# the Whitepaper

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## Highlights

While 2009 was all about companies "protecting profits" through spending cuts, LPL Financial Research expects 2010 to be a transition year from simply surviving to the pursuit of growth.

Our view is that companies:

- Are beginning to re-allocate spending back to capital intensive projects in an attempt to invest for the future.
- Need to make sure that their shelves are stocked to meet the rising consumer and business demand.
- Will accelerate hiring to help fuel future growth.
- Will begin to fund exploration and R&D efforts in 2010.

In this edition of the White Paper, we will explore the importance of companies to make the transition from surviving to planning for growth, as well as identifying potential portfolio opportunities to capitalize on this return of corporate investment.

## The Shift to Fueling Future Growth

With the increasing sophistication of video games, I have found that it is easier than ever for kids to "disappear" with their latest electronic contraption and circumvent old-fashioned family game time. As a result, it is harder and harder to compete with the Nintendo Wii for some quality family moments with the kids. One of the traditions that my family enjoys during the holidays is to play board games. The good old games of the past: Monopoly, Clue, Yahtzee, Sorry, Battleship.

This winter, my family adopted the board game Life as our competition of choice. For those that have not played the game in a while, the goal is to be the first person to navigate around the board, which is a proxy for the journey of life. You begin with college, navigate through the life decisions of an adult, and end with retirement. Along the way, you encounter real life events, such as starting a family, buying a house, choosing careers and every other imaginable event on the path through life (literally).

Now, I am the first to admit that my record of winning board games during most holiday seasons is quite low, as the kids seem to have a strangle-hold on the first-place blue-ribbons. I would like to attribute my losing record is because I let the kids win; unfortunately the truth is that I just seem to get outplayed by my family of six. But this year, I was unstoppable and won every game of Life my family played. As I have reflected on my unique strategy for winning (after gloating at dinnertime each evening), I came to the realization that winning was quite simple. At the start of each game, I decided to go to college and my kids elected to immediately join the workforce — a decision that gave me a distinct competitive advantage.

Why they chose this route of avoiding college at the start of each game was likely for one of two reasons. One, they currently go to school in real life and could just not get themselves to elect for even more "schooling" in a pretend board game. Or two, and the more likely reason, my kids could not see the value of starting off "in the hole". You see, if you choose to go to college at the start of Life, you start off $100,000 in debt immediately (a reality that so many of us parents can certainly relate to). This is something that my pre-teen kids just could not rationalize. However, what they missed was that the $100,000 debt led to better paying career choices in the game and ultimately in a beneficial outcome when paydays rolled around.

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This is certainly one of the tougher lessons of life and here I am talking about the real journey of life, not just the board game Life. The decision to forgo immediate benefit and invest for the future is something not easily practiced, but is quite rewarding. For kids, and frankly most adults, seeing through the sacrifices of today for benefits tomorrow is something that is not an easy task. It is why investing for retirement down the road or exercising for a healthy tomorrow are hurdles that are not easily cleared. The lesson is that sometimes sacrifices today can lead to greater successes down the road.

## Companies Shift from Surviving the Present to Growing for the Future

In 2009, investing for the future was not a top goal for many companies. In a year when market giants like Lehman Brothers, AIG, Bear Stearns, and Washington Mutual all went under, companies were more focused than ever on surviving the present rather than investing for the future. To do this, companies cut spending, eliminated redundant business lines, and most notably laid off staff. In fact, since December 2007, companies have reduced their workforce by a total of 7.24 million jobs. Overall the strategy for 2009 was quite simple: survive.

But while 2009 was all about companies "protecting profits" through spending cuts, LPL Financial Research expects 2010 to be a transition year from simply surviving to the pursuit of growth. This transition from protecting the bottom line (profits) in 2009 to growing the top line (sales) in 2010 will be a key mile-marker in the economy's continued road to recovery.

