CAPTURING THE ALPHA IN STOCK BUYBACKS

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INVESTOR ALPHA, NOT EXECUTIVE ALPHA…

HIGHLIGHTS

What is a stock buyback?

- A stock buyback occurs when a company purchases shares of its own stock, thereby reducing the number of shares outstanding.

- Buybacks are a way to return cash to shareholders, but are just one of several ways that a company can deploy its cash.

Buybacks are growing

- Buybacks grew by 50% from Q1-2013 to Q1-2014, representing the third largest dollar amount for any quarter since 2005.

- Listed companies are the largest group of buyers in today's stock market, buying more than individuals, hedge funds, and investment institutions.

WHERE DO BUYBACKS COME FROM?

- Companies must have a strategy for their cash, including:
  - investing in growth opportunities such as R&D, acquisitions or other general capital expenditures;
  - returning the cash to shareholders via a dividend or a stock buyback program.

- Today's post-crisis environment which has offered fits of economic uncertainty has resulted in companies choosing to return their cash to shareholders rather than investing it in riskier growth-related activities.

- *What are the implications for investors?!*

THE MECHANICS OF A BUYBACK PROGRAM

- A stock buyback takes place when a company buys shares of its own stock, often in the open market, reducing its number of shares outstanding. A company can either buy back the stock with cash, or finance the buyback.

- A company starts the buyback process by announcing publicly that it will repurchase shares.

- It announces how much stock it intends to repurchase (usually in dollars, not shares), and a timeline for the repurchase.

- It will typically update shareholders on the status of the buyback program during quarterly announcements.

HOW SHAREHOLDERS BENEFIT

- Excess returns can be attributable to:
  - Reduction in shares outstanding; all else equal this increases EPS growth rate;
  - At a constant P/E ratio, this drives the stock price higher.
- Can have a positive effect on investor confidence; indicates management has faith in the company.
- Provides a net higher share demand and price support.

	PRE-BUYBACK	5% BUYBACK	10% BUYBACK
A. TOTAL EARNINGS TRAILING 12 MONTHS	$1,000	$1,000	$1,000
B. TOTAL SHARES OUTSTANDING	100	95	90
C. EARNINGS PER SHARE (A/B)	$10.00	$10.53	$11.11
D. PRICE TO EARNINGS RATIO	15	15	15
E. CURRENT PRICE (C*D)	$150.00	$157.89	$166.67
F. RETURN		5.26%	11.11%

Source: Nasdaq

COMPANIES ARE NOT LIMITED TO PURCHASES

- Stock buybacks aren't the only transaction that a company can execute on its stock. It can issue new shares at the same time that it is buying back shares.
  - Secondary offerings, executive bonuses, option exercises, etc.

- New issuance of shares could actually outpace share repurchases, leading to a company having a net increase in total shares outstanding (TSO) at the completion of its buyback program.
  - In fact, many companies have buyback programs <u>specifically</u> to offset expected new issuance activity.

BUYBACK MARKET TRENDS

- Stock buybacks have been increasing in dollar amount over the past few years; poised to grow again in 2014.
- Major U.S. companies have announced or expanded buyback programs this year including Ford ($1.8B) and Apple (increase from $60B to $90B).
- S&P 500 companies spent $478B on buybacks in 2013, a 24% increase over 2012.
- The latest projections show that S&P 500 companies will spend $565B on repurchases, a y-o-y increase of 18%.
- Buybacks are not limited to only one sector. Each sector in the Russell 3000 saw between 7% and 20% of its companies announce a buyback program in 2013.

Source: Apple, Ford

BUYBACK MARKET TRENDS (CONT.)

- Despite large dollar amounts spent on buybacks, some companies only saw small decreases in shares outstanding. Two factors are at play:
  - The size of a company can mask the effect of a share buyback.
    - Exxon Mobil spent almost $4B in share buybacks in Q1-2014
    - However, with a market cap over $400B, this was less than a 1% decrease in TSO.
  - New share issuance can cut into or completely eliminate the decrease in TSO by offsetting the shares repurchased with new shares.

