



# Capital allocation in a changing investment landscape



**Michael Mauboussin, head of Consilient Research for Counterpoint Global, a unit of Morgan Stanley Investment Management, has spent nearly four decades analyzing capital markets and investments. His work focuses on identifying key factors in decision-making for both investors and managers, including how internal and external factors impact a company's ability to drive long-term value per share. Mauboussin recently wrote about the breadth of capital allocation decisions facing companies and shared insights on how investors and boards can better evaluate a management team's capital allocation skills.**

The KPMG Board Leadership Center (BLC) caught up with Mauboussin to discuss his research and how capital allocation discussions are changing in the current business environment.

**BLC: In your paper,<sup>1</sup> you highlight five principles of capital allocation. Which two or three principles would you emphasize in today's business environment? How are capital allocation discussions today different than a few years ago?**



**Michael Mauboussin:** The first would be the idea that executives should constantly evaluate opportunities with fresh eyes. Academic research reveals that companies would do better if they shifted resources among divisions more actively than they do and, relatedly, that financial executives are conservative by nature.

Next, I would say that it is useful to have a sense of value for all businesses and financial strategies, and executives should be willing to act when large gaps between price and value appear. For example, companies should have a sense of the fair value of their stock and be willing to buy or sell it, as constraints allow, when appropriate.

The biggest issue with capital allocation decisions today is that the nature of investment has changed. Historically, tangible investments were larger than intangible investments on company balance

sheets. But that has reversed in recent decades. Importantly, tangible and intangible investments differ in both their accounting and strategic implications. But the core of effective capital allocation—get more than what you pay for—remains the same.

I would also add that there remains a lot of confusion about buybacks and dividends among investors, companies, and others—notably politicians. Understanding the issues that surround shareholder payout policy has never been more important.

**BLC: What do you mean by zero-based capital allocation?**

**MM:** The zero-based approach basically dictates that managements, and boards, consider the right amount of capital and proper number of people a business should have to support the strategy that creates the most value.

For example, the manager of a portfolio of stocks should ask every day if that group of stocks offers the best opportunity for attractive returns. Likewise, the manager of a collection of businesses should ask if the units are realizing their potential and what changes might add value.

<sup>1</sup> Michael J. Mauboussin and Dan Callahan, CFA, "Capital Allocation: Results, Analysis, and Assessment," Morgan Stanley Investment Management, November 5, 2025.

## Five Principles of Capital Allocation

### 1. Zero-based capital allocation:

Start each planning cycle from a clean sheet; fund (or shrink) units based on forward value, not history. Expect pushback, push through inertia.

### 2. Fund strategies, not projects:

Approve strategy first; then select the bundle of projects that maximizes strategic value—even when some single project internal rates of return look low (or high) in isolation.

### 3. Avoid capital rationing, but earn sufficient returns on the capital you use:

Capital is accessible but not free—whether internal cash, debt, or equity. Demand returns above the cost of capital, including the cost of stock-based compensation.

### 4. Zero tolerance for bad growth:

Invest to learn, then quit fast when odds of value creation drop.

### 5. Know the value of assets and be ready to take action to create value:

An informed view of value and price allows management to do the right thing at the right time.

*Adapted from Counterpoint Global Insights, "Capital Allocation: Results, Analysis, and Assessment," Morgan Stanley Investment Management, November 5, 2025.*

The challenge is there is a lot of inertia—economists call it the “status quo bias”—which means the natural tendency is to keep doing what you are doing. Zero-based capital allocation is an attempt to address that tendency.

### **BLC: You emphasize funding strategies rather than funding projects (i.e., grouping related initiatives into “strategy bundles”). What challenges do boards and executive teams face in determining the optimal bundle of projects?**

**MM:** Michael Porter, a well-known professor of strategy, famously said that the essence of strategy is choosing what not to do. Strategy is about coming up with a value proposition that is different, supported by a value chain, and inevitably includes trade-offs that make a company stand apart from its competitors.

Projects, then, become a means to support a strategy. What is important is that a good strategy may include some projects that do not appear to pass the net present value test (they are often in the form of options) but still support the strategy. But “good” projects can still be embedded in poor strategies.

