Capital Costs And Returns

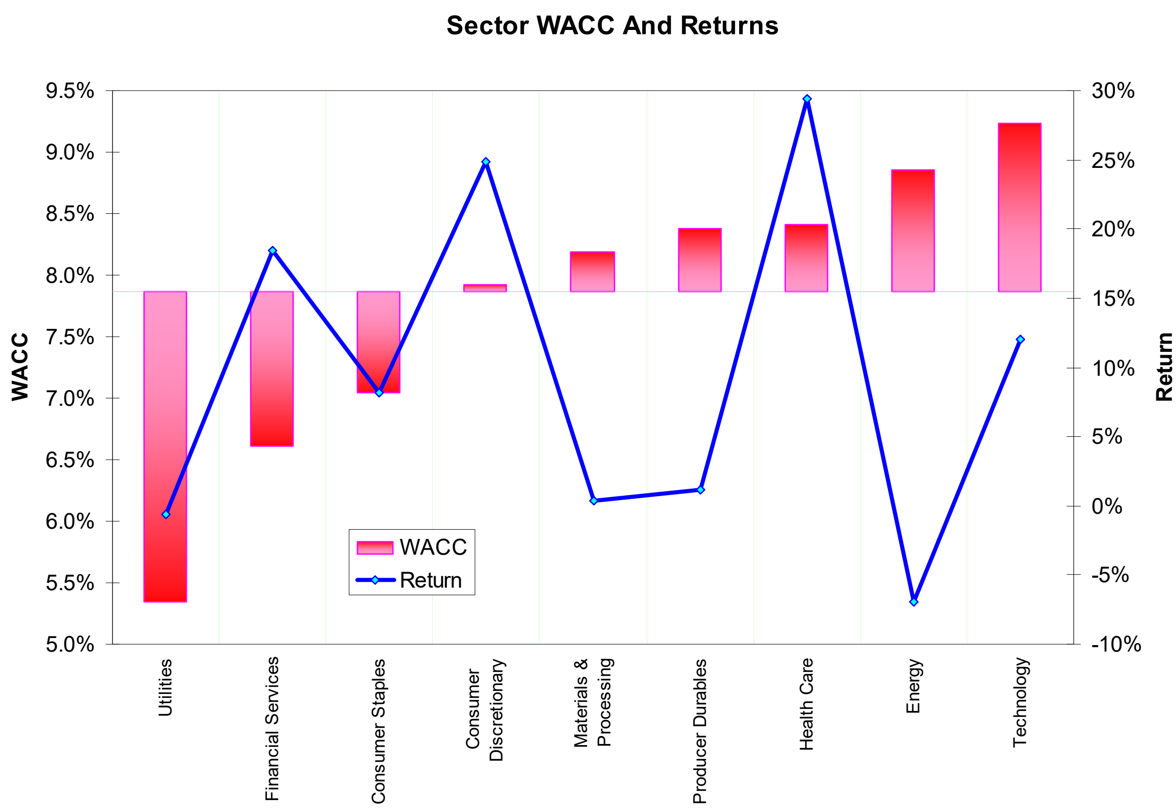
If someone told you corporations with lower weighted-average costs of capital (WACC) had higher returns, you would not bat an eye. It just seems to make sense in the same way a refiner with lower crude oil feedstock costs should enjoy higher refining margins and therefore greater operating profits and higher returns.

But, as Socrates once said, in Greek no doubt, "The unexamined life is not worth living." Of course, Socrates ended his presumably examined life by guzzling some hemlock, so you might want to choose a better role model.

