Mind Matters

Investment myth busting: repurchase rip-offs

James Montier
(44) 20 7762 5872
james.montier@sgcib.com

Our industry has a bad habit of accepting statements at face value, and rarely examining the empirical truth underlying them. One good example concerns stock buybacks. Many investors thought that repurchases were a substitute for dividends. We have long argued that they are primarily used to distribute transitory earnings and as such represent the most ephemeral engine of returns. Surveys show that corporate managers use buybacks to raise EPS growth and offset options dilution. They also show that managers have few qualms about stopping buybacks. Investors face a double whammy of dividend cuts and vanishing repurchases.

- Psychologists use the term framing to refer to our habit of cognitive laziness. Effectively we do not see through the way in which information is presented to us. Buybacks provide a prime example of this behavioural trait. All too often it is the announced level of buybacks that captures the headlines. However, only 30% of the announced level of buybacks translates into net repurchase.

- This is largely due to the use of buybacks to offset options related issuance. A survey of US CFOs by Brav et al revealed that the top three reasons for repurchasing stock were (i) whether the stock was a good investment, (ii) increasing EPS and (iii) offsetting the dilution effect of stock option plans. Unfortunately the first of these seems like wishful thinking. For instance, US banks carried out net buybacks of $25bn per year in 2005-2007!

- The survey also shows the differing attitudes that corporate managers have with regard to buybacks vis-à-vis dividends. Nearly 90% of the managers said there were negative consequences to cutting a dividend payment. However, only 21% said there were negative consequences to cutting repurchases.

- Of course, in periods of prolonged earnings contraction dividends get slashed. The rolling year 'beta' of US dividends to earnings is only around 0.2. However, during periods of prolonged economic difficulty this rises to over 0.5, and at extremes to 1!

- If I am right that buybacks are used to distribute transitory earnings, then given the collapse in earnings we have witnessed, we shouldn't be surprised to see net buybacks plunge. This will be exacerbated by the massive rights issues from overly leveraged firms desperately trying to rebuild their capital bases.

- This exposes the fallacy of the debt for equity swap culture that has arisen in recent years. Firms were encouraged by unscrupulous investment bankers to seek more 'optimal' capital structures – flimflam for taking on extra debt. This 'capital' was then used to repurchase equity, causing EPS to rise, conveniently ensuring that managements' options were comfortably in the money!

- Many were excited by the buyback boom in the latter half of this decade. To us, it simply represented a sign that earnings were at cyclical peaks, and firms were distributing surplus cash in a way which benefited corporate managers the most. All this leaves investors facing a double whammy of dividend cuts and vanishing repurchases.

IMPORTANT: PLEASE READ DISCLOSURES AND DISCLAIMERS BEGINNING ON PAGE 6

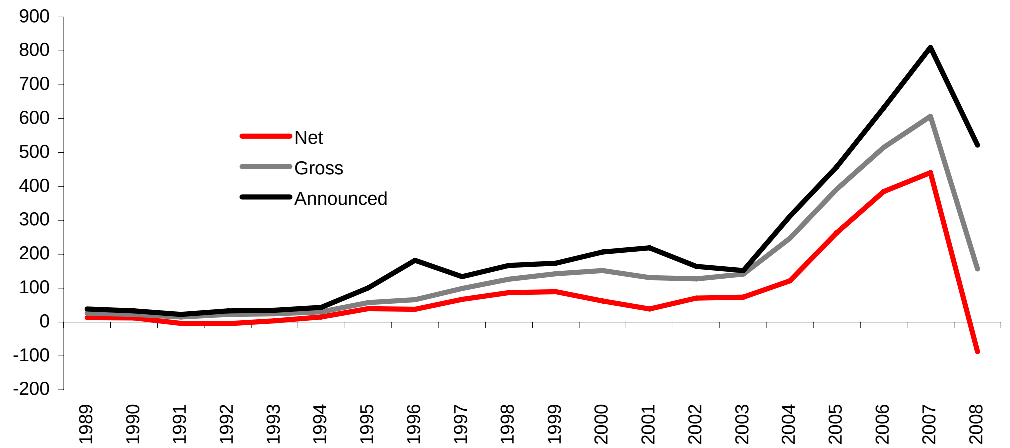
Investment myth busting: repurchase rip-offs

When the dust final settles from this crash, one of aspects which we will need to investigate is the use of stock buybacks. As long-term readers will know, I have examined this issue on many previous occasions (see Chapters 43 and 44 of Behavioural Investing as examples). One of the great myths that has grown over the years is that repurchases of stock are a meaningful generator of returns to investors. This is only true if you sell the stock to the company.

