"Share buybacks and the race for dogcatcher, 2020."

Wall Street's reputation, already quite bad on Main Street, has turned …. esoteric. To the surprise of many, an "inside-baseball" stock market practice, the share buyback, has become an early issue in the 2020 presidential campaign. Go figure. The first salvo was fired in the *New York Times* by two prominent Democrats, one of whom has run for President before and might again. A high-profile Republican senator, also a former White House contender and probable future one, could not resist temptation and chimed in with his view and proposal. The back and forth has led the financial chattering class to opine broadly (Twitter) and even occasionally deeply (Bloomberg & *WSJ*) on the topic. As an investment practitioner whose dayjob is defined largely in opposition to share buybacks, I have to admit to being intrigued by all the negative attention this rather specific market activity has garnered. But as much as I would like to jump in, bash share buybacks, and get elected City of Pittsburgh dogcatcher in 2020, I cannot. Here is why.

Share buybacks or repurchase programs are nothing more or less than buying out one's business partner and co-owner, just on a big scale for publicly traded entities. There is nothing illegal (since 1982 in the US stock market), unethical or immoral about doing so, and it happens in private businesses around the world all the time.

The issue is not foundational. It is about human judgment. The past three decades of experience have shown that companies buy back their shares at high prices and unattractive valuations rather than lower prices and more attractive ones. Think eve of the Internet bubble crashing; think eve of the sub-prime housing collapse and the resulting Great Financial Crisis. In recent years, share buybacks have reached an unprecedented level, as have share prices. Successful business people prefer to buy cheap, not dear. But business executives—who presumably had the acumen to become successful business executives in the first place—do pretty much the opposite. They buy their shares high and then (usually their successors) have to issue new shares to raise capital when times are tough, prices are low, and equity is dear. (This terrible track record is somewhat obscured by the latest bull market run—ten years—which has made the most recent crop of share buybacks look smart, for the time being.)

Another flaw, but a rather more innocent one, is that buybacks are semantically lumped with dividend payments to company owners and considered "returning cash to shareholders." A dividend is precisely that. A share buyback is precisely the opposite. It is paying someone to leave. They are no longer share owners. And in that regard, buybacks encourage near-term holding, speculation, trading, etc. rather than business ownership whose compensation is overwhelmingly from the distributable cashflows of a business, the dividend.

Despite the well-known poor track record of share buybacks and the semantic misdirection, executives engage in them with great gusto, partially out of self-interest—most C-Suite members are paid in part in shares or options and they feel they can drive up or at least prop up their shares by being the marginal buyer—and partially because they are egged on by the brokerage and hedgefund community which benefits from all the commotion. (I made all of these arguments against buybacks in *The Dividend Imperative* from 2013.)

The situation becomes somewhat darker and less "neutral" when companies use borrowed money to buy back their shares. When debt is cheap, borrowing to buy back shares usually pushes up EPS, which makes the executives behind the buybacks look smart. Should interest rates rise sharply or a company enter a difficult patch, however, then real trouble can occur. But even that is a matter of judgment, getting the right amount of debt and equity in a company's capital structure. There is no perfect formula. Modern Portfolio Theory and the corporate tax structure—interest on debt is deductible, dividend payments are not—encourage companies to take on too much debt, but that has been the case now for decades. And, curiously, that is not the primary assertion the 2020 candidate crop is making.

The Washington anti-share buyback crowd is making an entirely different and somewhat unusual claim—that share buybacks are diverting capital from investment. A quick review of basic accounting is in order here. Share buybacks come from free cashflow, that is the amount of money that is left *after* companies have met all their operating expenses that are reflected on the income statement, as well as all capital expenditures (capex) or big ticket purchases such as plant, property, equipment and other investment items that are not "expensed", but are amortized or depreciated over a period of years. These expenditures show up on the statement of cashflows. From the tenor of comments by the pols, they may not even realize that the buybacks are an *outcome*, not an *input*. Companies do not start with buybacks and then use whatever cash is left to pay their bills and invest in the future. Yes, it is true that if companies spend more in any given period, they will have less free cashflow to buy back their shares in that period. But getting the right level of investment—whether on the income statement or in the form of capex—can be hard to tell. Does your Senator know? Which projects will work out and which won't is not clear beforehand. Does your Congressman know?

