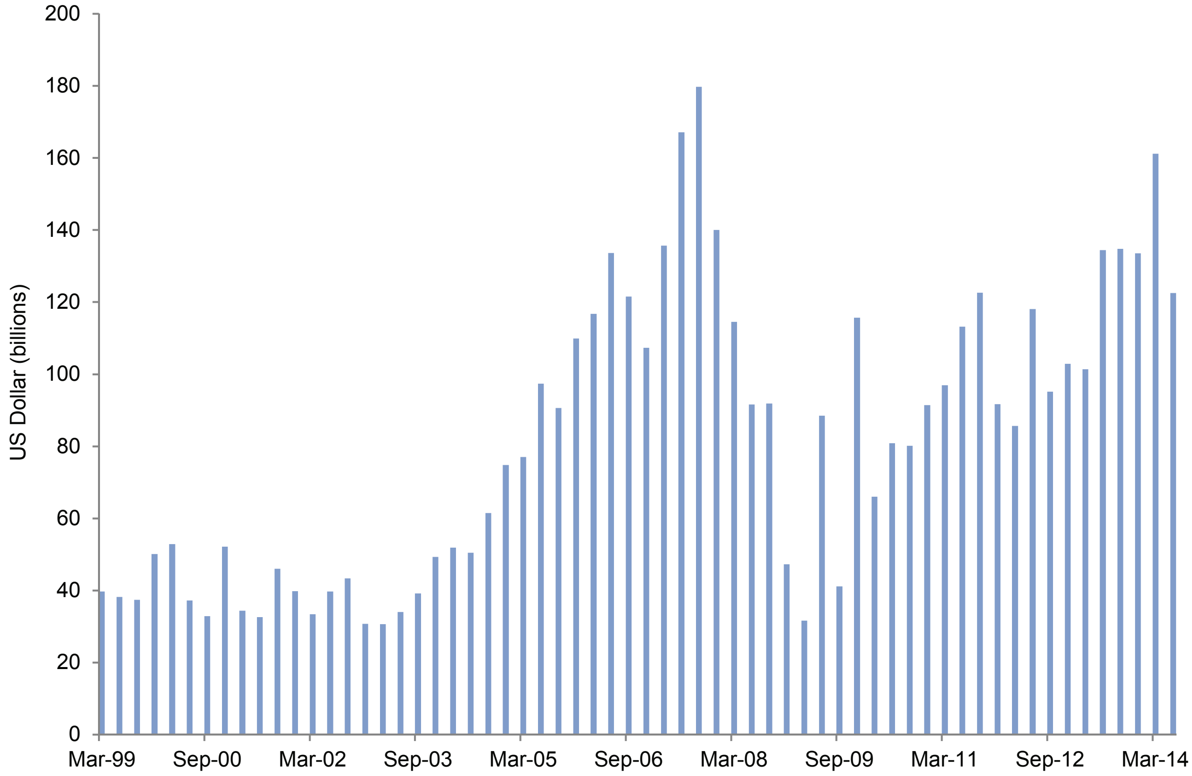
Yakety Yak, Just Buyback

In first quarter 2014, companies bought back the largest dollar amount of their own shares since 2007. With the S&P 500 Index reaching new highs, should investors be concerned that 2014 might set a new record level for share buybacks? Buybacks previously peaked in third quarter 2007, a famously bad time to buy US equities. As the current US equity cycle stretches into the later innings, the potential for a new record level of share buybacks should be viewed more skeptically than positively by investors. However, given aggregate balance sheet health, record low interest rates, and a global economy still healing from the financial crisis, investors cannot rule out the possibility that companies continue responding to the current economic environment much differently than in the past and carry on buying back shares despite stretched valuations.

