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Whose Capital; What Gains?

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EXECUTIVE SUMMARY

Long ignored calls for patient capital are increasing in the wake of the financial crisis, except by the financial industry that caused the damage in the first place.[1] It is critical that they be heeded if another economic collapse is to be avoided. The crisis was decades, and perhaps more than a century, in the making, and is the result of many different factors that can be found in the historical record. Two very significant factors are perhaps somewhat less apparent, and it is of those that I write. They are the sources of permanent capital and the sources of capital gains.

Stated simply, common stock has almost never been a source of permanent capital in American industry. Indeed the history of 20th century finance has been the disappearance of equity funding and its replacement with debt, typically (at least over the past decade and a half) off-balance sheet. Equity capital is so unimportant that in recent years the Fortune 500 often spend more on stock repurchases than on capital investment.

The sources of capital gains has also dramatically shifted from the 1950s, when Merton Miller and Franco Modigliani, developed their famous dividend irrelevance theory, from corporate profits in the form of retained earnings to future profits in the form of velocity-induced trading gains. While both of these propositions may seem counterintuitive, the latter will seem plainly wrong, at least to devotees of efficient market theory. But the empirical correctness of the former proposition underlies the contemporary theoretical weakness of the latter.

The net results are that shareholders, or managers on their behalf, are gambling with debtholders' money, and that the future profits of American industry are being spent today. Both call into question the sustainability of American industry and the future wealth of the United States.

1 Unless otherwise indicated, all references are drawn from my works listed in *Sources* below.

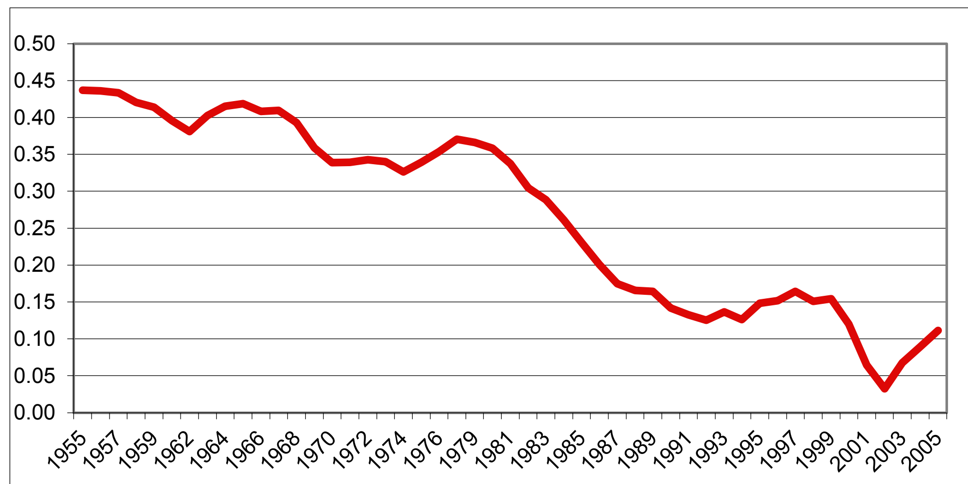
Sources of Capital

It is widely accepted that common stock is the principal form of permanent corporate capital in American industry. After all, stockholders invest their money with no expectation of its return except upon their sale of the stock or corporate buybacks. Returns in the interim are expected to be in the form of dividends. This of course is in contrast to debt, where creditors receive their returns in the form of interest and their principal investment is repaid at maturity.

But common stock is not, in fact, permanent capital. At least during the period from about 1962 to the present, American common stockholders have withdrawn more money from corporations than they have invested. The story is told by the disappearance of retained earnings from corporate balance sheets and the trends in net issuances of common stock.

