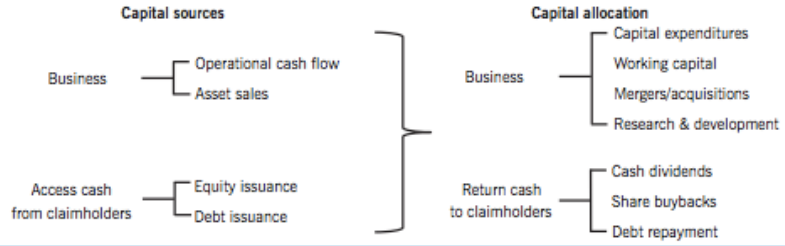
Mauboussin, M. J., & Callahan, D. (2014). Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance. Journal of Applied Corporate Finance, 26(4), 48-74.

- Successful capital allocation means converting inputs (money, ideas, people) into something more valuable (CEO responsibility)
  - Determined via NPV (present value of long-term cash flow > initial cost)
    - Strategy requires company to specify trade-offs it will make to establish position in market that creates value
- CEOs are often not skilled in capital allocation
  - Intelligent capital allocation requires understanding long-term value of an array of opportunities and spending money accordingly
    - Buying back shares might be wiser than expanding via capital expenditures or acquisition
    - A decision isn't good because subordinates can justify it or because some other company is doing it

Where does money come from and where has it gone?

- Internal (generated by business, 90%) and external (provided by capital markets: debt & equity)
  - All capital has an opportunity cost
    - The primary uses of capital by U.S. companies are M&A and capital expenditures, although M&A is very cyclical. Over the last 30 years, both capital expenditures and dividends have declined as a percentage of sales, while R&D and share buybacks as a percentage of sales have increased. These changes reflect the shift in the structure of the underlying economy.

Figure 1 **Sources and Uses of Financial Capital**



Source: Credit Suisse.

- Internal financing often represents high percentage of investment funding
  - Companies that are earning high returns on capital need not rely on capital markets to fund growth during periods when outside capital is scarce
  - Companies can waste internally generated funds on value-destroying investments
    - Markets more effective than companies at allocating capital

Recent trends in cash flow return on investment and asset growth

- Many companies shying away from investments with long-term payoffs in favour of returning cash to shareholders via dividends and buybacks