

# Pzena Investment Management

## Fourth Quarter 2013 Commentary

Is the party over? Elevated profit margins instill fear, yet a closer look reveals opportunities across a range of industries. And the party may just be getting started in the emerging markets.

One of the most heated controversies in today's investment world is the debate over whether developed world equities are attractive now that corporate profit margins are at peak levels. As bottom-up investors, our history tells us that sweeping generalities typically don't tell the whole story, and today is no different. In this article, we attempt to "peel back the onion" on the profit picture, and identify areas where profits are above and below their long-term history. As in prior bull markets, one should not conclude that all stocks are caught up in the boom. Interestingly, while investors are worrying about developed markets peaking, emerging markets are struggling and some major sectors are teetering. Profits in other sectors have yet to return to their long-term histories.

### An Impressive Rebound in Developed World Profits

Corporate managers have done an outstanding job restoring profitability after one of the deepest economic contractions in our lifetime, so much so that margins reached peak levels at the end of 2011. As can be seen in Figure 1, net profit margins today are 7.0%, off their peak of 7.6%, but up from 4.5% at the recent trough in 2009.

At the same time, however, another measure of profitabil-

ity – return on equity, or ROE – was only slightly above average at the end of 2011, and is now at a long-term average. Since net margins are equal to profit divided by sales, and ROE is equal to profit divided by capital, one would conclude that capital intensity (capital divided by sales) has increased. Put another way,

$$\text{ROE} = \text{Net Margin} \times \text{Capital Intensity}$$

The evidence of greater capital intensity is clear. As economies mature, capital substitutes for labor and the share of GDP that is taken up by capital rises. We can see this in Figure 2 using U.S. data as an example.

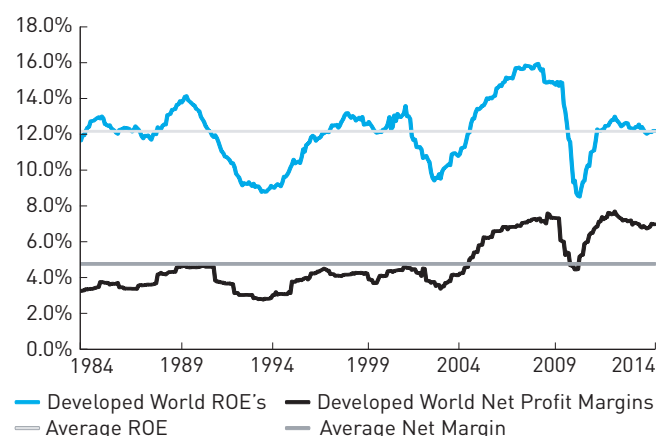
Since capital is invested with the expectation of earning an adequate return, we would expect that margins would have to be higher on average to earn the same return than if the capital wasn't invested. Accordingly, we observe generally that businesses with higher capital requirements have higher margins.

Rising margins are reasonable as capital substitutes for labor within each business. Yet, we still have to worry that they have risen too much. We believe that ROE is the more appropriate measure to use in assessing whether profitability is above or below trend. When we start breaking the market down into sectors, we find that some sectors are indeed above trend, yet others are below their long-term averages (Figure 3, on the next page).

### Financials Still Stick Out

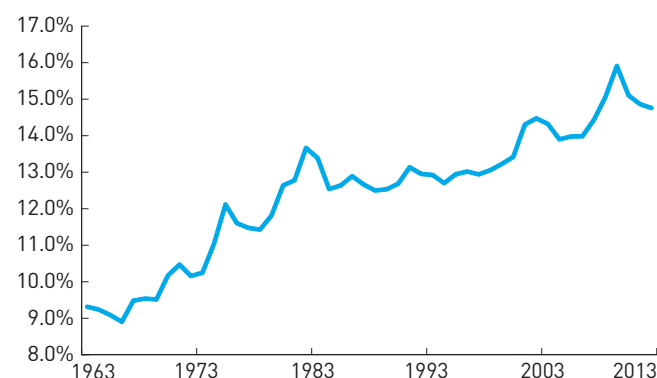
In general we would seek to avoid areas where conditions have been too rosy, favoring those where a return to long-term norms and low valuations provides opportunity. Figure 3 indicates that healthcare, energy, financials and utilities are sectors

**Figure 1: Record Margins; ROE's Only Average**  
Developed World Net Margins and ROE's, 1984-2013



Source: Sanford C. Bernstein & Co., Pzena Analysis

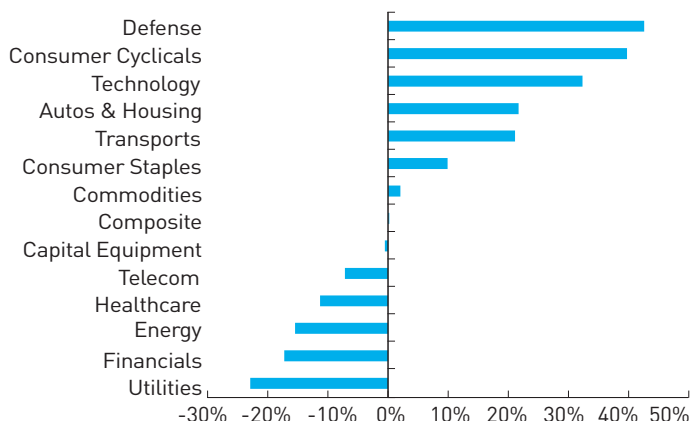
**Figure 2: Capital Intensity Increases Over Time**  
Consumption of Fixed Capital Per Unit Sales, 1963-2013



