Strategist's Corner
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Births, Deaths and Indices

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In brief

- For hundreds of years, markets have set the cost of capital.
- Today, markets aren't functioning normally. "Zombie" companies are proliferating as governments and central banks put their thumbs on the scale.
- Markets today, unlike in the past, aren't able to wring out the excesses, putting the onus on active managers to avoid the dead wood in many major indices.

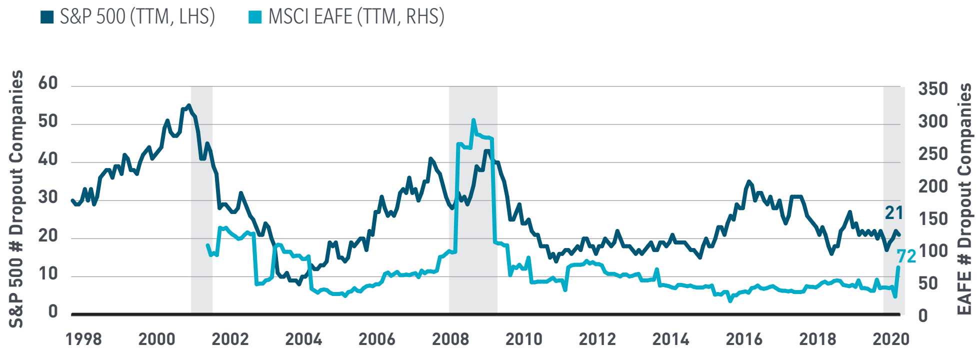
Beginning a few hundred years ago, many societies began utilizing a capitalist model to allocate resources, a system in which producers sought and competed for savers' capital to fund projects. Since then, the hurdle rate, or the financial return that motivates savers to put capital at risk, has been set by the marketplace.

In normal functioning markets, weak government balance sheets or enterprises with uncompetitive products have a very different capital cost than those with more dynamism. In response to the coronavirus pandemic, central banks have materially suppressed the investment hurdle rate by opening the borrowing window to all and have prioritized balance sheet financialization above all else.

Companies and financial markets are comprised of people making decisions (and mistakes). Companies, like people, have life spans, some long and some short. Given a long enough time frame, every company gets disrupted or competed away. New projects lure capital from underperforming enterprises as investors seek better opportunities. New businesses are born while established ones perish. That's capitalism. But the capitalist Grim Reaper has been usurped by monetary policy, leading to a historic period of capital raising in 2020. What are the consequences of this?

As business cycles mature, creative destruction tends to accelerate, and it generally peaks during recessions, when owners of capital seek better opportunities. Recessions have historically been corrective processes, washing away redundant enterprises, resulting in their stocks being removed from benchmark indices. That hasn't been the case during this recession, however. The illustration below charts the number of companies that have fallen out of the S&P 500 and MSCI EAFE indices over the past few cycles on a rolling 12-month basis. The dropout rate so far this cycle barely registers compared with prior episodes thanks to aggressive, government-sponsored life support measures.

Exhibit 1: Number of companies removed from the index



Source: FactSet Portfolio Analysis, S&P, MSCI. S&P 500 monthly data from 30 January 1998 to 31 July 2020. MSCI EAFE monthly data from 28 September 2001 to 31 July 2020. A constituent is considered to be removed from the index when it drops to a 0% weight in the current month after having an index weight in the prior month. The analysis is a rolling sum of these instances on a trailing-twelve months (TTM) basis.

The pandemic catalyzed preexisting trends. It didn't create online shopping, but it massively increased its adoption rate. It didn't spark cloud computing or digital payments, but it pulled forward years of behavioral change. Given the step-function change brought about by technology today combined with the worst recession in nearly 100 years, I think most would have anticipated a historic number of broken companies and bad equities and credits

The number of unprofitable, or "zombie," companies accelerated during the post-GFC cycle as exceptionally easy central bank policy and the explosion of passive investing thwarted creative destruction. Like technology shifts, the expansion of financial lifelines to unprofitable or uncompetitive businesses catalyzed this dynamic. I'm not an economist, but I understand what central banks are trying to do — prevent a deflationary spiral. I'm not passing judgment, but thwarting the natural selection process of markets can't be costless. Extending the life of companies that may otherwise have left the playing field raises the cost of resources for others. It also lowers financial returns and disincentivizes new competition. And it hinders price competition while creating inefficiencies. The result is an overabundance of unproductive resources and lower returns on capital.

Every cycle's different, but there's a pattern: Recessions are processes that correct the excesses of the prior cycle. The excess of the post-GFC cycle was extending credit at low rates to uncompetitive companies to make up for their declining operating cash flows rather than allowing the imbalances to correct. And it's even worse now.

In such an environment, it's up to active managers to cull unviable companies from portfolios even if indexers leave such companies in their benchmarks. To do otherwise may be unsustainable.

The **S&P 500 Index** measures the performance of the 500 largest US publicly traded companies in the US equity market.

The **MSCI EAFE Index** measures the performance of large- and mid-cap securities across 21 developed market countries, excluding the United States and Canada.

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