The chart below shows the difference between the various measures of buybacks. As ever, the data was complied by our resident numbers maestro, Rui Antunes. The announced buybacks are the ones that corporates tell us that they intend to do. The completed buybacks measure the actual gross level of repurchases. The line that should matter most to investors is the net series. This measures the level of stock buybacks net of any issuance.

The differences between the measures can be vast. For instance, on average since 1989, some 70% of the announced buybacks have been completed. However, only 30% of the announced amounts translates into net buybacks! This is largely due to the use of buybacks to offset options related issuance.

Various measures of US buybacks (US$bn)



Source: SG Global Strategy

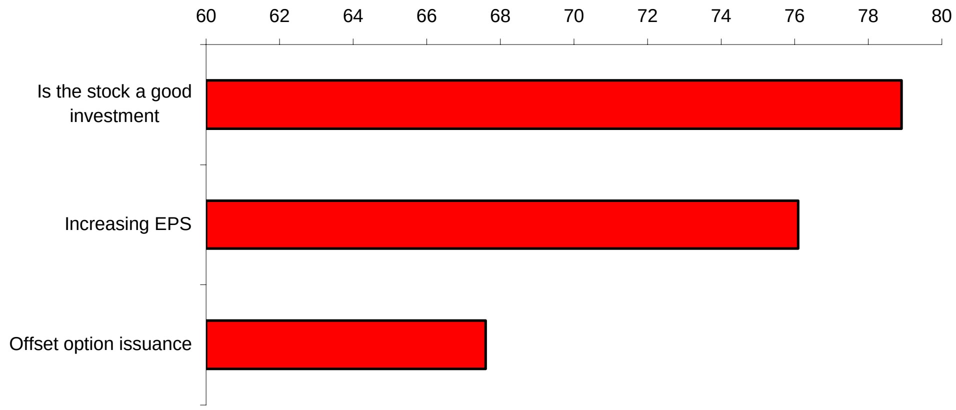
Evidence to support this view can be found in a survey of CFOs conducted by Brav et al (2004)[1]. They asked nearly 400 CFOs/CEOs at US corporates to rate the importance of various factors in their decisions to buy back stocks.

The chart below summarises their findings. The top three reported reasons where (i) whether the stock was a good investment relative to other opportunities, (ii) increasing earnings per share, (iii) offsetting the dilution effect of stock option plans. All the other reasons were supported by less than 50% of respondents.

[1] Brav, Graham, Harvey and Michaely (2004) Payout Policy in the 21st Century, available from www.ssrn.com

The blatant admission that CFOs were trying to manipulate the EPS shouldn't come as a surprise to those of a sceptical nature (which surely includes the regular readers of my work), but to those true believers this is likely to be a shocking revelation.

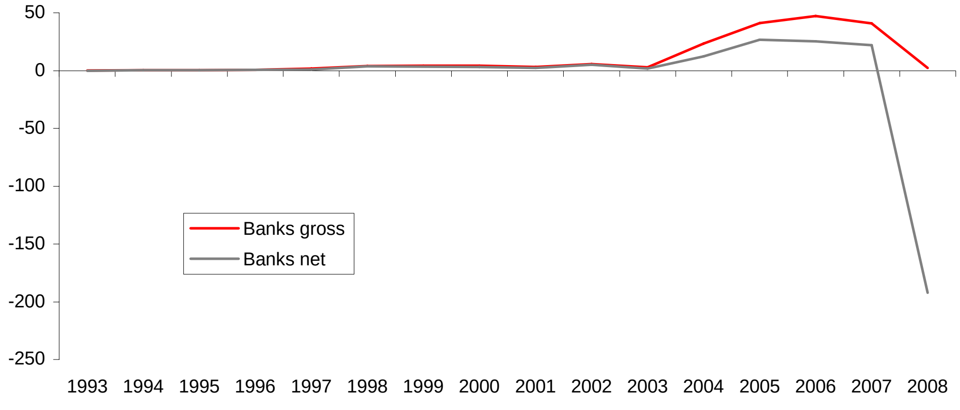
% of respondents saying the factor was important or very important



Source: Brav et al (2004)

We can largely discount the first motive offered above by a cursory glance at the chart below. It shows the repurchase activity of US banks over recent years. Their net buybacks surged from $5bn in 2002 to over $25bn per year in 2005-2007! So much for buying back stocks when they are cheap!

