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Do Reinvestment Rates Matter?

With financial theories a dime a dozen on Wall Street, it is fair to ask if a company's reinvestment rate really makes a difference in its prospects for long-term growth. One of several fundamental characteristics we monitor on a regular basis, the reinvestment rate is the amount of earnings that management has available to fund future growth. In theory, companies with superior reinvestment rates should be able to expand without taking on debt or selling assets and therefore grow at above-average rates. The reinvestment rates for our top twenty-five equity holdings and the Standard & Poor's 500 Index for the five-year period 2007 through 2011 are shown below:

<u>Company</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Abbott Labs	14%	15%	15%	17%	18%
Apple	24	23	21	29	34
Automatic Data Proc.	11	12	11	10	9
Church & Dwight	14	13	14	13	11
Coca-Cola	13	17	12	13	15
Colgate-Palmolive	52	65	47	44	52
Ecolab	16	21	17	18	4
ExxonMobil	27	33	10	15	21
IBM	29	72	46	50	52
Johnson & Johnson	17	19	15	13	14
MasterCard	33	57	40	34	40
McCormick & Co.	14	16	14	15	14
McDonald's	12	18	16	18	20
Microsoft	33	38	26	31	32
Nike "B"	16	17	15	14	16
PepsiCo	19	22	19	16	15
Praxair	16	22	14	11	20
Procter & Gamble	9	11	10	9	9
Qualcomm	16	13	9	11	13
Sigma-Aldrich	16	20	16	16	17
Stryker	17	19	14	15	15
Sysco Corp.	17	18	15	16	12
TJX Companies	35	33	35	36	39
United Technologies	15	22	12	14	15
Walgreen	<u>16</u>	<u>14</u>	<u>11</u>	<u>11</u>	<u>12</u>
25-Company Average	20%	25%	19%	20%	21%
Standard & Poor's 500	10	5	7	10	11

Source: Value Line, Standard & Poor's

The information provided herein represents the opinions of David Wendell Associates and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

As a group, these companies maintained their reinvestment rates at levels far superior to that of the average company, even through the financial crisis and economic recession when many companies were strained to the breaking point. At the height of the crisis in 2008, these companies, on average, increased their reinvestment rates by some 25% while the Standard & Poor's 500 saw a 50% drop in its rate.

One of the ways in which management teams can fund future growth is through research and development. Done effectively, R&D efforts help develop new products and services and/or expand existing offerings. Not all companies disclose their expenditures for research and development activities but eighteen of our companies do:

Research and Development Expenditures Per Share

<u>Company</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	
Abbott Labs	\$ 1.62	\$ 1.77	\$ 1.77	\$ 2.41	\$ 2.63	
Apple	0.90	1.25	1.50	1.95	2.62	
Automatic Data Proc.	0.91	1.03	0.99	1.05	1.18	
Church & Dwight	0.38	0.36	0.39	0.38	0.39	
Colgate-Palmolive	0.11	0.11	0.12	0.11	0.12	
Ecolab	0.34	0.36	0.36	0.38	0.39	
ExxonMobil	0.15	0.17	0.22	0.20	0.22	
IBM	4.44	4.73	4.46	4.91	5.38	
Johnson & Johnson	2.70	2.74	2.54	2.50	2.77	
McCormick & Co.	0.38	0.39	0.37	0.40	0.44	
Microsoft	0.76	0.89	1.01	1.01	1.08	
PepsiCo	0.23	0.25	0.27	0.31	0.34	
Praxair	0.31	0.32	0.24	0.26	0.30	
Procter & Gamble	0.67	0.73	0.64	0.69	0.72	
Qualcomm	1.11	1.38	1.46	1.52	1.78	
Sigma-Aldrich	0.45	0.53	0.52	0.54	0.59	
Stryker	0.91	0.93	0.84	1.01	1.21	
United Technologies	<u>1.71</u>	<u>1.88</u>	<u>1.66</u>	<u>1.90</u>	<u>2.27</u>	Cumulative Change
18-Company Average	\$ 1.00	\$ 1.10	\$ 1.08	\$ 1.20	\$ 1.35	35%
Standard & Poor's 500	31.24	31.38	25.97	27.62	27.74	-11
% change:						
18-Companies	10%	10%	-2%	11%	13%	
Standard & Poor's 500	3	0	-17	6	0	

Source: Bloomberg, Standard & Poor's, Value Line

Notice how these companies maintained their research and development expenditures at fairly consistent growth rates throughout the crisis years. After 2008, when it was necessary to cut back, they did not decrease their R&D spending as much as the average company did. And in terms of the cumulative change from 2007 to 2011, these companies actually increased their R&D funding some 35% while the average company in the Standard & Poor's 500 saw an 11% decrease.