While tough markets test the resolve of corporations, investing for the future is the lifeblood of corporate success — it sets the stage for future innovations, discoveries and enhanced product lines, as well as preparing for the increasing demand of a growing customer base. The modified adage that you have to spend money to make money is certainly appropriate as companies look to invest today for benefits in the future. To do this, LPL Financial Research expects companies in 2010 to increase capital expenditures, continue inventory re-stocking, and accelerate the pace of re-hiring staff to fuel future growth. In this edition of the White Paper, we will explore the importance of companies to make the transition from surviving to planning for growth, as well as identifing potential portfolio opportunities to capitalize on this return of corporate investment.

**1** Cap-Ex Tends to Decline During Recessions as Companies Reduce Spending to Protect Profits

## Cap-Ex = Fuel for Future Growth

Perhaps the greatest proxy for corporate investments is capital expenditures, or simply Cap-Ex. Cap-ex is the outlays that corporations make to upgrade machinery, embrace new technology, and start new product lines — it is corporate America's version of investing for the future.

In the nearby chart, it is easy to see that Cap-Ex (government surveys call this Manufacturers' New Order) has fallen precipitously during the last 18 months. It certainly is not uncommon in recessionary periods, which are identified on the chart as shaded periods, for companies to reduce spending in an attempt to protect profits. This concept of protecting profits means that when sales (top-line) falls due to reduced demand, companies must offset the reduction

Now that the economic danger has begun to subside, companies have shifted their strategy from reducing spending in an attempt to assure survival.

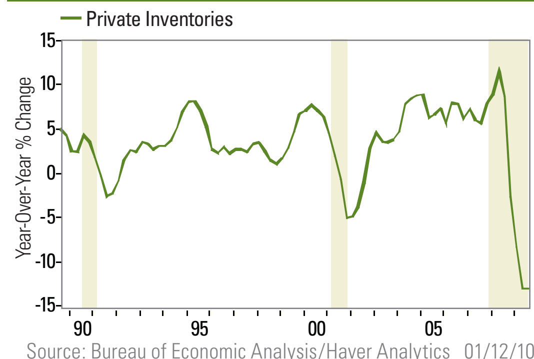
in new business by cutting costs to protect profits (bottom line). Cap-Ex is usually a prime candidate for spending cuts in recessionary periods.

After peaking at nearly $56 billion in monthly Cap-Ex spends in late 2007, corporations reduced Cap-Ex dramatically during the next 18 months. In fact, Cap-Ex bottomed out in mid-2009 just below $31 billion, which is almost a 50% reduction from its peak. However, as the economic backdrop has begun to improve and visibility for better times in the future has become more clear, many companies are beginning to re-allocate spending back to capital intensive projects in an attempt to invest for the future. In other words, now that the economic danger has begun to subside, companies have shifted their strategy from reducing spending in an attempt to assure survival to increasing spending for potentially long-term growth opportunities.

## Replacing the Bare Shelves

When companies cut spending in order to protect profits in recessionary times, another area often reduced is inventories. Because inventories are goods bought in advance for future sales, it makes sense that when consumer demand slows, companies reduce the amount of products on the shelves. This was certainly the case in 2008–2009, as companies severely reduced inventories, as shown in a nearby chart. However, companies cannot go for long with barren shelves and low inventory levels, especially in an economy that is recovering. With retail sales having improved by more than 5% on a year-over-year basis as of December 2009, companies need to make sure that their shelves are stocked to meet the rising, albeit tepidly, consumer and business demand.