Completed and net repurchases by US banks (US$bn)

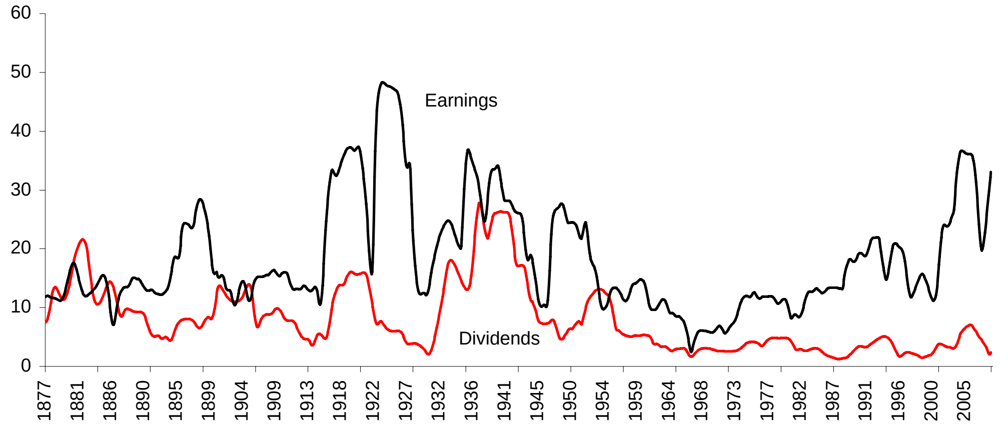


Source: SG Global Strategy

I have long argued that firms effectively use repurchases to distribute transitory earnings. In normal times, if a firm increases its dividend, they are generally reluctant to then later cut the dividend as it sends a poor signal to investors. Hence dividend changes are not taken lightly by firms, resulting in a high degree of dividend stickiness.

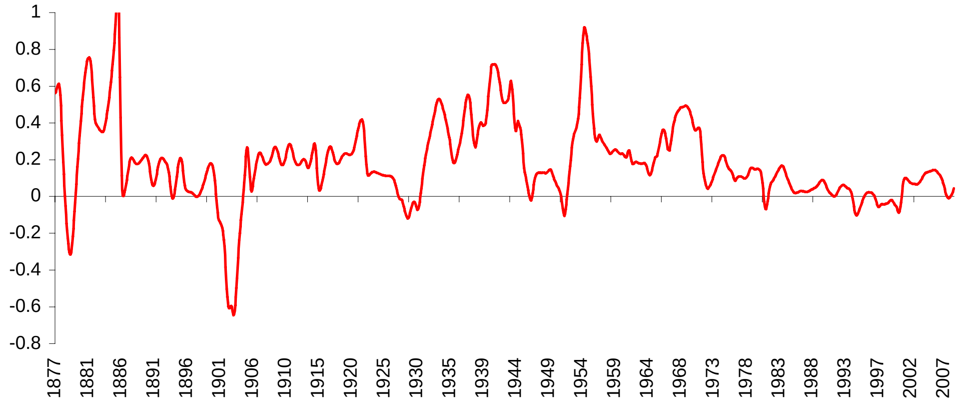
Using the long-term history in the US, since 1871 US dividends have a 'beta' of just 0.2 with earnings. The chart below shows the rolling five-year standard deviation of US earnings and dividends. The lower volatility of dividends relative to earnings is transparent. Although it should be noted that in severe downturns like the 1930s, there is a much closer feed through from earnings to dividends (as shown by the five year rolling 'beta' below). This, of course, is a function of the duration of the downturn. Firms are often willing to absorb short-term earnings downturns and protect their dividends. However, in the face of a protracted earnings slump, a pass through into reduced dividends is required.

