Warm Winter Coat

As temperatures turned, most Canadians went into their closets to unpack their winter clothes. Many will have taken a look at last year's coat and made a decision. The coat was warm enough last year, the coat was still stylish enough, it would make it through one more winter. Or it would have to be replaced; the reason for replacing it hardly matters, the simple fact is that a decent coat is not an optional accessory in most of Canada.

Having determined the need, or want, of a new coat, next comes the matter of price. To pay up for something warm enough for the harshest winter? To buy a brand name or an off-the-rack, choosing plain black or something to been seen in on the slopes? Or to try to make it through one more winter, and maybe suffer the cold and wet here and there, but to keep the money? Each person might make a different choice, and as a result pay a different price. The decision of how much to pay measured against comfort, utility, and style is actually a very important financial metric on display.

Put simply, the purchase of consumer goods and deciding which investment represents a value come down to the same distilled question. What do I get in exchange for the money I pay today? The question, when phrased in investment terms is what return do I expect on my invested capital? Setting the parameters around portfolio expectations is easy, wanting more tomorrow is why we save today. In deciding which investments belong in a portfolio, experts turn to an array of metrics, some more popular than others, to compare the universe of stocks.

Price to earnings, commonly called the P/E ratio, has always been popular; comparing the price of a stock to the earnings provides a simple idea of how quickly an owner will be paid back their investment. Price is easily figured, the earnings of a stock remain variable year to year. The average constituent of the U.S. centric S&P 500 index had a price to earnings ratio of 18 in December 2014, meaning an investor would need to hold a stock for eighteen years to be fully paid back through earnings – assuming earnings never change, which of course they do. Dividends have always been a popular reason to own stocks, owning companies that have been steadily paying and growing their payout has been instrumental to growing wealth for decades, searching and sorting stocks by their yields has never been more in vogue. But all of these metrics, price, earnings, and yield represent a second derivative. The over-arching metric which provides the clearest insight on the ability of a company to increase earnings and possibly to increased dividends is known as Return On Invested Capital, or ROIC.

As a metric, ROIC encompasses a great many elements that investors need to consider. Can the company effectively earn its cost of capital? Is the sector of the economy the company traffics in robust? Are they commodity sensitive and left to take market pricing rather than set market pricing? Some element of management efficiency is captured in ROIC, but the skill of management is more often trumped by the realities of the economy and sector. To grow dividends and earnings, some combination of revenues growth, market share growth, or new efficiencies to increase margins must be found. On the whole, that can be put down to general business environment dynamics rather than management skill. While a skilled operator can make some modest differences to the fortunes of an individual corporation, by definition the average Chief Executive Officer will deliver only average returns, and differentiating the truly good from the truly bad is something that can generally only be done in hindsight.

When buying a share, that is exactly the same as buying a small stake in all the future of the company, good, bad, or ugly. Investors rely on operators, be they bankers, miners, operators of telecommunications companies, to exercise their best judgement when using shareholder capital. Ultimately, this means that investors are relying on management to generate reasonable rates of return, in what are generally competitive landscapes, and always facing outside forces beyond management's control.

Entering the summer of 2013, the three incumbent national Canadian telecom concerns, Bell, Rogers, and Telus, had posted five-year average ROIC figures of 11.7%, 13.8%, and 12.1%. These companies were earning their costs of capital, raising dividends, and entrenching themselves as essentially the only three telecom providers in most Canadian markets. Pricing and service reflected their standings as oligopoly providers, creating a very desirable market in which to operate. And then conditions changed. By invitation, Verizon was offered an entry into the market through an auction of wireless spectrum, and on the face of it, Verizon appeared keen at first to enter our market, and no wonder as Verizon comparable five-year average was 8.8%. Plainly, the Canadian marketplace would have looked lucrative relative to the more competitive American market in which Verizon operated. Ultimately, Verizon saw fit to purchase the roughly one-third of their company which was owned by Vodafone, rather than lay out the expense to enter the Canadian Telco market. Perhaps Verizon rightly deduced that though three firms can be adequately profitable and earn ROIC greater than their cost of capital, a fourth competitor would cause all participants to earn sub-standard returns, and the prudent choice was to simply stay home rather than engage in a cut-throat race to the bottom. Incidentally, the most recent ROIC figure for Verizon was just over 14%, proving their decision to stay away from Canada to have been, at least in the short-term, a prudent one.

	2007 - 2012 Average ROIC	2013 ROIC
BCE	11.74%	9.22%
Rogers	13.81%	10.13%
Telus	12.18%	9.66%
Verizon	8.80%	14.05%

Why not simply rely exclusively on ROIC, buying only those companies posting the highest rates of return? ROIC is only part of the puzzle, but an important one, and reflects decisions made in the past, likely years ago. The highest returning ROIC buggy-whip company of 1885 would have survived for years, but was unlikely to thrive in a market where cars supplanted horses, and by the turn of the 20th century would be but a memory. Great management cannot escape the basic conditions of their industry, no matter how savvy any CEO in the oil or gold space might be, market pricing will trump their skill every time. Economies change, and so to do asset prices.

The recent and dramatic slides in both gold and oil have had dramatic impacts on the share prices of producers. Looking backwards to when gold was over $1900US per ounce, finding projects with probable payoffs became far easier – in theory. Giant gold companies bought up small and mid-tier explorers and producers, paying premiums to buy claims, racing each other to overpay for what was only potential. Today, with gold trading eight-hundred dollars lower, give or take, and few of these purchases and projects remain economically viable. Write-downs, write-offs, and survival mergers have already begun. It is precisely this pressure which is being applied to oil stocks; boiling off tar-sands or arctic drilling can be profitable with WTI crude prices over $100US per barrel, many projects labour to break-even in the eighty dollar range, and at sixty dollars the oil is best left in the ground.

Generating greater returns on capital provides management extra capacity to address all the traits that investors seek in stocks, the room to buy back shares, increase scale and reduce costs, reduce leverage, pay higher dividends – all behaviours that tend to drive share prices higher, making both investor and manager happier. ROIC is a useful and instructive tool, helping to answer the question – what do I get in exchange for my money? Given how easily – and frequently – potential disruptions can occur, be they rising interest rates, the invitation of a fourth entrant in a three provider market, or falling commodity prices, ROIC is where the investment decision begins, not ends.

Companies that earn their cost of capital should outperform those that do not, in the long run. Funding operations through debt can be a drag on earnings, and excessive leverage has brought down Titans before. Funding operations through equity issuance can be the most expensive path to growth for long-term shareholders, as it dilutes economic interest. A second, but not secondary, focus on barriers to competition should help answer the what do I get for my investment question. Companies with an irreplaceable network, or who operate in a space where regulations forbid foreign competition, those with a high cost to enter the market, or a brand with tangible value all represent a plausible second screen to apply against high ROIC companies; those companies are likely to already earn high ROIC metrics and even more importantly, to continue to.

While no single metric has yet proven to be the singular be-all and end-all when it comes to buying stocks, using only tools such as price-to-earnings or dividend yield seems destined to produce sub-par results when the driver of earnings, dividends, and ultimately price is ROIC. Using a derivative of ROIC, be it yield, be it earnings, rather than all of what comprises Return on Invested Capital and the economic underpinnings will make for a threadbare coat. Knowing how to measure the efficiency of an investment will always be warm and stylish.

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