Does The Cost Of Capital Matter?

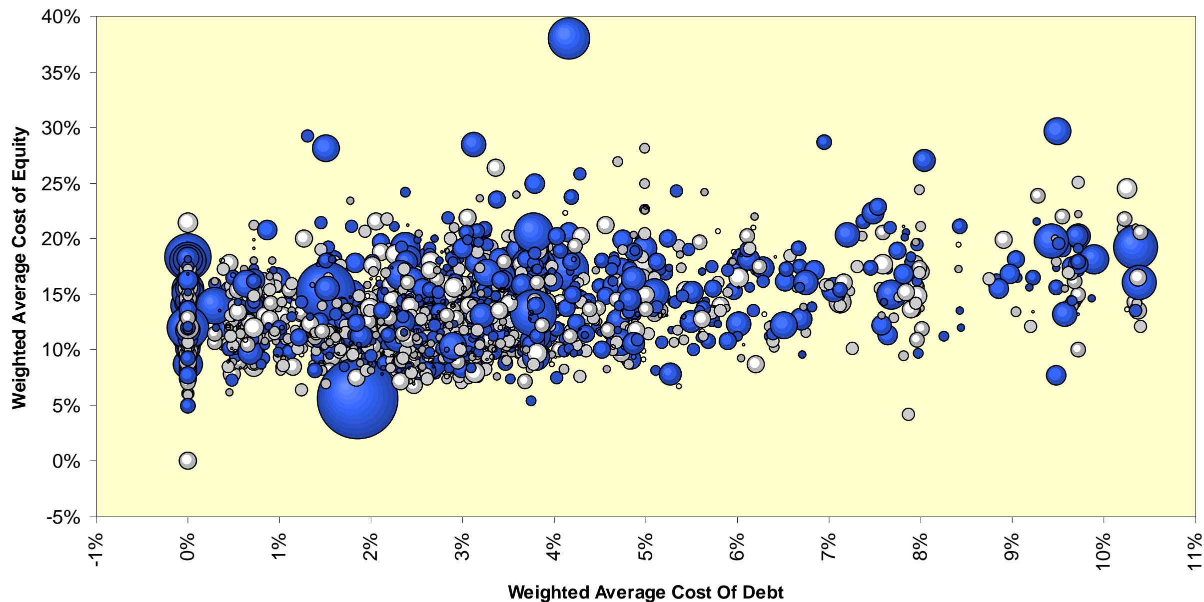
There was a time when the titular question would have seemed absurd, or at least uneducated: Of course the cost of capital matters to a corporation. One of the compelling pitches to any small firm being pursued as an acquisition target is, "Our balance sheet will lower your financing costs."

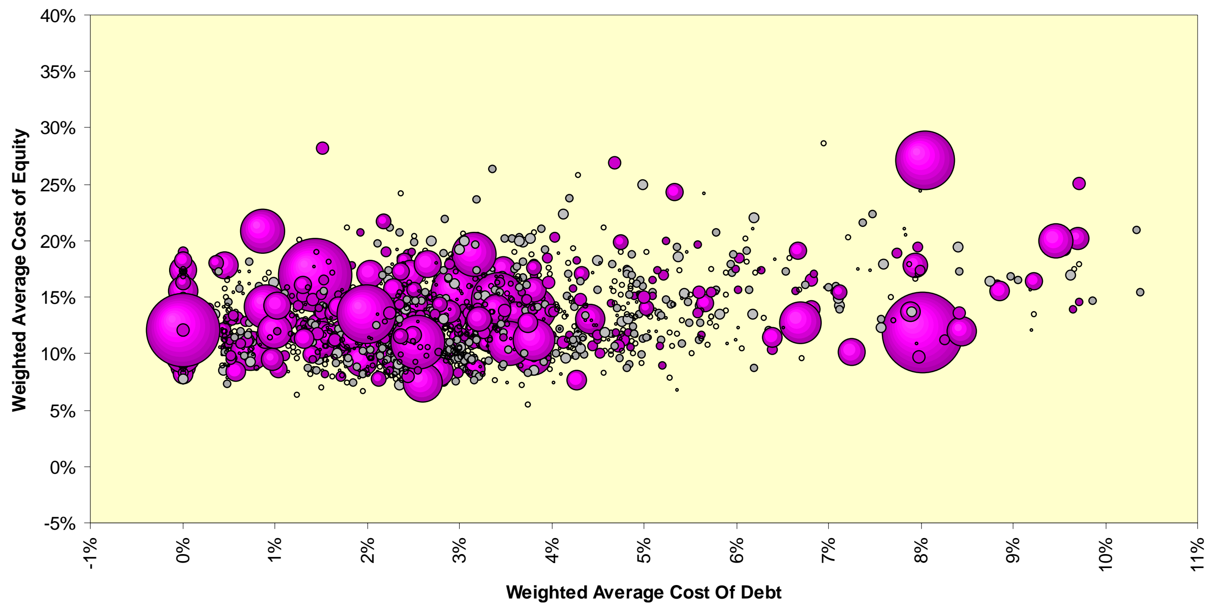
Over time, though, the seemingly straightforward relationship between a corporation's performance and its cost of either debt or equity financing – we will leave out preferred stock – just does not manifest itself in the data. As an aside, I used to look at this relationship quite regularly and then put it to the side when massive government bailouts in the finance and automobile industries rendered the cost of capital somewhat meaningless. If a Citigroup is being pumped full of air by loan guarantees and government-owned preferred stock, or if a General Motors finds itself on life support from the U.S. and Canadian governments, does it really have a true cost of capital? I would say no: The stock in those firms has been transformed into something more akin to a vertical call option spread where the downside is floored and someone else gets a claim on superior upside performance.

Return And Prospects

Let's map two variables against the weighted average cost of debt and the weighted average cost of equity for each member of the Russell 3000, its incremental trailing total return over the past year relative to that of the IWV exchange-traded fund and each stock's price/earnings ratio relative to the Russell 3000's P/E ratio. The weighted average cost of equity is defined as the ten-year Treasury yield plus the stock's beta multiplied by the national risk premium, which happens to be 848 basis points for the U.S. at the time of this writing.

If the cost of capital was a prime determinant of either variable, we should see the large colored bubbles clustered in the southwest corner of the charts and the large white bubbles clustered in the northeast corner of the charts. Neither seems to be the case.





We could extend the analysis to other variable related to each stock's risk, such as the implied volatility of the issue versus the index or five-year credit default swap costs. The answer for both of these more forward-looking variables is the same as what we see above for trailing return and relative P/E: The cost of capital, either debt or equity does not seem to matter.

This is more than a trivial issue best confined to some musty financial journal. Much of the Federal Reserve's policy to drive interest rates lower is based on the belief these rates are stimulative to business. You know the drill: The investment thingy and let's not forget jobs, jobs, jobs. So far, the cost of capital has plunged and the only people who seem to be benefiting are the large banks and Uncle Sam himself. The market has voted with its feet for an index of 3,000 stocks and it says the policy has failed.