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> *"Shareholders share in the downside and not necessarily in the upside; that's the whole story."*
> ***-John Gutfreund, ex-CEO of Salomon Brothers***

Share Buybacks: Perception vs. Reality

Dear Investor,

In this U.S. presidential election year, CNN et al are enjoying the boost in advertising revenues, with viewership up substantially. Investor sentiment rises and falls with the daily poll numbers. Will it make a difference who wins?

While investors may favour one candidate's policies over the other's, whomever is elected will be forced to deal with a weak global economy, a plethora of geopolitical challenges and an increasingly disenchanted middle class at home. Not to mention having to work with a dysfunctional Congress.

The reality is that the leader of the world's largest economy cannot change the global business cycle, improve emerging market growth, increase corporate earnings, nor solve the problems of other sovereign nations.

All this to say, regardless of the outcome, markets will be more impacted by valuation, interest rates, earnings and economic growth, than by which party is in power.

A note on valuation

For the first time since the financial crisis, earnings for S&P 500 companies declined for five consecutive quarters (through June 2016); and if estimates are correct, the September quarter will follow suit. Notwithstanding, stock markets have continued to march higher, as investors shun low-yielding bonds in favour of dividend-paying equities, without paying much attention to valuation metrics.

The result is that the Price-To-Earnings ratio for the S&P 500 has risen from 18x in 2014 to almost 25x today (Wall Street Journal). That said, it is important to remember that the value of a business is, and will always be, a function of its financial strength, earnings and growth. If interest rates decline further, equity markets may continue to be supported for some time. However, as we saw during the dot-com collapse and the financial crisis, when valuations become stretched, risk increases and investors often get hurt.

Share buybacks

> *"Today, too many corporations reduce investment in research and development and brand building. As a result, we see a general decline in the value of their brands and other assets. To make up for those declines and for anemic revenues, businesses buy back their stock (now at record levels) and thus artificially boost earnings per share."* **-PETER GEORGESCU, chairman emeritus of Young & Rubicam**

Every day we read about companies announcing share buybacks (buying back their own shares on the open market). Typically, the companies involved say that they are “returning money to shareholders” or “creating shareholder value.”

Share buybacks were virtually non-existent until 1983, when the SEC (Securities and Exchange Commission), an organization that helps govern public companies, issued a regulation providing companies with greater flexibility to buy back their own shares. Share buybacks for S&P 500 companies soon accounted for about 10% of operating cash flow.[i]

In 1993, Congress changed the taxation of executive compensation (for those earning more than $1 million per year), which made it more tax efficient for companies to issue stock options to senior executives rather than increase their cash compensation. This caused a steep escalation of the average stock-based compensation from about 33% of total compensation, in the early 1990s, to about 75% today.[ii]

At first glance, stock options may have seemed like a good way to compensate senior management – they would only benefit if the share price went up. However, too often, the unintended consequence has been to incentivize CEOs to make short-term decisions, with the specific intention of boosting the share price in order to cash out their options. This is often to the detriment of the company and its long-term shareholders.

With the popularity of stock option compensation, corporate share buybacks have soared. As of 2014, **S&P 500 companies spent more cash on buybacks and dividends than they earned**, meaning that, increasingly, companies are using debt to buy back shares. Buybacks by themselves accounted for 71.5% of net income over the past 12 months, continuing an upward trend. Over the past 12 months, buybacks for approximately one-quarter of S&P 500 companies exceeded free cash flow.[iii]

With low interest rates, companies often use so-called “financial engineering” to borrow money for share buybacks, in an attempt to increase their EPS (earnings-per-share), rather than invest in their businesses to create real long-term value.

A perfect example of this is IBM. Revenues at IBM are lower today than they were in 2005, but the company has doubled its EPS since then. Much of this EPS growth is due to its ongoing share buyback program. In 2005, IBM’s net debt stood at about $11 billion. Today, its net debt exceeds $30 billion. The company has increased debt to boost its EPS. Granted, even with the added leverage, it remains an exceptionally strong company. However, at some point IBM will be forced to curb the debt expansion, especially if interest rates rise.

As noted above in Peter Georgescu’s quote, companies are regularly sacrificing valuable long-term investments in their businesses in order to boost short-term earnings. It is not just the boards of directors and CEOs who have been incentivized to push for buybacks. Many so-called “activist hedge funds” have also been aggressively threatening companies to increase share buybacks, in an effort to boost the share price. These firms are short-term investors with no interest in the long-term viability of the businesses in which they invest. They often take a small stake (as little as 1% or 2%) and then threaten to replace the CEO or the board unless their demands are met. Rather than risk a public fight, boards frequently respond by taking on debt to buy back shares, laying off staff and selling profitable divisions. Their motivation is to boost the share price so that the activist investor can make a quick profit and exit their investment. Unfortunately, the business is often damaged by such short-term decisions and the remaining investors are left holding the bag.

Share buybacks - who wins?

Factset attempted to measure the relative performance of companies that buy back shares versus the market as a whole. They did this by comparing exchange-traded funds that specifically focus on companies that repurchase shares with the broader market. The data showed that as of mid-September 2016, the share buyback funds underperformed the general market for the 1, 3 and 5 year periods, suggesting that buybacks have more to do with perception than creating actual shareholder value. [iv]

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: **High Yield Quarterly**.

Final Thoughts

Does it ever make sense for a company to buy back its own shares? Yes, but price matters. Buying back shares may indeed create value for shareholders, but **only** if the company's share price is trading at a discount to its intrinsic value **and** the company is sitting with excess cash.

However, as absurd as it sounds, too many companies that buy back shares acknowledge that the price of their shares does not factor into the decision-making process. Numerous companies, such as GE and Goldman Sachs, spent billions of dollars repurchasing shares every year, regardless of prices, only to find themselves undercapitalized during the financial crisis. They were then forced to issue new shares at far lower prices, destroying shareholder value in the process.

All of this relates to "short-termism," whereby corporate management often make decisions designed to boost their share prices at the expense of the long-term health of the business they are supposed to be managing - as John Gutfreund succinctly pointed out in the opening quote.

For these reasons, when analyzing a new investment opportunity, it is important for us to "look under the hood" to assess the quality of a company's earnings and financial data, its corporate governance and compensation practices, as well as management's track record in creating long-term value for its stakeholders.

As always, we welcome the opportunity to discuss our outlook and investments with you.

Sincerely,

Lorne Steinberg
President

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[i] John Tierney , Deutsche Bank Research, June 2015
[ii] John Tierney , Deutsche Bank Research, June 2015
[iii] Factset report link: http://www.factset.com/websitefiles/PDFs/buyback/buyback_9.20.16
[iv] Factset report link: http://www.factset.com/websitefiles/PDFs/buyback/buyback_9.20.16