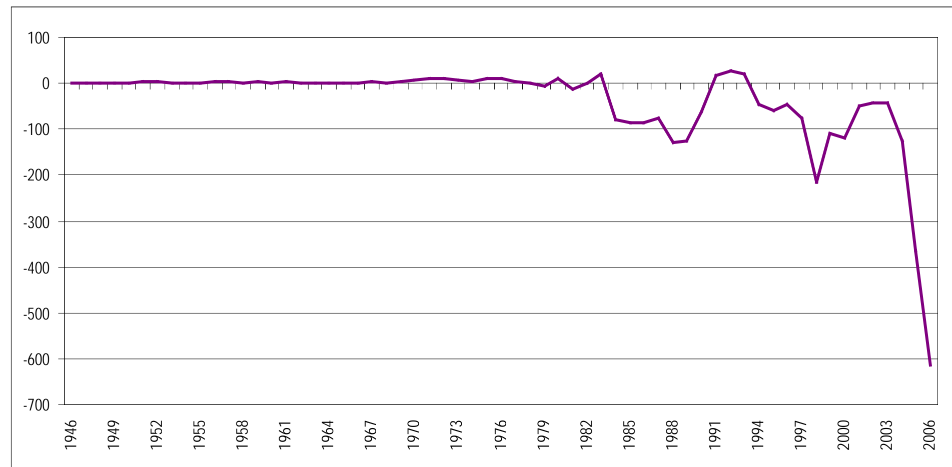
From the beginning of the 20th century until the early 1960s, American corporations retained on average 50 percent to 60 percent of their earnings for reinvestment, with the balance paid as dividends or as a result of occasional share repurchases. But matters began to change, and change rapidly. By 2002, retained earnings had dropped on average to 3percent, returning to a paltry 11 percent in 2007, just before the panic.

Figure 1: Ratio of Retained Earnings to External Financing



In addition, Federal Flow of Funds data show that, except for two short periods between 1991 and 1993, net common stock issuances hovered around zero, with negative net issuances between 1982 and 1991 (undoubtedly representing the withdrawal of public equity as a result of takeovers), and significant negative net issuances between 1992 up to the crash (which period, interestingly, includes the entirety of the dot.com boom).

Figure 2: Corporate Equity - Nonfinancial Corporations (Billions of Dollars)



There is little question that public equity largely has disappeared as a significant form of permanent capital.

If common equity, represented by retained earnings, does not provide permanent financing for industrial production, what does? Retained earnings, which represent permanent stockholders' equity, were replaced by debt. Aggregate balance sheet data make this conclusion more circumstantial than one might like, largely because of the use of off-balance sheet financing, which began to gain currency in the 1980s, initially in the form of finance leasing. As long ago as 1994, for example, off-balance sheet finance leasing accounted for almost one-third of the capital equipment used by American industry. Perhaps the most famous example of the abuse of off-balance sheet financing is Enron, which, prior to its bankruptcy, reported debt of $10.2 billion when in fact its real debt was $22.1 billion. In any event, when other potential sources of finance are examined (accounts payable, short-term debt), nothing is left but long-term debt, thus leading to the conclusion that debt has replaced equity.

This trend should be disturbing for a number of reasons, but one in particular is relevant to the problem of impatient capital. The laws of corporate governance rest ultimate corporate control in the hands of common stockholders, who elect the board of directors. While the board has often been decried as unresponsive to shareholders, its incentive structure, as well as the dominance of institutional investors who increasingly assert their power, leads to the conclusion that the board does in fact manage in the common stockholders' interests. The fundamental theory upon which common shareholder control lies is that they are the residual claimants of corporate wealth and thus bear the greatest risk. Control compensates. This residual characteristic of common stockholders remains true. But, as I have demonstrated, their investment in their corporations, their real capital at risk, is almost nil. The real riskholders are the creditors. Thus, we have the dangerous anomaly of boards and managers managing for shareholders (with shareholder interests in stock price maximization and shareholder taste for risk) with creditors' money. This ability to use other peoples' money for shareholder profit creates powerful managerial incentives to

short-change the long-term health of the corporation for short-term gain, putting the American productive sector at risk.

