DENNY CENTER CONVERSATIONS
A Q&A with Ariel Babcock, Head of Research & Allen He, Associate Director FCLTGlobal

Ariel Babcock is Head of Research at FCLTGlobal. She has over 15 years of experience in the financial industry having managed value-focused mutual funds at both American Independence Financial Services and Calamos Investments and serving as director of investor relations and corporate communications for a Nasdaq-listed clean energy company. Ariel holds a BA in Economics and Environmental Studies from Tufts University and is a CFA charterholder.

Allen He is the Associate Director of FCLTGlobal. Prior to FCLTGlobal, Allen served as a senior research analyst in the litigation and finance practice area at The Brattle Group, working alongside leading industry experts in the risk, corporate finance, and industrial organization fields. He holds a BA in Math and Economics from Cornell University, a MS in Finance from MIT Sloan School of Management, and is a CFA charterholder.

FCLTGlobal (Focusing Capital on the Long Term) is a non-profit organization that develops research and tools that encourage long-term investing and business decision-making.

This interview has been edited for length and clarity.

Denny Center: Ariel, could you start by giving an overview of FCLTGlobal and explain the central questions you were attempting to answer with the R&D project?

Ariel Babcock: At FCLTGlobal, our mission is to conduct evidence-based research that drives capital towards longer-term investment horizons to improve outcomes across the investment value chain. When we add a new project or an area of investigation to our agenda, we look for potential causes of short-term behavior in capital allocation decision-making.

When we started investigating corporate spending on research and development, we found that even though R&D garnered increasing amounts of aggregate capital, the overall returns from that investment weren't panning out. We started digging into this question in particular because R&D is foundational to creating economic growth over time. And a stagnant economy is linked to an array of problems, including the ties between economic growth and strong democracies.

So the questions at the heart of the project are: Why have returns from R&D spending declined? Is short-term behavior at the heart of that decline in returns? What can we do to reverse that trend?

Denny Center: That question touches a central nerve at the Denny Center because we want to measure the health of democratic capitalism -- and R&D spending and innovation are likely to be covered in our key measures. Allen, shifting to your project on buybacks – what key questions were you asking in this project?

Allen He: Like R&D, we view buybacks to be under the capital allocation umbrella. We hear a lot of negative press about buybacks and we wanted to understand if there are misconceptions in the media's portrayal.

We wanted to answer the questions: Can buybacks be used for long-term purposes? Are there times where buybacks are the best option in terms of capital allocation? If buybacks and dividends both return capital to shareholders, why is the perception of buybacks worse than dividends?

Denny Center: Why are buybacks getting all this attention? How did it get on the FCLT radar?

Allen He: Politicians, academics, and business leaders have focused a lot of attention on buybacks and their ancillary effects. We hear things about executive compensation gaming, income inequality, rising debt on the corporate balance sheet, and COVID-19 leading to a lack of resilience, which are all directly or indirectly related to buybacks. One of the goals of our research was to differentiate the direct effects of buybacks as a tool from the indirect effects.

Denny Center: In the report you discuss legal structure and restrictions around buybacks by country. Is it true that the U.S. is kind of a free-for-all?

Allen He: Right. We saw that looking at buybacks across different jurisdictions, the U.S. was definitely one of the most relaxed. U.S. companies are required to disclose their buyback activity on quarterly reports. Other jurisdictions like Hong Kong, U.K., Canada, and Japan have much more frequent disclosure requirements. Without transparency it becomes much harder to police.

Denny Center: What are some of the misconceptions about buybacks that you found?

Allen He: The biggest misconception is that people directly link buybacks to income inequality and executive compensation. It is true that buybacks affect executive compensation, especially if compensation is linked to metrics like earnings per share. But we'd like to challenge whether this is a key result of buybacks or if it is just related to poor executive compensation plan design.

The next point that we found is that there are legitimate uses for buybacks. They are more flexible than a dividend. For instance, a company can turn a buyback authorization on and off without being tied to a certain level. Likewise, shareholders can choose to sell into a buyback or to continue holding stock depending on their own views.

Buybacks can lead to economic growth in the whole ecosystem. Buybacks recycle capital that potentially would have been trapped in companies that are so big or have so much cash that they can't do much more investment in capital expenditures. Returning money to shareholders through a buyback, potentially gives investors an opportunity to put that money to better use for growth in other sectors.

Denny Center: Got it. Could you say more about how buybacks fit into long-term strategies?

Allen He: Buybacks are part of the bigger capital allocation framework. What we've heard from a lot of our members is that companies consider not only buybacks, but also dividends, R&D spending, investment in capital expenditures, and acquisitions in terms of their overall capital allocation strategy.

It's prudent for companies to have this long-term plan on what they think the best use of capital is. It can be buybacks, if there isn't a next attractive target to acquire or a new plant to be built, or if they believe their stock is undervalued on the market.

Above all, our research suggests that regardless of how they allocate their money, companies should disclose their long-term plan and why they think that's the best use of capital to their shareholders. On the flip side, investors should demand that information so they know how the company is planning to allocate capital and can use their vote as a shareholder to influence decisions.

Denny Center: Turning to Ariel on R&D, when you started the project, did you expect to find one thing, and then the data surprised you?

Ariel: That's right. At the outset of the project we suspected that allocation to R&D had been declining. The first surprise was that companies on an aggregate basis have not cut their spending on R&D. It's actually gone up slightly. Another thing that surprised me was the growth in R&D spending that we've seen in other countries.