Source: Bureau of Economic Analysis; Pzena Analysis

**Figure 3: Divergent Sector Performance**

Developed World ROE's Above and Below their Long-Term Average, %\*



Source: Sanford C. Bernstein & Co., Pzena Analysis

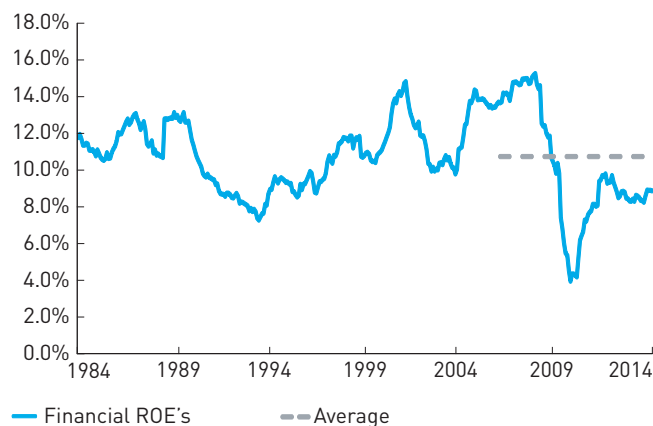
\* Variance/Long-Term Average, 1984-2013

where today's profitability is lower than what history would suggest. Financials are an obvious example. Figure 4 shows the 30 year history of developed market financial ROE's.

ROE's for developed market financials are 8.9% today, below their 30-year average of 10.7%. In the U.S., the picture is quite similar with ROE's at 8.8%, versus their long-term history of 11.6%. Some of this gap is attributable to cyclical conditions (e.g., low interest rates), but much is due to greatly increased capital, driven by changes in regulatory requirements following the events of 2008. The large bank sector, in particular, is in the midst of a substantial adjustment of its business model to fit the new regulatory regime. We believe the path to normalization of returns in the sector will likely include widening of net interest margins, recovery of global fixed income trading

**Figure 4: Financial Profitability Still Below Normal**

Developed World Financial ROE's, 1984-2013



Source: Sanford C. Bernstein & Co., Pzena Analysis

volumes, greater fee income, additional cost rationalization, and more optimal capital deployment. Though institutions are also feeling the effects of elevated operating costs and legacy legal settlements in an evolving regulatory environment, history indicates that as regulations become more certain and past issues resolved, the industry adapts and adjusts its business model to restore profitability. Coupled with low valuations, financials represent opportunity.

In other sectors, utility ROE's have followed interest rates lower, and health care returns have fallen off the unsustainably high levels experienced during the 1990's and early 2000's, yet valuations are generally elevated in both sectors.

### Other Sectors in Transition

In our third quarter newsletter we pointed out that many commodities linked to the boom in emerging markets have begun to correct, and this could continue for some time. Capital equipment is looking similar; profitability has fallen to trend but is not lower than history, and valuations are not yet cheap (Figure 5).

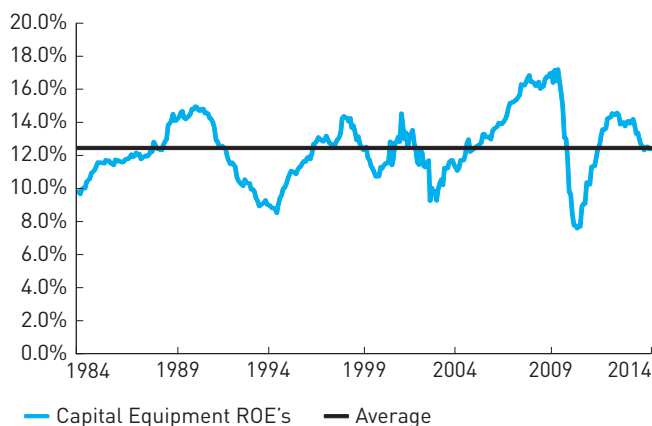
Many of these businesses are directly linked to emerging markets, and profitability is following trends in those economies, having turned down after peaking in 2012. The correction is well on its way. It is this constant transition of profitability between parts of the overall economy that gives global value investors their opportunities.

### Understanding Tech

The technology sector is currently experiencing profitability above historic norms, but those changes may be more

**Figure 5: Capital Equipment ROE's Weakening**

Capital Equipment ROE's 1984-2013



Source: Sanford C. Bernstein & Co., Pzena Analysis

sustainable. That's because software has become a much larger portion of total technology spending. Since the intellectual property associated with software is frequently not capitalized on the balance sheet, the accounting based measures of return could be misleading. Without putting the historical development cost (or the tremendous value of barriers to entry) on the balance sheet, stated ROE's could conceivably rise even further. That is just a problem with accounting overstating ROE by understating assets. When we look at technology companies, we seek to understand the underlying franchise and whether it is subject to competitive erosion. Accordingly, it is important to use judgment to distinguish what is a cyclical issue and what may be more permanent. Selectivity is the key in tech.

## Conclusion

Profit margins cannot be looked at in isolation. Understanding the capital intensity of a business, and the profits required to earn a return on that investment, is fundamental to drawing a conclusion as to whether profits are truly above normal. Profit margins should trend upward if more capital is employed. The good news is that although overall profit margins are high, conditions are really not bubble-like in many industries today. We believe that buying good businesses where conditions are below trend and valuations are attractive is the key to navigating from here forward. ■

## DISCLOSURES

*Past performance is no guarantee of future results. The historical returns of the specific portfolio securities mentioned in this commentary are not necessarily indicative of their future performance or the performance of any of our current or future investment strategies. The investment return and principal value of an investment will fluctuate over time.*

*The specific portfolio securities discussed in this commentary were selected for inclusion based on their ability to help you understand our investment process. They do not represent all of the securities purchased, sold or recommended for our client accounts during any particular period, and it should not be assumed that investments in such securities were, or will be, profitable.*