PRESCIENT

WHICH ASSET CLASSES HAVE THE BIGGEST IMPACT ON JOB CREATION?

Robust economic growth is imperative for sustainable employment creation. Over the years, there has been ample academic literature that proves the existence of a positive relationship between capital formation and economic growth. Ultimately, the answer to the question posed is two-fold. One needs to address the question of optimal capital structure and how efficiently corporations deploy capital within an economy.

Broadly speaking, companies have two choices when it comes to the financing of investment projects. They can either borrow money or use shareholder capital. These different sources of financing each have their advantages and disadvantages. The challenge here is to find an optimal mix of debt and equity in order to minimize overall cost of capital. This would lower the hurdle rate of return required from investment initiatives for them to be attractive in turn allows companies to take on more investment projects which will benefit economic growth.

Looking into the characteristics of each source; debt offers the lowest cost of capital due to the tax deductibility of interest payments. However, this comes with contractual obligations to make periodic payments to service the debt. This means that too much leverage increases the financial risk to shareholders and the return they require when providing equity capital. On the other hand, equity financing is expensive. On a relative basis, an equity investment is way riskier than an investment in debt securities. As such, shareholders require a return that fully reflects the riskiness of the investment. Therefore, companies seeking financing for new projects need find to the optimal point at which the marginal benefit of debt equals the marginal cost.

Naturally, optimal capital structures will differ across business models and industries. For example, companies in highly cyclical sectors might want to steer away from having too much leverage, while those in more defensive sectors – with more stable cashflows - would probably have more capacity to service debt through the cycle. However, even with an optimal mix of debt and equity financing, for an investment to have a lasting impact on economic growth and employment creation, management needs to allocate capital efficiently - by channeling resources to projects that will maximize shareholder value. Absent which, things like write-offs and impairments of assets might come to the fore in the future, as projects fail to deliver returns higher than the weighted-average cost of capital. This would most likely result in job losses.

This leads us to believe that both the bond and equity markets are important for employment creation. These are the conduits through which resources are channeled from savers to entities seeking funding for investment initiatives. Cash or commercial paper, on the other hand, is generally used to finance short-term needs. While it is an important building block in the capital structure of almost every corporation, its most appropriate use is for funding working capital as opposed to investments. It is prudent for companies to use long-term funding when undertaking long-term investment projects. For this reason, we believe that cash, as an asset class (or short-term funding), has the lowest impact on employment creation. Growth in gross fixed capital formation is the fuel that keeps the economic engine running, and the wheels of growth turning, ultimately leading to job creation.

About Prescient

- Prescient Investment Management (Pty) Ltd (Prescient Investment Management), is an authorised financial services provider (FSP 612).
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