

DM Monthly Report

MARCH 2019

PORTFOLIO ACTIVITY

Aside from rebalancing transactions, no trades were executed in DM equity portfolios in February.

FEATURE STOCK

Danaher Corp. (DHR)

DHR designs, manufactures, and markets medical, industrial, and commercial products and services globally. It's also one of the best run companies in the world, with an enviable track record of acquiring businesses, improving their processes, and then integrating them into the rest of its operations. At the end of February, DHR announced its largest acquisition to date when it struck a deal to buy GE Biopharma, the life sciences division of the now beleaguered conglomerate, for \$21.4bn. GE Biopharma is a leading provider of instruments and software used in the development of biopharmaceuticals and the fact that 75% of its revenue comes from the sale of consumables fits well with DHR's drive to increase recurring revenue. Last quarter, our models indicated that DHR share price was ahead of fundamentals and that a trim of our position was in order. We decided to override the signal, though, believing that the company's balance sheet could support an acquisition and knowing that the market usually rewards such buys. Our hunch was correct and DHR stock rallied by as much as 15% during the month.

SHARE REPURCHASES REACH RECORD LEVELS IN 2018

Though identifying companies which are able to generate and grow cash flow is fundamental to our equity investment process, perhaps even more important is the emphasis we put on understanding what management will do with excess capital once received. As we see it, a company can invest surplus funds to generate organic growth, it can acquire other firms to realize synergies, it can boost its dividend, and/or it can buy its own stock in the open market. If management is effective in its use of capital, the company's intrinsic value will rise and, eventually, this should be reflected in share price. Of cash deployment options, share buybacks probably generate the most scrutiny from our research team, both because the decision to retire stock may signal a dearth of attractive investment opportunities and because it's possible that such a course reflects a conflict between management interests and those of shareholders. In other words, if executives hold stock options or are compensated based on earnings per share, they may be disproportionately incentivized to boost short term share price or reduce the number of shares outstanding.

Buybacks have also attracted a populist glare in recent months, with several politicians in the US calling for their curtailment on the basis that this capital should be used for more productive undertakings, such as R&D, expansion, or worker compensation. This acrimony has been driven in large part by the belief that much of last year's massive corporate tax cut has not been directed toward investment, as policy makers had promised, but instead to the retirement of common stock. The chart below provides some credence to this suspicion, by showing that S&P companies reduced their debt issuance markedly in 2018 while simultaneously buying back more shares than ever before. Perhaps regulatory or tax changes will soon discourage this use of capital and buybacks will begin to fall out of favour - *if companies instead devote more cash to dividend increases and pro-growth investment, that would suit us just fine!*

Net share buybacks vs. annual change in debt
US non-financial cos. (bn USD)