STOCK BUYBACK EXAMPLES

- Buybacks tend to be ad-hoc while dividends are stable.
- Viacom (VIA) announced a buyback program and a quarterly dividend in June 2010.
- Original authorization was for $4B in repurchases. This increased in 2011 to $10B and again in 2013 to $20B. As of May, Viacom had $8B left in authorized repurchases with plans to purchase $3.25B in fiscal year 2014.

VIACOM CASH RETURNED TO SHAREHOLDERS (IN MILLIONS)

YEAR ENDED	SHARES REPURCHASED	DOLLAR AMOUNT SPENT ON SHARE REPURCHASE	DIVIDEND PAYMENTS	TOTAL CASH RETURNED TO SHAREHOLDERS
2010	4.7	$162	$91	$253
2011	55.7	$2,500	$417	$2,917
2012	59.9	$2,800	$554	$3,354
2013	69.2	$4,800	$555	$5,355

Source: Viacom, Nasdaq

STOCK BUYBACK EXAMPLES (CONT.)

- Some companies have ongoing stock buyback plans.
  - Intel has repurchased shares every year since 1990.
  - 4.4 billion shares repurchased at a cost of $92B. Currently has $2.6B left in authorized purchases.
- Not uncommon for companies to halt or cancel buyback plans.
  - JPMorgan announced plans to repurchase $15B worth of stock in March 2012.
  - Just two months later it rescinded the plan following a multi-billion dollar trading loss.
    - Shares had surged the day after the repurchase announcement, but retreated following its cancelation.

Source: Intel, Dealbook

BUYBACK PROGRAM ≠ BUYBACK PORTFOLIO

- Announced, or even completed, buyback programs alone do not capture the range of activities that companies can carry out on their own shares.

- When constructing a portfolio of buyback companies, look at the **net reduction in total shares outstanding.**
  - Identify companies that are executing their buyback program
  - Ensures that the company isn't offsetting buybacks with new share issuance

UNDERSTANDING TOTAL SHARES OUTSTANDING

NUMBER OF STOCKS BY CHANGE IN TOTAL SHARES OUTSTANDING

	TOTAL	SECURITIES WITH NET INCREASE IN TSO	SECURITIES WITH NET DECREASE IN TSO	SECURITIES WITH ΔTSO<= X%				
YEAR END	UNIVERSE	ΔTSO ≥ 0%	ΔTSO < 0%	< -1%	< -2%	< -3%	< -4%	< -5%
2004	4,564	3,622	942	719	517	376	282	210
2005	4,590	3,854	736	569	415	300	213	160
2006	4,624	3,792	832	668	515	364	279	205
2007	4,543	3,512	1,031	850	644	495	376	290
2008	4,425	3,261	1,164	994	790	646	526	402
2009	4,421	3,025	1,396	1,162	952	750	592	482
2010	4,336	3,478	858	655	481	334	235	186
2011	4,147	3,385	762	595	438	323	250	191
2012	4,148	3,175	973	790	627	493	399	318
2013	4,021	3,030	991	779	601	480	386	303
2014*	4,098	3,162	936	716	549	421	320	255