**2** During Recessions, Inventories Drop Dramatically as the Demand for Products on the Shelves Slows




Source: Bureau of Economic Analysis/Haver Analytics 01/12/10

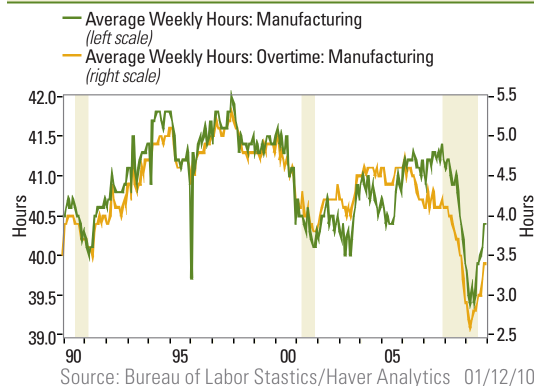
## Re-Hiring Expertise

In 2009, soaring unemployment was a by-product of companies "right-sizing" to meet diminished customer demand, which resulted in significant lay-offs, reduced work hours, and an unemployment rate that topped 10% for the first time since 1982. However, with the steady improvement of the economic environment, many companies have realized that they may have cut too many staff in order to adequately meet improving demand.

Validating the fact that the employment situation is improving, the average work week for manufacturing employees across the U.S. has risen by almost one hour per day since the low point in early 2009, which is very significant when this extra hour is pooled across millions of employees. Additionally, overtime hours in the manufacturing segment of the economy have been on the rise, as increased orders and customer demand have resulted in more hours worked.

The end result is that less people are losing their jobs, more hours are being worked, and average hourly earnings increased slightly. While these increases have largely been to re-engage workers to meet current demands, LPL Financial Research believes that companies will accelerate hiring to help fuel future growth. New initiatives that companies intend to undertake will require additional staff as current workers are increasingly being maxed out. This investing for the future will result in a rising demand for workers and will translate into positive job growth in 2010.

**3** Hours Worked and Overtime are on the Rise

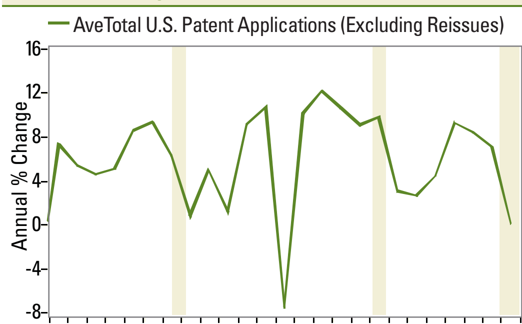



Source: Bureau of Labor Stastics/Haver Analytics 01/12/10

## Uncovering the "Next Big Thing"

The cliché that you either grow or disappear is true. Innovation is what enables companies to maintain and gain market share. During the last 50 years, names like Atari, Polaroid, and U.S. Robotics have given way to a new breed of companies like Google, Apple, and Research In Motion. Innovation is what enables companies to maintain a distinct competitive advantage over peers. But the "next big thing" is not usually something that is easily and quickly uncovered—it requires time to develop, uncover, and test new ideas to find the recipe for an innovation that can be brought to market.

4 "Innovation" Declines in Recessions Due to R&D Cost Cutting




Source: U.S. Patent & Trademark Office/Haver Analytics 01/12/10

To do this, companies rely on research and development (R&D) and exploration spending to find these new ideas. In recessionary years, it is common for companies to scale back R&D expenses in an attempt to protect profits, which is illustrated in the nearby chart highlighting the recent fall off of patent applications. However, LPL Financial Research believes that in 2010 we will see companies begin to fund exploration and R&D efforts to transition to a strategy of enhancing growth through investing for the future.

## A New Decade, A New Strategy

As history turned the page on another decade a few weeks ago, the word that may best describe the last 10 years is "survival". Surprising to many is that the S&P 500 Index began the new millennium in 2000 at 1469 and closed the decade at 1115. One of the primary reasons for the difficult decade for investors was the fact that the 10-year time period was book-ended by two major recessions. But 2010 starts a new decade and perhaps a new paradigm. Emerging from the worst recession since the Great Depression, economic recovery appears to be the theme for the coming few years. As a result, companies are poised to transition from a strategy of surviving to one of fueling growth. Like the game of Life, sometimes investments today can lead to profits down the line and result in a winning strategy versus both competitor firms and kids over holiday break.

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