Buy, Buy, Buy

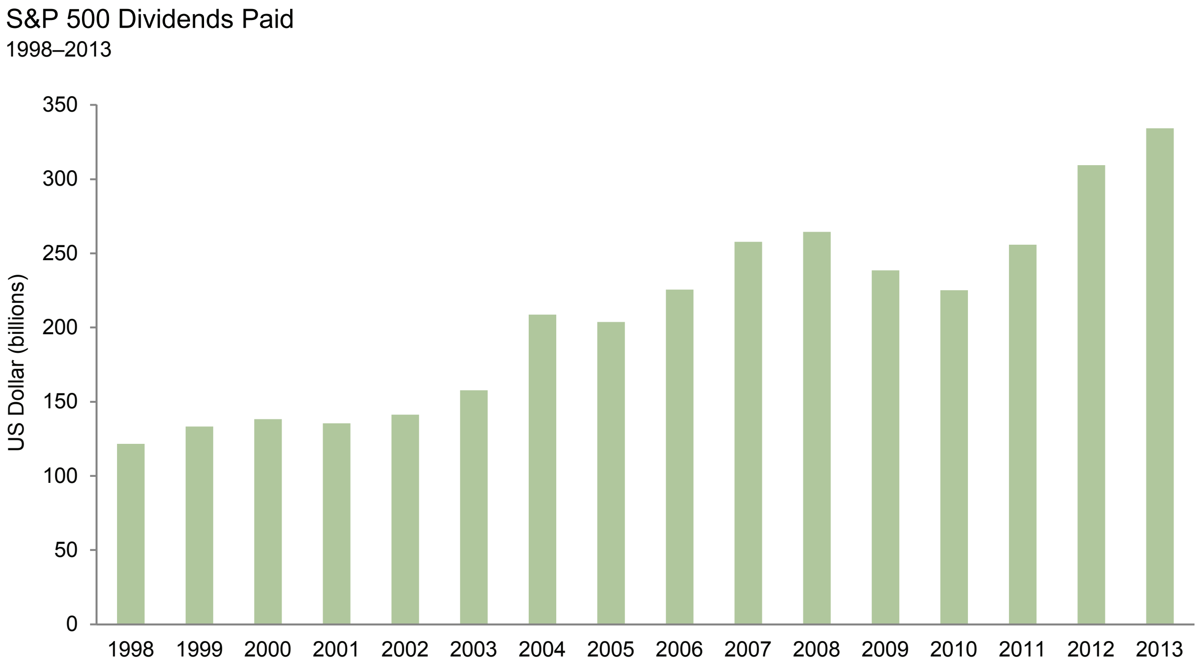
Based on the increasing amount of dollars companies are spending on them, buybacks, not dividends, now appear to be the preferred way to return cash to shareholders. This makes sense for two reasons. First, when a company initiates a dividend it usually is expected to be able to maintain and grow that dividend over time. For many companies, prioritizing their use of cash to support continuous dividend payments can be problematic in a year like 2008. Second, buybacks check many boxes for investors, executives, and Wall Street alike. From a signaling perspective, buybacks can project confidence in the company and its prospects while at the same time allowing companies flexibility with their cash flow. Should some exogenous event occur or companies find better uses for their cash, they can change their minds and reduce or stop buying back shares altogether. Buybacks can also have a meaningful short-term impact on the earnings per share (EPS) numbers that companies report quarterly and annually. As Wall Street analysts tend to emphasize short-term EPS-based

S&P 500 Share Buybacks
First Quarter 1999 – Second Quarter 2014



valuation metrics and many executives have compensation tied to EPS goals, the allure of controlling some element of the EPS figures has obvious appeal to those closest to the numbers.

Do buybacks have any benefits for shareholders? A share buyback works in theory by reducing a company's outstanding shares, thus increasing each shareholder's per share claim on a company's assets and income. It is much more difficult in practice to judge how effective share buybacks are in aggregate as a return of cash over time. Much of the ultimate benefit (or lack thereof) from buying shares has to do with the price at which a company is able to retire shares. At low price-earnings (P/E) ratios when prospects for long-term earnings growth are bright or underappreciated, buybacks should be value additive for shareholders. However, at high and declining or even stable P/E ratios, the overall benefit of share buybacks is less clear and more difficult to judge. Dividends, on the other hand, represent a clear return of cash to shareholders, and as of 2012 have already surpassed their peak, which occurred in 2007.