If research and development activities are adequately funded and effectively performed, then it would be reasonable to expect to see an increase in a company's revenue stream. Our group of twenty-five companies is shown below along with their revenue data as well as that of the Standard & Poor's 500:

Revenues Per Share						
<u>Company</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	
Abbott Labs	\$ 16.72	\$ 19.40	\$ 19.82	\$ 22.73	\$ 24.74	
Apple	27.52	36.56	40.61	71.21	116.49	
Automatic Data Proc.	14.56	17.20	17.67	18.15	20.13	
Church & Dwight	16.76	17.28	17.87	18.18	19.32	
Coca-Cola	12.45	13.82	13.46	15.32	20.57	
Colgate-Palmolive	27.09	30.57	31.02	31.45	34.86	
Ecolab	22.16	25.98	24.94	26.17	23.34	
ExxonMobil	66.63	85.42	58.30	68.60	91.58	
IBM	71.31	77.39	73.36	81.33	91.92	
Johnson & Johnson	21.51	23.02	22.47	22.49	23.87	
MasterCard	30.99	38.62	39.29	42.32	52.45	
McCormick & Co.	22.82	24.42	24.22	25.07	27.79	
McDonald's	19.55	21.09	21.12	22.85	26.44	
Microsoft	5.45	6.60	6.56	7.21	8.35	
Nike "B"	32.41	37.93	39.50	39.29	43.87	
PepsiCo	24.59	27.85	27.62	36.58	42.52	
Praxair	29.80	35.18	29.22	33.28	37.69	
Procter & Gamble	24.42	27.53	27.09	27.81	29.85	
Qualcomm	5.39	6.72	6.22	6.82	8.90	
Sigma-Aldrich	15.40	18.02	17.64	18.61	20.56	
Stryker	14.60	16.95	16.90	18.72	21.75	
Sysco Corp.	57.27	62.41	62.46	63.30	66.35	
TJX Companies	21.79	23.01	24.78	28.16	31.05	
United Technologies	55.79	62.27	56.49	58.97	64.14	Cumulative
Walgreen	<u>54.24</u>	<u>59.68</u>	<u>64.07</u>	<u>71.83</u>	<u>81.17</u>	<u>Change</u>
25-Company Average	\$ 28.45	\$ 32.60	\$ 31.31	\$ 35.06	\$ 41.19	45%
Standard & Poor's 500	950.55	991.56	900.72	940.38	1,012.31	6
% change:						
25-Companies	14%	15%	-4%	12%	18%	
Standard & Poor's 500	9	4	-9	4	8	

Source: Bloomberg, Standard & Poor's, Value Line

As can be seen, these companies grew their revenues at fairly consistent rates throughout the crisis years while the average company in the Standard & Poor's 500 had a less consistent and slower record. Compared to 2007 levels, our companies saw their revenues per share increase 45% in 2011 while the average company in the Standard & Poor's 500 saw an increase in revenues per share of only 6%.

With good management, consistent and effective research and development and growing revenues, a company's earnings per share should also expand at superior rates:

Earnings Per Share <i>(Diluted from Continuing Operations)</i>						Cumulative
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Change</u>
25-Company Average	\$ 3.15	\$ 3.65	\$ 3.70	\$ 4.55	\$ 5.75	83%
Standard & Poor's 500	84.65	60.15	61.49	83.95	92.23	9
% change:						
25-Companies	24%	16%	1%	23%	26%	
Standard & Poor's 500	1	-29	2	37	10	

Source: Bloomberg, Standard & Poor's, Value Line

The management teams of top-quality companies tend to reward their shareholders with better-than-average annual increases in their dividends per share:

Dividends Per Share <i>(Includes special dividends)</i>						Cumulative
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>Change</u>
25-Company Average	\$ 0.90	\$ 1.03	\$ 1.15	\$ 1.28	\$ 1.43	59%
Standard & Poor's 500	29.56	28.58	23.51	23.49	26.65	-10%
% change:						
25-Companies	20%	14%	12%	11%	12%	
Standard & Poor's 500	17	-3	-18	0	13	

Source: Bloomberg, Standard & Poor's, Value Line

With superior growth in earnings and dividends per share, it is reasonable to expect these facts eventually to be recognized in a company's share price. As a group, our top twenty-five equity holdings outperformed the Standard & Poor's 500 in all years except one during the 2007 through 2011 period:

Total Return <i>(Capital Appreciation and Income Combined)</i>					
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
25-Company Average	27%	-21%	33%	14%	15%
Standard & Poor's 500	5	-37	26	15	2

Source: Baseline/Thomson Reuters

On Wall Street, some financial theories are little more than speculative hypotheses built on abstract assumptions. For investment success over the long haul, investors should focus on the fundamental characteristics that are the foundation of investment quality, including reinvestment rates. The proof, after all, is in the pudding.