Rolling five-year volatility of US earnings and dividends



Source: SG Global Strategy

5-year rolling 'beta' of US dividends to earnings

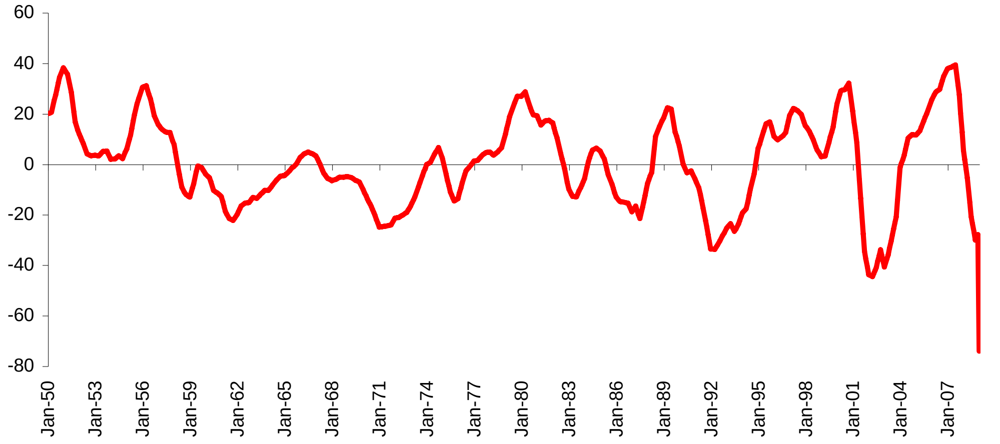


Source: SG Global Strategy

The corporate view of repurchases is very different from their view of dividends. The Brav survey again shows that firms view repurchases as a much more flexible tool than dividends. For instance, nearly 90% of the survey respondents said there were negative consequences to cutting a dividend payment. However, only 21% thought there were negative consequences to cutting repurchases.

Thus, as earnings collapse, we shouldn't be surprised to see net buybacks plunge. Of course, this is exacerbated by the massive rights issues caused by overly leveraged firms trying to rebuild their capital bases. This is another of the fallacies of the debt for equity swap culture that arose in recent years. Firms were encouraged by unscrupulous investment bankers to seek optimal capital structure – flimflam for taking on extra debt – and then used the capital to repurchase equity, causing their EPS to rise and ensuring the managements' options were comfortably in the money. Everybody wins, right up until they don't!

US – Earnings deviation from trend %

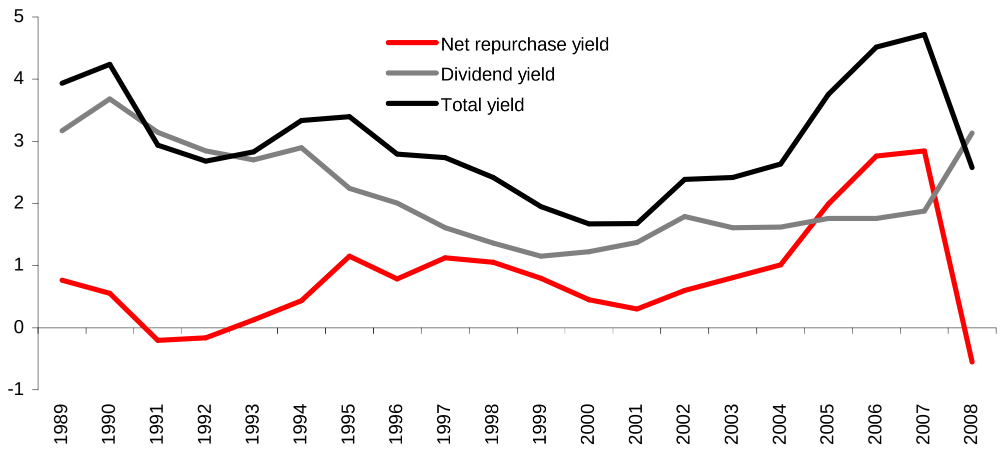


Source: SG Global Strategy

For the sake of completeness, there is one final aspect of repurchase which I should address before I bring this diatribe to an end and that is the impact of repurchases upon the overall valuation of the US market. The chart below shows the way I tend to view this. I add the net repurchases (transformed into yield terms) to the dividend yield in order to give a picture of total yield.