Looking back, in terms of overall usage of corporate cash, share buybacks gained popularity in the last decade. According to Goldman Sachs, in 1992 just 40% of S&P 500 companies bought back their own shares. In 2013, over 83% repurchased shares. In 1998, companies spent 70% of their cash flow investing for growth—defined as capital expenditures, research & development, and mergers & acquisitions—compared to 30% for returning cash to shareholders, defined as buybacks and dividends. That split shifted to 52%/48% in 2007 and has hovered around 60%/40% for the last few years. Within the context of the relatively limited history that includes buybacks as a major use of cash, 2014 is higher on a percentage basis than 1999 but less than 2007, the last period US equities approached "extreme" market valuations. However, the absolute dollar amount spent on buybacks is approaching 2007's previous peak.

Keep Buying?

As valuations for US equities become more stretched, investors would be wise to question companies' rationales and the effectiveness of buybacks at today's purchase levels and going forward. Two of the biggest tailwinds for US equities and US EPS over the last six years have been reduced share counts and margin expansion.

Since 2009, companies have spent over $2 trillion buying back their own shares. Unfortunately for investors, pinpointing the exact effect of buybacks on overall S&P 500 earnings and EPS is complicated. Constituents enter and leave the index, relative

weightings for each constituent within the index change, and companies also issue shares, making it hard to isolate the effect of buybacks on index EPS and overall index share count. However, had companies not purchased $2 trillion worth of shares since 2009, index EPS would likely be nowhere near as high as it is today.

Margins for US equities are at all-time highs, rising 300 bps from 6.2% in 2009 to 9.2% at the end of 2013. Should margins begin to normalize, or at least stop expanding, and companies slow their buybacks of shares to reduce the amount of shares outstanding, then revenue growth will likely be needed to sustain the rally in US equities. At just 3.8% and 2.2% year-over-year for 2012 and 2013, respectively, revenue growth for the S&P 500 has not been robust. Few signs on the horizon point to an imminent reversal of these trends given where markets are in the current cycle.

Different This Time?

Artificially low interest rates and a global economy still healing from a financial shock are forcing corporations to rethink their capital allocation and balance sheet decisions. In addition to share buybacks, merger & acquisition volumes are making new records at the same time that issuance of leveraged loans and other low-quality credits have surpassed their 2007 peaks. As dangerous as it is to think that "this time it's different," when it comes to the overall question of how to use corporate cash, some factors do seem to be different today. Overall corporate leverage at 51% is below its prior cycle peak of 69%. In the current zero interest rate environment, where the effects of US and global deleveraging are still working their way through the system, judging the decisions a company makes about use of its cash today—particularly as it relates to buying back stock—versus what was done historically is difficult.

The Bottom Line

Buying back stock can be a highly effective strategy for a company if done at the right time and under the right conditions. However, the perception of buybacks and their intended use has gone from a capital allocation tool that, when used properly, can increase shareholders' per share wealth over time to almost a formality and mechanism used by companies large and small, to appease investors and Wall Street by "doing something" with their cash. Given where US equities are in the current cycle, investors would be well served to look at the growing level of stock buybacks with a healthy dose of skepticism. ■

Contributors

Alex Jones, Senior Investment Associate

Exhibit Notes

S&P 500 Share Buybacks
Source: FactSet Research Systems.
Note: Data for the second quarter of 2014 are preliminary.

S&P 500 Dividends Paid
Sources: FactSet Research Systems and Standard & Poor's.
Note: Data represent trailing four-quarter sum as of December 31 for calendar year.