The key here is to properly define a strategy and focus on what it takes to support it. In my views, few companies have a clear view of strategy; most of what they discuss are tactics.

### **BLC: As spending tilts from tangible capex to intangibles like software, data, brand, and other intellectual property, how should companies adapt their capital allocation frameworks and processes?**

**MM:** Start by understanding that investments can show up on the income statement as well as the balance sheet. Take a subscription business as an example. Customer acquisition costs are generally expensed, but the benefit from serving the customer comes over time. So even if customer lifetime value is terrific, it may show up as a loss in the near term. It’s essential to understand the unit economics.

Next, when analyzing selling, general, and administrative (SG&A) expense, it is useful to distinguish between maintenance and investment spending. Maintenance is what the company needs to spend to maintain its current position (say, in sales or market share), and investment is in pursuit of value-creating growth.

In my experience, most companies don’t have a clear sense of that breakdown, but that awareness is useful for capital allocation.

Finally, intangible assets can have different characteristics than tangible ones—some good and some bad. For example, intangible assets can often enjoy the benefits of economies of scale because the upfront fixed cost is high but the incremental variable cost is low. Think software.

But intangible assets can be hard to protect and don't retain much value if they fail to meet the market's needs or become obsolete. In our work, we find that the intangible-intensive industries have more extreme winners and losers, measured using return on invested capital, than tangible-intensive industries.

**BLC: Capital spending across the AI value chain has grown rapidly—from hardware and data centers to software and services. How do you think about what's going on in the current environment in terms of helping management and boards identify how aggressively to pursue an investment?**

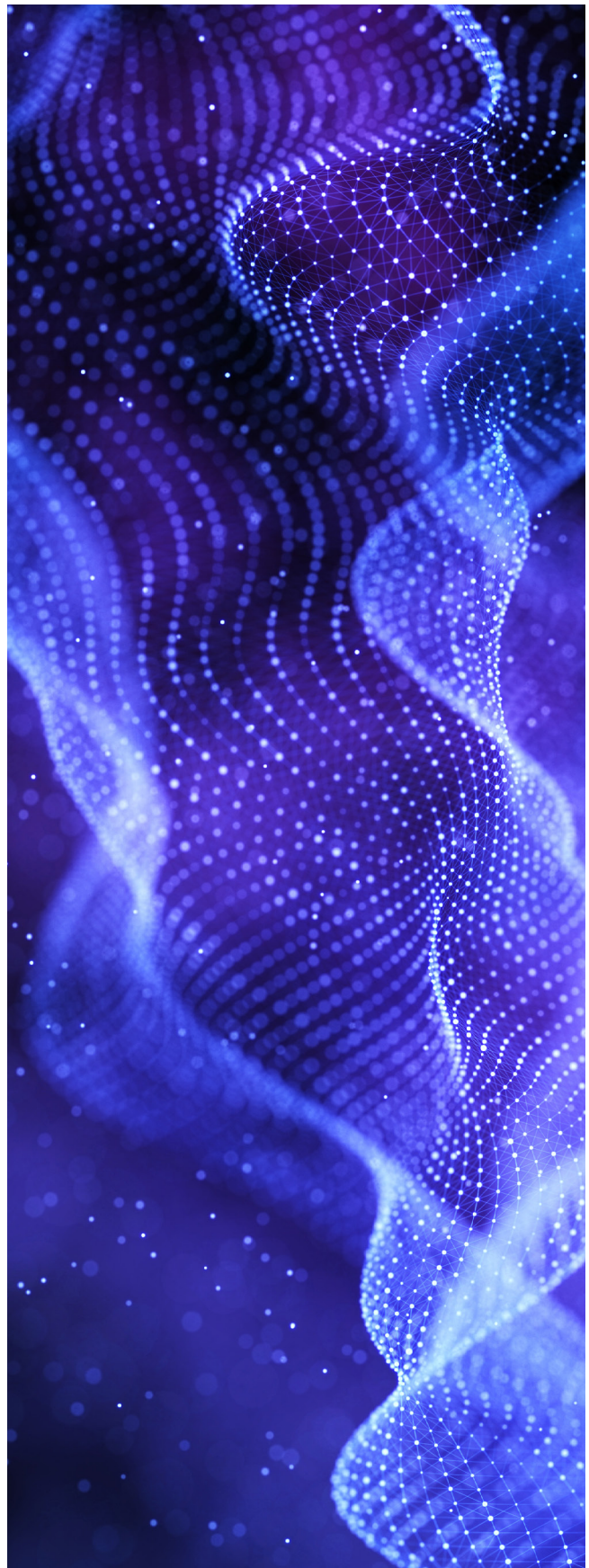
**MM:** This issue needs to be considered from the points of view of finance and strategy. They are related, of course.