On average, since 1989 repurchases have added the equivalent of just over 80bps to the dividend yield. Whilst many were getting excited about the surge in repurchases in the latter half of the current decade, we took this as a sign that earnings were reaching cyclical peaks, and firms were just distributing surplus cash in a way which benefited corporate managers. Sadly, this means that investors face a double whammy – dividend cuts and vanishing repurchases.

Total yield on the US market (%)



Source: SG Global Strategy

IMPORTANT DISCLAIMER: The information herein is not intended to be an offer to buy or sell, or a solicitation of an offer to buy or sell, any securities and including any expression of opinion, has been obtained from or is based upon sources believed to be reliable but is not guaranteed as to accuracy or completeness although Société Générale (“SG”) believe it to be clear, fair and not misleading. SG, and their affiliated companies in the SG Group, may from time to time deal in, profit from the trading of, hold or act as market-makers or act as advisers, brokers or bankers in relation to the securities, or derivatives thereof, of persons, firms or entities mentioned in this document or be represented on the board of such persons, firms or entities. Employees of SG, and their affiliated companies in the SG Group, or individuals connected to then, other than the authors of this report, may from time to time have a position in or be holding any of the investments or related investments mentioned in this document. Each author of this report is not permitted to trade in or hold any of the investments or related investments which are the subject of this document. SG and their affiliated companies in the SG Group are under no obligation to disclose or take account of this document when advising or dealing with or for their customers. The views of SG reflected in this document may change without notice. To the maximum extent possible at law, SG does not accept any liability whatsoever arising from the use of the material or information contained herein. This research document is not intended for use by or targeted at retail customers. Should a retail customer obtain a copy of this report they should not base their investment decisions solely on the basis of this document but must seek independent financial advice.

Important notice: The circumstances in which materials provided by SG Fixed & Forex Research, SG Commodity Research, SG Convertible Research, SG Technical Research and SG Equity Derivatives Research have been produced are such (for example because of reporting or remuneration structures or the physical location of the author of the material) that it is not appropriate to characterise it as independent investment research as referred to in European MIF directive and that it should be treated as a marketing material even if it contains a research recommendation (« recommandation d’investissement à caractère promotionnel »). However, it must be made clear that all publications issued by SG will be clear, fair, and not misleading.

Analyst Certification: Each author of this research report hereby certifies that (i) the views expressed in the research report accurately reflect his or her personal views about any and all of the subject securities or issuers and (ii) no part of his or her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed in this report.

Notice to French Investors: This publication is issued in France by or through Société Générale ("SG") which is authorised by the CECEI and regulated by the AMF (Autorité des Marchés Financiers).

Notice to UK investors: This publication is issued in the United Kingdom by or through Société Générale ("SG") London Branch which is regulated by the Financial Services Authority ("FSA") for the conduct of its UK business.

Notice To US Investors: This report is intended only for major US institutional investors pursuant to SEC Rule 15a-6. Any US person wishing to discuss this report or effect transactions in any security discussed herein should do so with or through SG Americas Securities, LLC (“SGAS”) 1221 Avenue of the Americas, New York, NY 10020. (212)-278-6000. THIS RESEARCH REPORT IS PRODUCED BY SOCIETE GENERALE AND NOT SGAS.

Notice to Japanese Investors: This report is distributed in Japan by Société Générale Securities (North Pacific) Ltd., Tokyo Branch, which is regulated by the Financial Services Agency of Japan. The products mentioned in this report may not be eligible for sale in Japan and they may not be suitable for all types of investors.

Notice to Australian Investors: Société Générale Australia Branch (ABN 71 092 516 286) (SG) takes responsibility for publishing this document. SG holds an AFSL no. 236651 issued under the Corporations Act 2001 (Cth) ("Act"). The information contained in this newsletter is only directed to recipients who are wholesale clients as defined under the Act.

IMPORTANT DISCLOSURES: Please refer to our website: http:\\www.sgresearch.socgen.com