F.L.PUTNAM
INVESTMENT MANAGEMENT COMPANY

MARKET INSIGHT
SEPTEMBER 2014
VOLUME 13, ISSUE 3

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WHAT IS A U.S. COMPANY?

BY ELLEN K. HAZEN, CFA, VICE PRESIDENT

A lot of attention has been paid recently to so-called "inversions," whereby a U.S. corporation seeks to lower its corporate tax rate by merging with a non-U.S. company. This merger partner is typically located in a country with a lower corporate tax rate than the U.S. corporate tax rate.

A recent example is AbbVie Pharmaceuticals. AbbVie, a U.S. company, is in discussions to merge with Shire Pharmaceuticals, a U.K. company. Although AbbVie's market value is almost twice Shire's, the transaction would involve Shire "purchasing" AbbVie, so that the resulting company would continue to be headquartered in the U.K.

Why would AbbVie do this? The tax rate on income earned by a U.K.-domiciled combination of AbbVie and Shire would be substantially lower than that of the same company headquartered in the U.S. – possibly as much as 15 percentage points lower.

Should we care?

Activists have publicly criticized this type of transaction. They say that the U.S. companies are unpatriotic or are gaming the system in order to avoid paying U.S. taxes. Those with this perspective have tried to discourage companies from doing inversions, and in some cases have been successful. For example, Illinois-based Walgreens has publicly announced that its impending merger with U.K. company Alliance Boots will not result in a tax inversion, partially as a result of this pressure.

Let's take a step back. Generally, investors benefit when companies maximize profits. Lower taxes equal higher profits. So there is a case to be made that investors are better off with inversions.

Setting the tax question aside, there are many other reasons why an investor might be happy about a company focusing its energies outside the U.S. One clear example is growth potential. The U.S. comprises 41% of the global stock market value and 22% of global GDP, yet is home to less than 5% of the world's population. As other countries (particularly in emerging or developing markets) grow their economies faster than the U.S., companies can tap into that growth – and investors who own those companies' stock can, too. Owning non-US companies can also reduce overall portfolio risk by increasing diversification since non-U.S. economies are less correlated to the U.S. economy, meaning they don't always move in the same direction as the U.S. economy. In short, adding non-U.S. companies to an investor's stock portfolio is a time-tested way to enhance returns while reducing risk.

To tap into these benefits, one could theoretically argue that companies should be located overseas for tax purposes, or even for other purposes, such as locating its operations in areas with lower labor costs. After all, shareholders should benefit: the company moves overseas, pays fewer taxes, has lower labor costs, and can tap into this higher international growth. A win-win-win.

So the answer to "Should we care?" would seem at first glance to be "Yes."

But if we investigate further, we find that most large U.S. companies already have substantial operations outside the U.S. The average S&P500 company derives 34% of its revenue from outside the U.S. Some industries are even higher: for the average U.S. healthcare company it is 39% of its revenue, while for the average U.S. tech company it is 53% of its revenue. It's true that some U.S. companies are aptly described: AT&T gets nearly all of its revenue from the U.S., as do many utilities and smaller banks. But many more derive a meaningful portion of revenue from outside the U.S.

Similarly on the tax question, if we dig we find that U.S. companies have already found ways to reduce the tax they pay. Although the statutory federal U.S. tax rate on corporate profits is 35%, the average S&P500 company pays only 29%. Indeed, Amazon pays 6%, Verizon pays 9%, and Apple pays 14% in corporate taxes – all without doing inversions.

So, what does it mean to be a U.S. company, anyway? Should it be defined by where the company earns its revenue? Where its costs are? Where it is located for tax purposes? There is no clear answer. Take Accenture as an example. Accenture is the former Andersen Consulting technology consulting business. Forty-seven percent of the company's revenue is from the Americas, 38% percent is from Europe, the Middle East, and Africa, and 14% percent is from Asia Pacific. Yet the company is headquartered in Ireland. Conversely, Procter & Gamble receives only 35% of its revenue from sales in the U.S., but is headquartered in Cincinnati, Ohio. Intel is an even more extreme example: it receives only 17% of its revenue from sales in the U.S., but remains headquartered in Santa Clara, California.

It is no surprise then that the benefit of international diversification is slowly decreasing. As U.S. companies get more global – from their revenue base to their cost base to where they pay taxes – they begin to look more and more like the rest of the world. And as a result, while ten years ago the correlation between the U.S. stock market and global stock markets was 75%, today it has risen to 85%.

So where does this leave us? Companies have a variety of decisions to make regarding geography – where they plan to source their growth, where they want to locate their production facilities, and where they want to be domiciled and pay taxes. Few large U.S. companies have clear-cut footprints that define them as U.S. or non-U.S. Long-time F.L.Putnam clients will appreciate that we have always sought to find attractive investment opportunities, regardless of the geographic footprint of the company under analysis. The access to global growth and lower costs has arguably helped our clients over time. The recent tax inversions are just playing catch-up with reality.

2014 MARKET DIARY		
	9/30/14	YTD Change*
Dow Jones Industrials	17,042.90	4.58 %
NASDAQ	4,493.39	8.56 %
S&P 500	1,972.29	8.33 %
Russell 2000	1,101.68	-4.40 %
10-Year Treasury Bond Yield	2.49 %	-54 b.p.

Source: *Bloomberg Capital Markets*

* Includes dividends for equity indices

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