Take A WACC At It

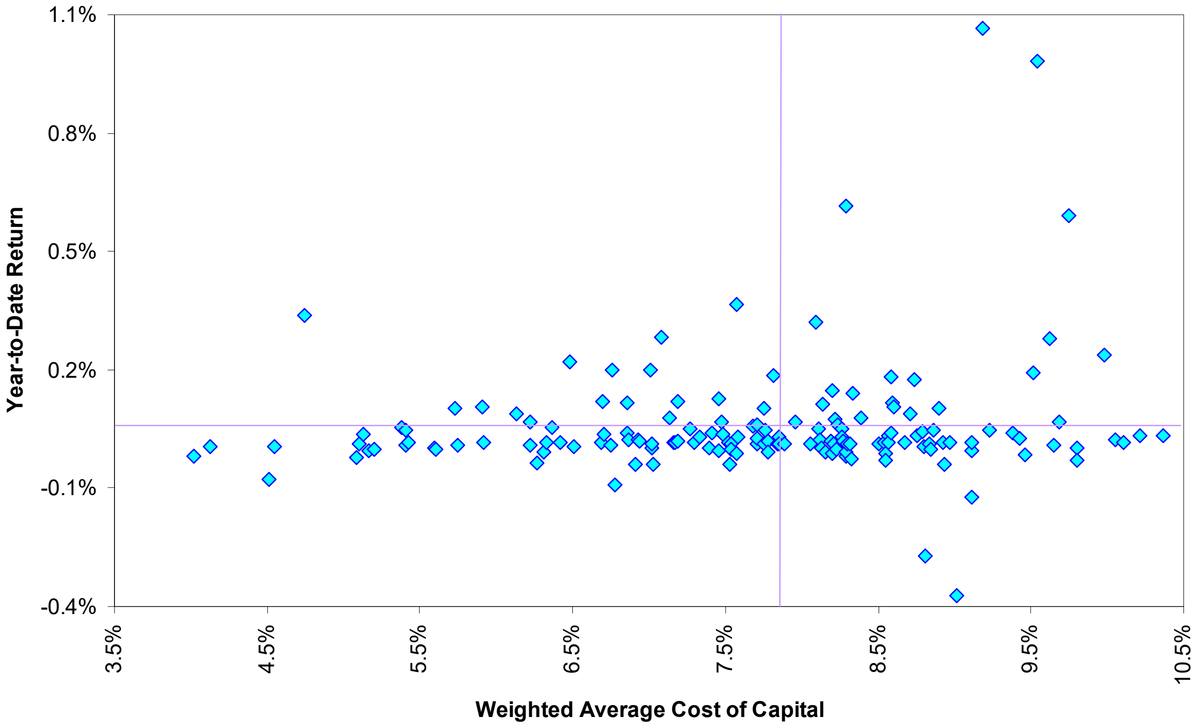
I took the WACC for each member of the Russell 3000 index, multiplied it by its weight in the index and then aggregated the results across the nine economic sectors as defined by Russell. The current WACC for the Russell 3000 is 7.864%, presented in the chart below as the internal X-axis.

If we map each sector's 2015 year-to-date return against its WACC we see a very random relationship. Three sector's WACCs, Utilities, Financial Services and Consumer Staples are below this average; Energy and Technology have the highest sector WACCs. The year-to-date weighted total returns for each sector are unrelated to these WACCs.



If dividing the U.S. market into nine sectors seems a little coarse, let's split it into the 154 GICS industry groups and repeat the exercise of mapping industry group WACC against 2015 year-to-date weighted total returns. The market's weighted total return and WACC are superimposed as the internal axes.

Weighted-Average Cost of Capital And Industry Group Returns In 2015



The same random relationship is visible. The two highest industry group returns in 2015 have been Internet Retailers and Biotechnology with WACCs of 9.18% and 9.55%, respectively. These WACCs are higher than those for the two lowest-returning industry groups, Integrated Oil and Oil Exploration & Production, whose WACCs are 9.02% and 8.81%, respectively.

We would be hard-pressed to argue the poor returns in the two oil-related groups are a function of their relatively high WACCs, and investors seem pretty unfazed by the relatively high WACCs for the Internet Retailers and Biotech.

I have no idea whether Socrates kept a ledger with two columns entitled, “Matters” and “Doesn’t Matter,” and if he did, who knows what entries would have been on each side. I do know if he crunched some numbers, he would have been forced to conclude WACC does not matter for returns. It is not what capital costs you, it is what you do with the capital you have.