Net present value is the golden rule of capital allocation. It says that the present value of future cash flows should exceed the investment required to generate those cash flows. We know the investment part is large and rising, as reflected in the capital expenditure commitments of the hyperscalers and other AI-related companies. That means that the anticipated cash flows must be large and rising as well. The encouraging sign is that the new supply from hyperscalers is going to satisfy the demand that currently exists. But it's not just revenue that matters, it's ultimately profits.

This mindset extends to assessing the effectiveness of AI-related investments for any company. The question is whether the spending on AI will lead to higher cash flows.

The strategic part has to do with how to compete. We now have a handful of powerful generative AI models, each of which has been expensive to build and maintain. As industries mature, it is extremely rare to have lots of winners, especially in products that serve similar functions.

To some degree the return on investment for many large technology companies comes down to what their competitors do. If all companies spend at a breakneck pace, it will be hard for any of them to generate an attractive return. However, companies that choose not to spend may miss out on developing technology they deem vital to compete effectively. It is a classic challenge in the realm of game theory.



Operational effectiveness measures how well a company does the activities it has in common with its competitors. This is not supposed to be a source of advantage. But research shows companies vary in their ability to execute on operational effectiveness, leading to substantial difference in financial performance. How well companies integrate AI will separate winners and losers.

**BLC: In assessing whether a management team is truly skilled at capital allocation, what are the most telling metrics or patterns in the data that you would look at (e.g., ROIC, incremental returns, M&A track record, etc.) and over what time horizon?**

**MM:** First, look for a management team that thinks well about capital allocation and acts with discipline. The correct answer to nearly every question about capital allocation is, “it depends.” Is buying back stock good or bad? It depends. Is an M&A deal attractive? It depends. And knowing what it depends on, which is almost always value versus price, is the key skill.

In my experience, some executives have a North Star for value creation. They just get it. Others do not. Warren Buffett, the chairman of Berkshire Hathaway, has said many times that the skills that get a person into the role of CEO may not include capital allocation, and capital allocation is the CEO’s number one job. So, there can be a mismatch between skills acquired and skills required.

Return on invested capital, incremental return on invested capital, and M&A track record are all important, but any one accounting measure has limitations. Ultimately, we want to know that investments bring in more cash over time than they cost.

A couple of final thoughts. Executives—and investors—make mistakes. That happens. The important thing is to mitigate the impact of mistakes and move on. It is a sin of capital allocation to throw good money after bad.

Further, executives like to grow and don’t like to shrink. But there’s a lot of evidence that divestitures and retiring shares at attractive prices can add value.

It is more natural for most executives to want to buy rather than to sell businesses. Going against the grain in that way can add value.

Time horizon is important. But the long term is an aggregation of short terms. Executives should try to do well in both. Warren Buffett has argued that it is essential for executives to make decisions that widen the economic moat around the business, but managers are sometime tempted to shortchange investments that would strengthen the business in the long haul to meet short-term objectives. Creating shareholder value is about allocating resources to generate strong cash flows over time. It’s not about managing short-term earnings to get a perceived short-term benefit.

### Questions for boards as they assess management’s capital allocation process and performance

How does the company’s allocation of capital align with and advance its strategic priorities? Is management appropriately incentivized?

Does management have a robust capital allocation process, including the right leadership, talent, and data?

Are we sensitive to possible biases in the capital allocation process? How does board gain confidence that capital is going to the highest and best use for the company’s long-term strategic plan?

How does the company measure its cost of capital, as well as the availability of capital? How flexible or resilient is the balance sheet?

Do we have the right controls and metrics to enable the board to oversee management’s capital allocation decisions and monitor its performance?

*Source: KPMG BLC*

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