Share Buybacks, Bad Companies, and Bear Markets

The star has fallen for a few companies out there, and for those that had previous share buyback programs, there have been some of the predictable "see I told you so" articles written about them.

We agree with some of their arguments, but disagree with most.

Firstly, we should stop and think about a couple of points here. After a stock blows up (for reasons that may have nothing to do with share buybacks), or indeed after the overall market drops precipitously, we will *always* be able to find instances where some share buybacks were done at higher prices. Performing a post-hoc, after-the-fact lookback to hunt for examples of post-buyback underperforming stocks is anomaly dredging, plain and simple.

To reduce the sample bias, these naysayers would need to study a dataset of *all* companies that did share buybacks, and see what they find. We suspect that some of those companies that did share buybacks will have underperformed, and some will have outperformed.

Kinda depends on who is doing the buyback...

If we were going to guess, we'd bet things are pretty evenly distributed on both sides of the mean; and if anything there might be a slight (nor not so slight) outperformance tilt toward the companies that repurchased shares. But again, we shouldn't guess about this, we should look at the data.[1]

Naturally, in some of the negative cases, there will have been some buyback activity in names that ultimately suffered for a myriad of potential reasons (from poor products to poor management).[2] However, correlation and causation can be easily confused, and we shouldn't start doing it here.

And yes, some management teams can overpay for their shares. That *is* a bad thing. That isn't value investing. But just because Jeff Immelt overpaid for his own shares, it doesn't mean share buybacks didn't make sense for anyone else.

In addition, if a market move (say, for example, this drop we've had since early October) takes shares lower, that similarly does not imply that previous buybacks were ill-informed, no more than buybacks before the market rips higher were well-timed. That isn't idiosyncratic stuff, that is just beta. It is the rare (any?) fund manager that is a good market timer; and the skillful market-timing CEO or CFO is even more elusive.

Bottom line is that a buyback makes great sense if it is the best use of cash, the shares are under-priced, and it doesn't put the company in any financial duress. It's that simple.

But…

[1] *And even here, where "buybackers" outperform, they may be outperforming for reasons that also are merely correlated with the buyback, not caused by the buyback. It could just be a good company, generating lots of cash, that goes from being a lot undervalued to a little undervalued, all while the share buybacks are continuing. To really separate the two, we'd need a dataset of companies that had share buybacks during period A, compared to companies that didn't, but where both groups did no buybacks in period B, the evaluation period. And even then, there may be some negative signal for companies that have share buyback programs, but then all-of-the-sudden stop doing them. Bottom line is we can't draw any conclusions about share buybacks just because one famous company that has been in the Dow Jones Industrial Average since the 19th century falls on hard times. There is better work to be done first.*

[2] *Image Source: My Myself and Irene (2000), Twentieth Century Fox*

Indeed there have been some cases where buyback activity may have ultimately put a company in some sort of duress from a balance sheet perspective yet we'd have to ask ourselves whether or not share buybacks trail-blazed their paths to ruin, or if they were merely shortened by them. And even in those cases, for every GM where the management overpaid for their own shares, there is probably an Apple where they underpaid. And for every GE that bought back its own shares at higher prices, there is probably a HP or two that overpaid for acquisitions (either with cash, stock, or both) instead of decreasing their own share count.

Finally, despite our view that we should be broadly agnostic about share buybacks and objective about their benefits, we will say this; if share buybacks aren't really share buybacks, but instead are well-timed re-distributions of excess company cash to the management team, well, then they indeed are horrible, and value destroying (for everyone not working in the C-Suite).

There are dozens of companies out there that are serial issuers of options as a form of helping company executives to pocket a significant amount of additional cash (and paying capital gains for the comp rather than the top marginal tax rate). These companies will typically be as quiet as possible about these grants (often masking them from "adjusted" operating metrics). As these options vest, the calls are exercised, and the selling commences; it's not coincidental that these same companies will decide (and excitedly announce) a big share buyback that overlaps with these sales. This is nothing short of institutionalised embezzlement and borderline tax fraud, and somehow, it is legal.

We won't mention these companies by name. They know who they are, and – unsurprisingly – they don't care.