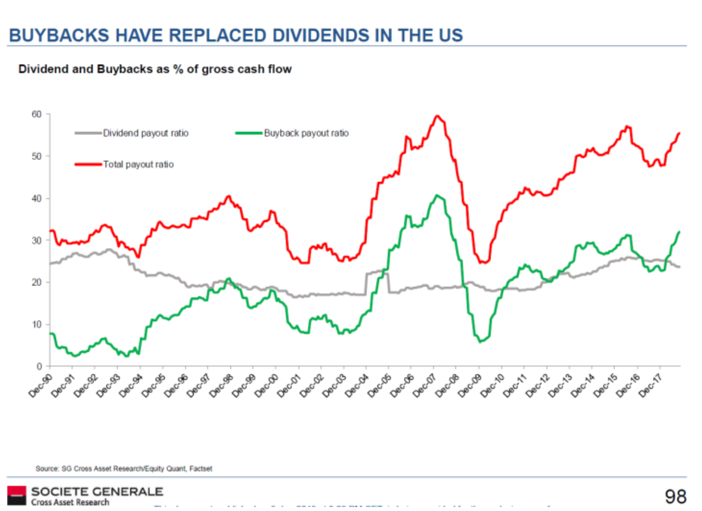
The pols may not like the level of investment that certain companies are making currently, but they are hardly in a position to substitute their judgment for those of the managers. Open markets—even those that are highly regulated—come with agency costs. Unless you have the ability to make all investment decisions in the economy, you outsource that function to others who presumably are in a better position to do so than you. Those individuals will get some right and some wrong. The Edsel was a technological marvel when it was introduced by Ford in 1958. But it failed. Remember new Coke? Both were approved by their respective boards after due consideration and review. There was a lot of fiber laid throughout US cities in the late 1990s as part of forward-looking investments, but much of it remained dark. For every Amazon and Google there are *thousands* of startups that burned through their seed capital and did not survive. Most recently, we have the Airbus A380 jumbo jet. Every single one of these projects had a great business plan and a compelling presentation deck. The simple fact is that not all investment is successful investment. Do you really believe Washington would successfully dictate private sector business decisions?

The DC boys make the specific argument that that cash spent on share buybacks could be used to pay higher wages. That's a head scratcher. Real wages have been stagnant for decades and the American middle class has become much more frail during that same time period. *On that we can all agree.* Globalization, digitalization, disintermediation, and the shift from skilled manufacturing jobs to the barista gig economy—these are the primary causes of that trend. But buybacks? If anything, they are an outcome of the deflationary trends we have observed in recent decades, not a cause. I don't have a a ready solution to the US job dilemma, but it is much more likely to be "upstream" in the economy and the investment process, not far "downstream" where share buybacks occur.

Having a central authority dictate the level of wages and investment means pretty much giving up on a market economy. At the time of the Great Depression, the Roosevelt administration made a handful of very good investment decisions—our country is clearly better off for the WPA and the CCC—but a lot of the other government efforts to stimulate the economy in the 1930s failed and failed miserably. And notably, the successful construction programs were direct government spending, not dictation of private investment choices. (In one of his typically insightful "Intelligent Investor" columns in the *WSJ*, Jason Zweig recently pointed out that during the Great Depression, President Roosevelt actually encouraged companies to buy back their stock, to put some of the cash that they had on the balance sheets into the moribund capital markets.)

If you think the 1930s is too remote to be relevant, how about the past decade? The hundreds of billions of dollars injected into the financial system—the total amount can be hard to calculate—after the Great Financial Crisis in the form of QE (quantitative easing) showed minimal results in the real economy. Despite all that money being made available for investment, GDP over the past decade was lackluster at best. That money came from the Fed, which was politically palatable. A huge new government infrastructure spending program—a new WPA for the digital age—might have had more economic impact, but additional deficit spending was simply not an option at the time. After ten years of ineffectual policy to stimulate the economy, has regulating corporate capital allocation decisions now become the right answer? I don't think so. *Ill-timed share buybacks are an unfortunate agency cost for long-term investors in the stock market. Porting them through Washington DC would only make matters worse.*

As buybacks have risen in prominence on Wall Street, dividends have diminished, despite their continued popularity on Main Street. The money comes from the same source—free cashflow—and is essentially the same money. Yet, decades ago, when the dividend payout ratio for corporate America was in the 50-60% range rather than the current 35-40% range, was anyone blaming the high payout ratio for a lack of investment? Not that I am aware of. And these were the postwar decades of great innovation and American industrial leadership.



Source: Societe Generale Cross Asset Management, 2019. Data is in regard to S&P 1500 ex-financials.

While some US corporations have "levered up" in recent years to support generous buyback programs—rather than using their free cashflow—that is generally not the case in regard to dividends. While dividends can be "borrowed" for short time periods if a company is going through a temporary rough patch, that can't continue for long. Over time, dividend payments will track a company's genuine free cashflow, its after-tax and after-investment profits.

Moreover, dividends do not carry with them the stigma of stock manipulation or senior executive self-dealing. They are a "plain vanilla" form of investment outcome that all investors can understand. Indeed, as I argued in *The Dividend Imperative*, and others such as Louis Kelso put forth a half-century ago, and Barry Ritholtz urged during the recent debate—getting more people to have an ownership stake in leading US corporations would be an improvement over the current situation. And rewarding those stakes with cash payments—the dividends—would go a long way to offsetting the popular view that the market is just a casino where the house always wins.

Finally, one of the pols did stumble upon a basic truth during this debate, and that is that corporations, like individuals, do react to the tax structure. An IRS code that favors capital gains over income will generally contribute to more buybacks than dividends, which is what we have seen in recent decades. Accelerated depreciation generally stimulates investments, etc. The government has a record of attempting to finetune economic activity through taxation. It is not a great record, but it is a time-tested mechanism, and it is far better than instituting direct capital controls.

Regardless of which side of the aisle you find yourself—or on neither side, as this author uncomfortably stands—the tenor of the discussion is dismaying. It shows how far the US stock market has become from being a business ownership platform for investors large and small. Getting investors to see the market that way is my program for 2020. Plus I like dogs.

February 15, 2019

Daniel Peris is the author, most recently, of *Getting Back to Business* (2018). He is a Senior Portfolio Manager at Federated Investors, Inc. in Pittsburgh.