Denny Center: And the point on R&D spending going up, that's in absolute terms?

Ariel Babcock: It's both, R&D spending has gone up in absolute dollars, as a proportion of GDP, and as a proportion of company revenues. However, the returns have gone down which was the puzzling factor for us in this project.

Denny Center: It sounds like a management team can be very supportive of R&D spending, but get it wrong. How does that happen?

Ariel Babcock: The biggest finding for us from this research was that although spending has gone up, it has been clustered at the short end of the curve. Projects with a 1-, 2-, or 3-year horizon were attracting the vast majority of R&D dollars. You could see how a manager might rationally select an over-weighted portfolio of short-term projects, since 'quick hit projects' tend to carry higher degrees of certainty. The return profile for this kind of portfolio is lower, but so is the risk.

The problem with clustering R&D spending on the short end of the curve is that you're not funding the truly transformational, innovative things. You're not investing in long-horizon moonshot projects that produce the J-curve style effects you want to see, those are the projects that make big money and create the breakthroughs an economy needs to sustain itself. The other thing that people forget is that long-horizon projects tend to have an asymmetric return profile. You don't need very many of them to go well to still come out far ahead of competitors that only allocate to safe things.

With a venture capital mindset, you can place a lot of small bets with the understanding that it's a portfolio game and that the combination will produce a better outcome over time. Sometimes this is hard for managers because it is difficult to ask a manager to invest in something they're not going to be around to see. There has to be a bit more of an ownership mindset and alignment with the executive management team to inspire longer-horizon investment. That also comes from good investor-corporate dialogue, incentive compensation structures, a strong relationship with the board of directors, and having the right management team in place.

Denny Center: Backing up a little, is there a formal definition of R&D spending?

Ariel Babcock: We took the accountant's definition but that isn't necessarily the way a management team would define their R&D spending.

One thing we heard in the interviews that we did alongside this research was that if you don't have a specific team dedicated to R&D, it doesn't happen. The distributed model works well for shorter term projects or for iterative style research and development where it's just a 2.0 version of something you already have on the books. If you're trying to create a new product category, for example, that is hard for someone who has other day-to-day responsibilities.

Denny Center: Did you find that returns were declining across industries, or did some industries show superior returns and others pull the average down?

Ariel Babcock: We didn't do industry-specific deep dives, but we are confident that this is a cross-industry trend. Huge declines in one industry are not pushing the average returns down for everybody.

Denny Center: If you had a short period of time to visit with a board of directors or a management team, what key pieces of advice might you offer based on these projects?

Ariel Babcock: We had a couple of key takeaways for a board that was interested in encouraging a longer-term project perspective in their R&D portfolio. The use of metrics is important to driving this behavior. Using performance metrics for short, medium, and long-horizon projects that account for the differences in project profile is important. If you compare a project you expect to come to completion in 10 years and use the same metrics on a project that is going to be completed in 18 months, you're not likely to pick the 10-year project.

The other thing that we found was a need for better scenario planning in order to inspire commitment. A lot of people use scenario planning to evaluate potential downsides, but not enough boards are thinking about upside potential. When you have a conversation that's really focused on risk and downside protection, that conversation doesn't give you the space to realize the potential impact in accelerating the profile and value creation of the company, you’re not going to be as committed to that project when some bumps in the road come along. I encourage boards to think about what their optimistic outcomes look like and how probable they are.

The other thing that we found that was especially important for boards was to focus on board education around the innovation strategy and how it connects to the broader long-term strategy and business model. Making sure the board really understands how those pieces fit together drives better alignment and commitment to maintaining that resource allocation.

Another piece of this scenario planning puzzle that came up in our interview process was gaming out what plan B might be in the event that hurdles popped up. If a competitor launches a product before we're able to for example, how would we pivot? Do we kill it, do we rush it to market? Thinking about things like that in advance are helpful for keeping those projects funded.

Denny Center: If you had to pick between companies having too few R&D projects and companies having too many (e.g., the right number would improve returns), what would you choose?

Ariel Babcock: We don't have any data on the number of projects. What we know is that there are too few in the long-horizon bucket. Companies might have the right number but the wrong mix in terms of time horizon. We heard a bit about resource constraints and whenever it came up, the constraining factor was people. You do have to be selective and pick your spots if you're constrained by not having enough people to run all the projects that you'd like to do.

Denny Center: Is another key here a corporate culture where people aren't afraid to fail? Since failure is common in R&D portfolios?

Ariel Babcock: Yes, you solve for that by making sure people are staffed across multiple projects. When you're staffed on just one project and your job is attached to it, the likelihood that you recommend killing that project is low. If you're staffed across multiple projects, you can take an objective view of how they're progressing and the likelihood of success.

Denny Center: Bringing the two projects together, is there evidence that companies are buying stock back when they should have been investing more in R&D?

Allen He: I think overall it comes back to the capital allocation question and a company's internal ROI metrics. Do they expect higher returns by investing in R&D or do they believe that they can buy back stock at a more efficient pace?

One of our other main findings is that managers are not great at buying back their own stock, especially when it comes to timing the markets. We also found that contrary to the nontion that the majority of buybacks are financed with debt, companies tend to buy back stocks with excess cash. Generally, you have excess cash when your company is doing well and your stock is on the high side. You'd actually want to buy back stock during a downturn when you believe it's undervalued, but you'd get crucified by your shareholders and stockholders.

To learn more, visit the FCTLGlobal website, or read their reports on stock buybacks and R&D spending.