That industrial corporations have risen to the bait is demonstrated by the sources of their profits and their balance sheets. Again, pre-crash (2006), over 30percent of the profits of American corporations classified as "industrial" came from financial transactions rather than the production of goods and provision of services. And financial assets constituted almost 48percent of the total assets of non-farm, non-financial corporations (with only a small proportion accounted for by accounts receivable).

It's difficult to avoid the conclusion that American industrial corporations are, or at least have every incentive to be, gambling with the future of our productive industry and thus the sustainability both of the American economy and our ability to create our own necessary goods. The first conclusion suggests an inevitable diminution in American wealth, for only through the production of goods and the provision of services can sustainable wealth be created (and financial markets supported). The second, to my mind, implicates national security. For while one can proclaim the economic self-interest of productive nations, like China, in the sale of their exports, there is no reason to believe that future belligerent nations with substantial economic surplus might refrain from providing essential goods to a potential enemy.

The Sources of Gains

Equally disturbing are the conclusions to be reached when the sources of investment gain are examined. Dividends are, of course, paid out of earnings (using cash). Capital gains, realized upon the sale of stock, can come from two sources. One is the increased value of the stock achieved by a corporation's retention and reinvestment of its earnings over time. Capital gains thus realized are backed by real corporate wealth. The other source of capital gains, theory tells us, is nothing more than the discounted future earnings of the corporation attributable to a share of stock. In light of the disappearance of retained earnings, one can conclude that this latter source is the principal source of capital gains today. The implications of this source of earnings are more disturbing than simple finance theory might suggest.

History demonstrates a significant shift in shareholder expectations, from the receipt of dividends to the expectation of capital gains. To some extent, this shift was planned and encouraged by the New York Stock Exchange, suffering from a lack of business in the 1950s. The NYSE clearly contemplated that increasing share ownership would enhance the speculative character of the market (as eventually it did). For example, in its 1955 Annual Report, it noted the low annual turnover of 19percent, stating that "[t]his is to be expected, of course, in a cash market of an investment character."[2] Low turnover meant low commissions and low profits for the specialists who controlled the NYSE, and it went on to complain that the Federal Reserve Board, through a lack of understanding of the importance of securities credit, had raised margin requirements twice that year. The annual report describes

2 New York Stock Exchange Annual Report for 1955 (New York; NYSE, 1955), p. 14

that the Exchange "devoted increasing effort to research and education in this area...[I]t should be made clear that an excessively high level of initial margin requirements, at a time when there is only a modest amount of credit employed by the securities industry, can be harmful to the nation's entire economy by adversely affecting the liquidity of our marketplace."[3] While buying stock on margin could in fact be consistent with the desire for dividends, it is significantly more related to investing for capital appreciation. Explosive market development in the succeeding years, with a marked turn to investing for capital gains, demonstrates the success of the NYSE's programs, despite the failure of the Fed significantly to reduce (and even sometimes to increase) margin rates.

This shift to capital gains investing has significant implications for corporate finance and governance. The famous Miller-Modigliani irrelevance theory, which, although debated, has wide adherence, holds that, transactions costs and taxation aside, dividend policy should be irrelevant to share price.[4] Once the issuer has disclosed its investment policy, the ratio of dividend payouts should be irrelevant to shareholders, because, among other things, share value depends upon the earning value of the company's assets, and the financing of those operations, whether from retained earnings, debt, or new equity issues, shouldn't matter. Thus, investors should be rationally indifferent between receiving dividends and capital gains. Public stock prices in a broad and efficient market should discount all future cash flows to present value and incorporate them in the stock price. Thus, one could receive dividends over the long term by holding onto the stock, or receive them now by selling the stock and receiving the equivalent of those dividends in the form of capital gains, that is, the proportion of the selling price that at least in part captures the seller's share of present and future retained earnings as well as future dividends. Thus, the shift to shareholder expectations of profits from capital gains should be untroubling because irrelevant.

