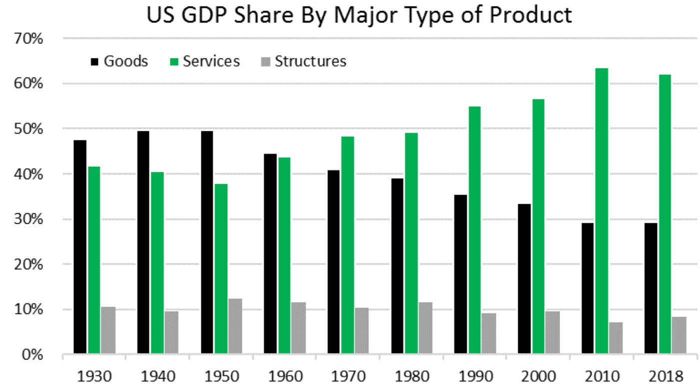
Ram Zilka, CFA | Mathew Hermary, CFA

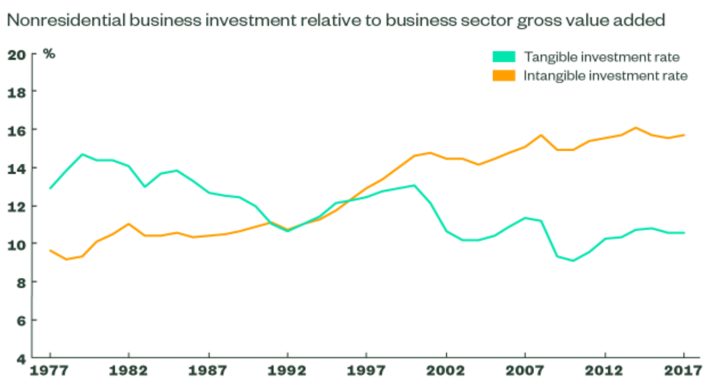
Long-Term Shifts & Intangibles

Over several decades we have seen a slow and steady shift within the US economy. While GDP was once heavily skewed towards the production of goods, the economy has become increasingly service-oriented over the past 40+ years.



Source: Bureau of Economic Analysis

In the 1970s, the largest share of business investment was related to tangible assets like machinery, buildings and land. With the growing share of service-oriented businesses in recent years, aggregate business investment has become much more focused on intangible assets like intellectual property, industry knowledge, software, brands, networks and relationships. The chart below demonstrates the growing divergence between levels of investment in tangible and intangible assets in the US.



Source: Transforming Intangible Assets into Tangible Value, State Street Global Advisors

An important consideration for analysts is that most intangible investments are expensed in the current period, while investments in tangible assets are generally capitalized on the balance sheet and then amortized over the estimated life of the asset. All else equal, this creates complexities when evaluating the quality of the franchise and financial results relative to other businesses.

While an emphasis on intangible assets isn't necessarily good or bad, it is important to understand their differing characteristics relative to tangible investments. 1) Investment in intangibles is generally a sunk cost – if your new design for a piece of machinery doesn't work out as planned, you are unlikely to find a buyer for it. However, if you buy a piece of machinery and no longer need it, you are more likely to be able to recover a portion of the cost. 2) Intangible assets also tend to be more scalable vs tangible assets. A new design can potentially be applied to an infinite number of new products, while a new piece of machinery likely has finite limits on the incremental production it could create. 3) Intangible assets are also more likely to have synergies with other intangible assets. If you created a new design last year that made a piece of machinery more durable and followed up this year with a design to improve efficiency, it could be possible to combine the two designs in some way. However, putting two pieces of machinery beside each other may not yield as much in terms of synergies.

QV Global Equity Strategy holding Johnson & Johnson (JNJ) is a good example of a business that makes considerable investments in intangibles such as research & development (R&D) and its brands. These investments have allowed the company to continually introduce new products and make improvements to its existing offerings, both of which help to support sales growth and sustain profitability. Many of the company's products are everyday needs for consumers which is one of the reasons we think the business will continue to perform well regardless of the economic environment.

QV Global Equity Strategy holding BASF is another example of a company that invests considerably in R&D. Within the chemicals industry, the company has consistently ranked in the top three in terms of spending on R&D. We believe these investments have allowed the company to maintain its strong market positions over the long term. Furthermore, these investments have led to the design and operation of six vertically integrated production sites which are known to be more cost effective and energy efficient relative to industry averages, contributing to strong cash flow generation throughout the cycle. We believe BASF's prospects over the next 3-5 years are relatively healthy despite near-term economic concerns.

Regardless of how companies invest, we believe our focus on high quality franchises and attractively valued businesses will remain a prudent way to allocate capital.