Scope of managerial economics

Economics

Firms represent a combination of people, physical assets, and information (financial, technical, marketing, and so on). People directly involved include stockholders, managers, workers, suppliers, and customers. Businesses use scarce resources that would otherwise be available for other purposes, pay income and other taxes, provide employment opportunities, and are responsible for much of the material well-being of our society. Thus, all of society is indirectly involved in the firm’s operation. Firms exist because they are useful in the process of allocating resources --producing and distributing goods and services. As such, they are basically economic entities.

- The most direct effect of a requirement to install newpollutioncontrol equipment would be an increase in the operating cost component of the valuation model. Secondary effects might be expected in the discount rate due to an increase in regulatory risk, and in the revenue function if consumers react positively to the installation of the pollution control equipment in production facilities.
- All three major components of the valuation model--the revenue function, cost function, and the discount rate--are likely to be affected by an increase in advertising. Revenues and cost will both increase as output is expanded. The discount rate may be affected if the firm's profit outlook changes significantly because of increased demand (growth) or if borrowing is necessary to fund a rapid expansion of plant and equipment to meet increased demand.
- The primary effect of newer and more efficient production equipment is a reduction in the total cost component of the valuation model. Secondary effects on firm revenues could also be important if lower

costs make price reductions possible and result in an increase in the quantity demanded of the firm's products. Likewise, the capitalization rate or discount factor can be affected by the firm's changing prospects.

- The time pattern of revenues is affected by such a pricing decision to raise prices in the near term. This will alter production relationships and investment plans, and affect the valuation model through the cost component and capitalization factor.
- A general lowering of interest rates leads to a reduction in the cost of capital or discount rate in the valuation model.
- Higher rates of inflation, leading to an increase in the discount rate, cause the present value of a constant income stream to decline. Unless the firm is able to increase product prices in order to maintain profit margins, the value of the firm falls as inflation and the discount rate increases. Of course, the economic effects of inflation on the economic value of the firm are complex, involving both asset and liability valuations, so determining the overall effect of inflation on the economic value of individual firms is a difficult task

The economic profit concept provides the most appropriate basis for evaluating the operations of a business since it allows for a risk-adjusted normal rate of return on all capital devoted to the enterprise.

Even when business profits are substantial, economic profits can sometimes be negative given the effects of risk, inflation, and other factors. Substantial business profits are no guarantee to the growth, or even maintenance, of

capital investment. In actual practice, investors adjust reported accounting data to account for additional factors that must be considered

Interesting perspective on the characteristics of wonderful businesses has been given by legendary Wall Street investors T. Rowe Price and Warren E. Buffett. The late T. Rowe Price was founder of Baltimore-based T. Rowe Price and Associates, Inc. , one of the largest no-load mutual fund organizations in the United States, and the father of the “ growth stock" theory of investing. According to Price, attractive growth stocks have low labor costs, superior research to develop products and new markets, a high rate of return on stockholder's equity (ROE), elevated profit margins, rapid earnings per share (EPS) growth, lack cutthroat competition, and are comparatively immune from regulation.

Omaha's Warren E. Buffett, the billionaire head of Berkshire Hathaway Inc. , also looks for companies that have strong franchises and enjoy pricing flexibility, high ROE, high cash flow, owner-oriented management, and predictable earnings that are not natural targets of regulation. Like Price, Buffett has profited enormously through his investments. To apply Price's and Buffett's investment criteria successfully, business managers and investors must be sensitive to fundamental economic and demographic trends.

Perhaps the most obvious of these is the aging of the population. Health-care demands will continue to soar. In recognition of this fact, investors have bid up the shares of companies offering prescription drugs, health care, and health-care cost containment (e. g. , home health agencies). Perhaps less obvious is that an aging and increasingly wealthy population will save

growing amounts for their children'seducationand retirement. This bodes well for mutual fund operators, insurance companies, and other firms that offer distinctive financial services.

