Miller, James Tobin, and so forth.

With respect to the technology bubble, the market will settle down. In that particular case, you had a number of contributing factors. Market values made sense through '98 and most of '99. Where it got out of whack was overshooting in the latter part of 99 and the first part of 2000. The risk premium was just too low, so those stocks got overvalued. It was simply an overshooting, but it corrects itself, and it's taken a year for that adjustment to unfold. What we're looking at here is fundamentally different: a 20-year decline in Cost of Capital, which will benefit the growth stocks tremendously. Even a small change in the discount rate will make a tremendous difference in the way firms are priced, and that has incredibly important implications for the kinds of strategic initiatives they take on.

VS: What does a lower cost of capital mean for competition? Will we see more intense competition and a faster pace of innovation?

CC: Definitely. You'll see an increase in R&D. You'll see an increase in capital spending. You ask where is the capital, and you have difficulty if you want to raise capital, but that will change. You have some monetary factors and seasonal factors that are slowing things down right now, but that will eventually improve. Another thing we've seen is shorter project lives, at least from an accounting perspective. Companies aren't building facilities that they'll be stuck with for twenty or thirty or fifty years. Instead, they're investing in technology and computers and networks. It's easier for firms to adjust. You have fewer barriers to entry. That means the pace of change and competition will continue to accelerate, which will drive down the average profit level and the average ROE. Again, growth is the factor that counts.

VS: Another implication of your research is that investors can expect to earn significantly lower investment returns going forward. How will CEO's and boards react when they can't deliver continuing double-digit returns to their shareholders?

CC: Remember, we're talking about the averages. The role of the specific firm is to outperform the average. That's where it comes down to longer-term strategies to differentiate the firms. Half will gain, half will lose. The question CEO's and boards face, is which of those groups they want to be in. Again, we see that the small firms and the growth firms are best positioned to take advantage of the situation. You've also got a whole new group of players coming in. Some will be successful, some less so.

VS: If equity returns are falling to the 4% range like you're predicting, how do investors make money? Do you need to do your own start-up?

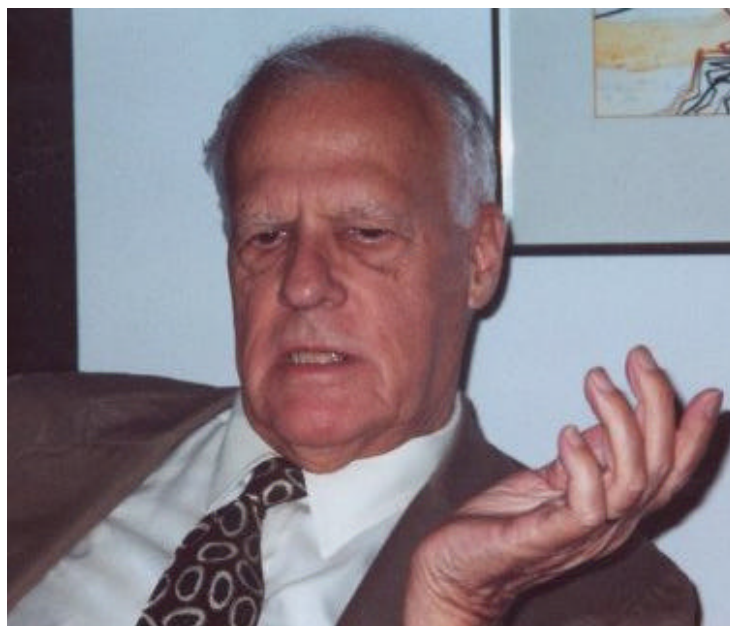
Interview: A New Era of Growth for the U.S. Economy

CC: That's one way. But it's going to be a different type of venture than we've seen in the past. The venture capitalists got carried away. They bid those companies up without any expectation of earnings over a five-year period. I think maybe the venture capitalists have learned that you've got to have a business plan.

VS: What are the key factors underpinning your forecast? What are the vulnerabilities? What's the upside?

CC: You do have risks: a shift in foreign capital flows, a collapse in the real estate markets, margin calls. All that can raise havoc with the banking system and put a crimp in the ability of firms to raise capital. But that's the worst case. The markets will adjust.

More of the foreign countries are talking about reducing their tax rates, which ultimately means a lower cost of capital. Japan made a significant reduction a couple of years ago, and they are in the process of being able to expand again. Another question is what will happen with the Euro. And then you have people in the US concerned about deficits, and even talking about increasing taxes.



Our interest is determining what happens to cost of capital in each country, and what that means for investment, growth, and competition. This all makes managing a multi-national firm far more complex, and provides a basis for suggesting that small firms will have an advantage.

When the Cost of Capital is low, more firms can expand. When it's higher, more firms will shrink. That's even more the case if you're competing with a country that's going in the other direction. Remember the early 80's. The US firms were more profitable than the Japanese, but the Japanese firms were the ones that could grow because their Cost of Capital was much lower.

I think Japan recovers. As long as the Euro currency works, Europe will be better off. The enhanced liquidity alone will improve their cost of capital and competitive position. Ultimately, as more people understand the

Interview: A New Era of Growth for the U.S. Economy

A JOURNAL OF STRATEGY & BUSINESS TRANSFORMATION

role of marginal tax rates, more countries will use this lever to lower their cost of capital and enhance their competitiveness. Ireland is a case in point. They've gone a long way. That'll be fun to watch. There's a lot of investment and R&D going on in Ireland.

Most countries are closing in on the US. That makes it a different world. There're two factors. First what's the trend in the US? That's favorable. Second, what about the rest of the world?. They'll be closing in on the US. All this ultimately intensifies the high-investment, enhanced competition scenario we're talking about.

The preceding interview took place in late August, well before the September 11 terrorist attack. Virtual Strategist checked back with Chuck Callard on September 17, the day the NYSE resumed trading after nearly a week.

VS: When we spoke back in August, no one would have foreseen the events that have shaken this country during the past week. What effect will this have on the financial markets, and specifically, does this undermine the New Era analysis you described earlier?

CC: Although the 2.5% after-tax requirement has held following prior crises (WW I, the 1930's, WW II, the Kennedy assassination, the Gulf War), a case might be made that the US now is facing a different type of risk. If so, let's assume that the 2.5% becomes 3.5%. The pre-tax requirement would become 5.3%. This is modestly above the current requirement of 4.1% but still well below the 7 to 8% required in prior decades. But carry this one step further: Another possibility is that the US will lower the capital gains rate to 15% and provide for inflation-adjusting the gains from future investments. The required pre-tax return then declines to 3.4%, or 30 times earnings.

Over the longer term, society adjusts, and markets adjust. Whatever the range of reasonable possibilities, this still is a New Era.