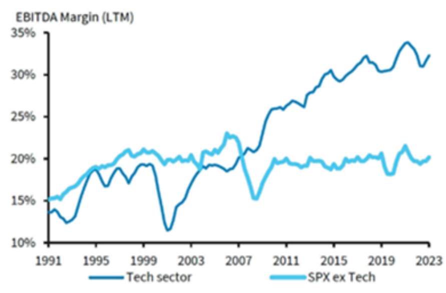
Low Margin for Error

The best performing stocks today are those that are expected to continue rapidly expanding operating profits. Operating profit designates the money made by a company after it pays for all of its direct expenses. Operating profit can also be thought of as a company's profit before paying interest, taxes, and third party expenses. It is a useful metric for tracking the earnings from a company's core business in a given period. Often, operating profits are expressed as a percentage of sales, or operating margins.

Currently, market participants are focused on innovation, such as Artificial Intelligence (AI), which allows the largest companies to earn greater operating profits. This can be readily seen in the chart below, outlining the margin expansion in the Tech sector versus the rest of the stock market over the prior decade.

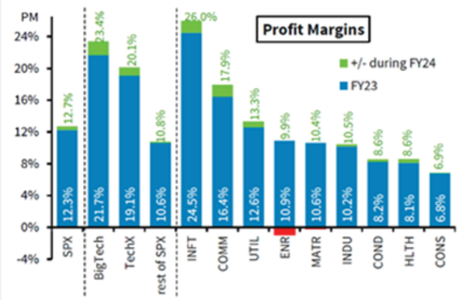
FIGURE 16. **The Tech sector has captured most of the EBITDA margin gains since the mid-2000s (widespread adoption of PCs)**



Data as of 7 March 2024
Source: LSEG Data & Analytics, Bloomberg, Barclays Research

Currently, it is clear the Information Technology sector (INFT) is much more profitable than the overall market as represented by the S&P 500 Index (SPX). The second most profitable sector is Communications Services (COMM), which includes such companies as Meta Platforms and Alphabet, considered by many to be technology companies. More traditional sectors of the economy, such as Consumer Staples, Health Care, and Industrials are at the lower end of operating profitability, currently.

FIGURE 7. **Big Tech profit margins are nearly double that of the S&P 500**



Charts uses net profit margins. Data as of 7 March 2024.
Source: LSEG Data & Analytics, Bloomberg, Barclays Research

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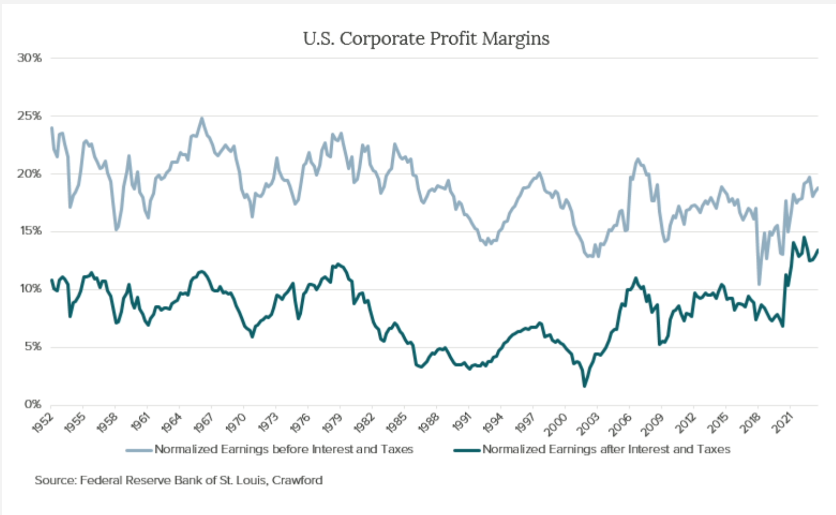
When we see data such as this, we utilize common sense to perform sanity checks. What is a sanity check? It is using an alternative primary data source to test the hypothesis. If the trend holds up on two disparate sets, it is much more likely a sustainable business and investing trend. One good data alternative is FRED, a large public database provided by the Federal Reserve Bank of St. Louis.

In aggregate, FRED's data shows two long-standing streams of corporate profits, below. The lighter blue line is closest to operating profit, while the darker blue line represents a metric closer to net profits. Net profit is the amount of cash left for shareholders after all expenses have been paid, which in this case is labeled as normalized aggregate profits after taxes and interest.

For operating profit, the sanity check works. The upward trend in normalized earnings before interest and taxes is what we would expect when one of the largest sectors in the economy is seeing operating margin expansion. However, the sharp spike in net profit (after tax and interest profit) was surprising. The increase in net profit could potentially present a bigger challenge for investors.



What has caused net profit margins for U.S. companies to almost double in the last five years? The easiest answer is very cheap debt and lower taxes. Corporations have taken on an increasing amount of debt as interest rates have declined. Debt, as measured as a percentage of revenue, has increased over 30% in the last decade, while interest expense on that debt has declined by about a third. With extremely loose monetary policy and ultra-low interest rates following the Covid pandemic, corporations levered up at a significantly lower cost. A secondary driver is accommodative government policies, including a change in the tax code and increased subsidies to invest in American plants and equipment instead of overseas.

At this point, we question the sustainability of both trends, not only Information Technology operating margins but also higher net margins from corporate America. The larger macro data set for operating profits shows cycles with the trend near a 20-year high and tax rates remaining relatively low. As profit margins regress toward the mean, we believe investors should be focused on companies with strong balance sheets and excess free cash flow, characteristics of quality companies that can weather refinancing at

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potentially higher interest rates. Additionally, investors should seek companies with sustainable business models, especially those with durable growth, pricing power, and some type of competitive advantage. At Crawford, we focus on building portfolios for our clients that include such high-quality, dividend paying stocks.