Understanding this argument in light of the contemporary belief that one derives capital gains from discounted future dividends requires emphasizing one very important fact: dividends must be paid out of cash earned currently, or at least cash that is held by the corporation, and therefore certain. Discounted future dividends, even if the market is efficient, are a risky proposition. Because they will only come in the future, they do not exist at the time that a stockholder sells his shares for capital appreciation. And, as a matter of financial reality, they are only as good as the assumptions one makes in applying various valuation models to the corporation's earnings and cash flows. So in one very real sense, the capital gains seller is shorting future dividends, and the capital gains buyer is gambling that the rather significant assumptions upon which valuation models are built turn out to be correct, or at least that he can find someone else to buy the stock who believes them to be correct. Moreover, as the data show, retained earnings have more or less disappeared from the books of industrial corporations, so the capital gains trader is

3 *Id.*
4 Miller, Merton, and Franco Modigliani. 1961. Dividend Policy, Growth, and the Valuation of Shares. *Journal of Business* 34:411.

effectively buying or selling what used to be referred to as “water.” While financial theory might establish equivalence, taking one’s profits in capital gains (taken as discounted future cash flows rather than as accumulated retained earnings) is a very different proposition in real economic terms from receiving a check from a corporation with money in the bank.

The disappearance of retained earnings might well have significant implications for the continuing legitimacy of the Modigliani-Miller theory, and thus the lack of concern from both a financial and governance perspective as to whether public shareholders are rewarded with dividends or capital gains. Miller and Modigliani published their papers in 1958 and 1961. Retained earnings constituted between 40percent and 61percent of corporate balance sheets in 1961, little changed from 1958. In a very real sense at that time, capital gains appear to have been supported by real deferred dividends, held as retained earnings, and while one assumes that market movements also affected stockholder profits, there were balance sheet assets to support stock prices. Thus, the irrelevance demonstrated by Modigliani and Miller makes perfect sense, even in light of the fact that valuation methods all are, necessarily, future -oriented. The situation is dramatically different where, as we see in 2005, retained earnings constituted 11percent of corporate balance sheet equity, following a steady 30 year decline. Capital gains are no longer supported by balance sheet assets. Market movements constitute virtually the entire amount of shareholder capital gains. Whatever power the irrelevance theory had at mid-century, the disappearance of retained earnings would seem to cast it in an entirely different, and far less persuasive, light.

The problem should be evident. Unless we are willing to put great faith both in an economic theory that was developed under very different circumstances and at least as much faith in market efficiency, capital gains trading under contemporary circumstances of rapid and massive stock turnover effectively results in shorting the profits of the future for the present. That is to say, unless one can be confident that future earnings will in fact materialize as predicted, the stockholders today are taking the potentially non-existent profits of tomorrow. Even assuming a level of future profits (which the first part of this paper suggests is in jeopardy), contemporary stock multiples are sufficiently high as to suggest the need for truly massive profits to avoid eventual financial collapse.

In order to protect the sustainability of American industry and its ability to create permanent and transferable wealth, we must create incentives for American investors to reap the rewards of their investments through industrial profits rather than market speculation. The perverse incentives of public common shareholders and the corollary incentives of corporate managers must be reversed. One suggestion I have been making for over a decade is to build long-term investing into the initial investment decision by developing a sliding scale capital gains tax, with highly punitive taxation for short-term trading, diminishing over time to tax forgiveness for long-term holding. As always, the devil is in the details, including the question of when exceptions should be made for necessity, definition of the long-term (perhaps on an industry by industry basis), and the like. But the concept is sound. If short-

termism costs more than it benefits investors, they will reverse their behavior and managers will manage accordingly. Other suggestions I have made include returning to largely insider boards (outside directors tend to manage by stock price) and making appropriate accounting changes to rely more heavily on cash flow than income statement accounting. A paper of this nature allows me only to suggest a few possibilities in broad terms, but the basic principle is clear. If we fail to change the incentive structures of American management and financial markets, our nation's long-term economic well-being and, with it, our national security, will suffer.

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