As the overall population continues to enjoy growing income, spending on leisure activities is apt to grow; companies that offer distinctive goods and services in this area will do well. Helping well-heeled customers have fun has always been a good business. Productivity enhancement to combat economic stagnation is also likely to be a major thrust during the coming decade. In this area, it is perhaps easier to pick likely beneficiaries of emerging technologies than it is to chart the future course of technical advance.

For example, catalog retailers, long-distance and cellular phone companies, and credit card providers are all major beneficiaries of the rapid pace of advance in computer and informationtechnology. Similarly, major broadcasters, cable TV companies, movie makers, and software providers are all prone to benefit from increasingly user-friendly technology for leisure-time activities. B. The American Express Company, Coca-Cola, Procter & Gamble, and Wells Fargo are well-known examples of major common stock holdings of Warren Buffett's Berkshire Hathaway, Inc.

Each of Berkshire's major holdings are large capital-intensive companies with long operating histories of above-average rates of return. Like any really good business, they display a wise use of assets as indicated by an average ROE that is well above typical norms. Enhancing the attractiveness of these companies is the fact that they also display above-average annual rates of growth in stockholders' equity. Thus, they can all be described as

beneficiaries of high-margin growth. As is often the case, attractive financial and operating statistics reflect essentially attractive economic characteristics of each company.

The American Express Company is a premier travel and financial services firm that is strategically positioned to benefit from aging baby boomers. The Coca-Cola Company, one of Berkshire's biggest and most successful holdings, typifies the concept of a wonderful business. Coca-Cola enjoys perhaps the world's strongest franchise owner-oriented management, and both predictable and growing returns. Also, the company is not subject to price or profit regulation. From the standpoint of being a wonderful business, Coca-Cola is clearly the " real thing. Newspapers, banks, and cable TV companies, such as The Washington Post Company and Wells Fargo &Company, translate immense economies of scale in production into dominating competitive advantages. They also fit Buffett's criteria for wonderful businesses. In the case of Gillette, above-normal returns stem from unique products that are designed and executed by extraordinarily capable management. The late T. Rowe Price was prone to invest in high-tech companies that produced distinctive products.

On the other hand, Buffett is fond of saying that he doesn’t “ understand” high-tech and doesn’t want to be blown out of business by a few guys “ working in a garage somewhere. ” Of course, Buffett’s thinly-veiled reference to Hewlett-Packard and the Silicon Valley revolution that was started by “ two guys in a simple garage” means that Buffett clearly does understand the problems of investing in hard-to-project high-tech companies. Thus, while Buffett avoids high-tech stocks, T. Rowe Price, if he were alive today, might

find compelling the advantages of high-tech companies such as Microsoft, Intel, and Cisco Systems, among others. C. Above-normal returns from investing in wonderful businesses are only possible to the extent that such advantages are not fully recognized by other investors. In the case of T. Rowe Price, early investments in Avon Products, Xerox, and IBM generated fantastic returns because Price saw their awesome potential far in advance of other investors. On the other hand, Buffett has profited by taking major positions in wonderful companies that suffer from some significant, but curable, malady. In 1991, for example, Buffett made a large investment in American Express when the company suffered unexpected credit card and real estate loan losses.

When the company absorbed these losses without any lasting damage to its intrinsic profit-making ability, its stock price soared and Buffett cleaned up. Companies that are conservatively financed enjoy a similar ability to profit when an unexpected business downturn causes financially distressed rivals to sell valuable assets at bargain-basement prices . Therefore, while above-average stock-market returns provide the clearest evidence of having picked good businesses for investment, short-term results can be disappointingly average or below-average if the virtues of these good businesses are clearly recognized in the marketplace.

More frustrating still is the problem of finding and investing in good businesses at attractive prices and then having to wait while conventional wisdom comes around to recognizing them as such. The overall stock market is extremely efficient at ferreting out bargains and adjusting prices so that subsequent investors earn only a risk-adjusted normal rate of return. For

individual investors seeking above-average returns, finding good businesses is a necessary first step, but they must also be incorrectly priced (too cheap). Buffett succeeds because he is unusually adept at finding high-quality bargains.