Source: Ford Equity Research, Nasdaq

LINKING TSO AND EXCESS RETURNS

ANNUAL PERFORMANCE OF STOCKS BY CHANGE IN TOTAL SHARES OUTSTANDING

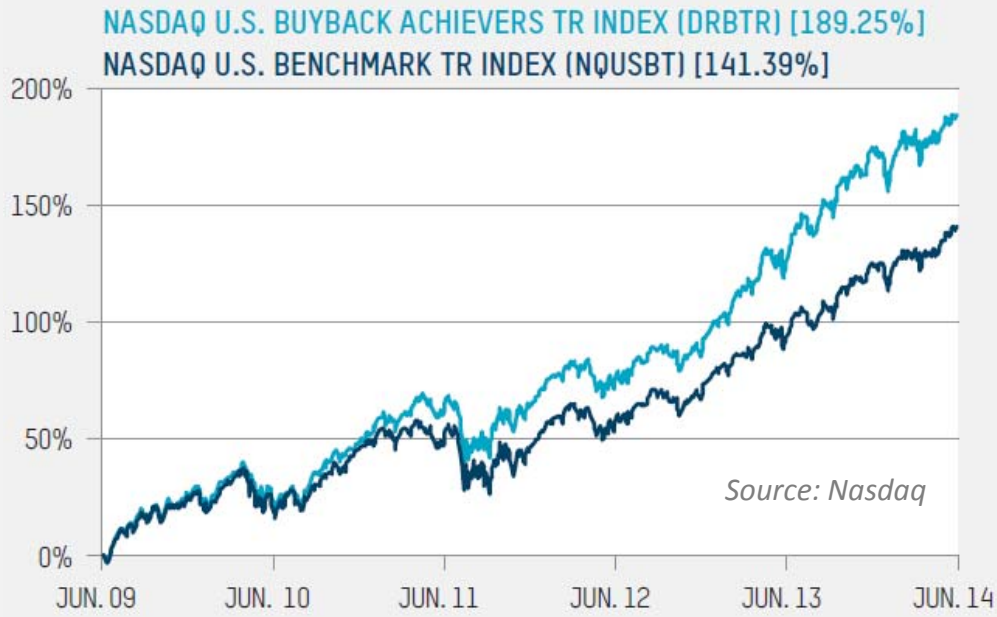
	TOTAL	SECURITIES WITH NET INCREASE IN TSO	SECURITIES WITH NET DECREASE IN TSO	SECURITIES WITH ΔTSO<= X%				
YEAR END	UNIVERSE	ΔTSO ≥ 0%	ΔTSO < 0%	< -1%	< -2%	< -3%	< -4%	< -5%
2004	20.6%	20.1%	21.4%	20.9%	21.1%	21.8%	22.8%	23.1%
2005	4.3%	3.4%	7.3%	7.7%	8.5%	8.3%	10.1%	9.7%
2006	17.6%	17.6%	16.9%	16.3%	16.7%	17.4%	18.0%	19.2%
2007	-5.8%	-5.8%	-5.4%	-5.3%	-5.3%	-5.3%	-5.6%	-5.1%
2008	-44.2%	-45.9%	-38.0%	-37.6%	-37.5%	-38.1%	-39.0%	-39.2%
2009	66.8%	76.0%	50.8%	48.5%	51.8%	52.0%	55.4%	56.1%
2010	28.8%	28.3%	30.6%	29.9%	27.7%	30.5%	33.0%	34.1%
2011	-7.5%	-9.2%	2.8%	2.6%	2.8%	4.1%	4.2%	5.7%
2012	20.2%	21.1%	18.3%	18.2%	18.7%	18.6%	17.1%	17.1%
2013	42.8%	42.9%	43.8%	43.4%	44.6%	44.7%	45.7%	48.1%
ANNUAL	10.2%	10.2%	11.9%	11.6%	12.0%	12.4%	12.9%	13.5%
ANN. VOLATILITY	20.3%	21.0%	18.4%	18.1%	18.1%	18.1%	18.4%	18.6%

Source: Ford Equity Research, Nasdaq

U.S. BUYBACK INDEXES

- Multiple options for buyback-themed indexes with varying methodologies.
- **Nasdaq –** Selected from NQUSB; includes securities issued by U.S. corporations that have achieved a net reduction in shares outstanding of 5% or more in the trailing 12-month period; modified market cap weighting
- **S&P –** Selected from S&P 500; includes top 100 securities by "buyback ratio"; equal weighting
- Buybacks posted very strong years in 2011 and 2013 relative to benchmark indexes. As buybacks tend to lend support to a company's stock price, this outperformance is not surprising.

Ann. Returns	DRBTR	SPBUYUT	NQUSBT
2010	18.7%	20.9%	17.5%
2011	10.8%	4.8%	0.3%
2012	14.6%	16.8%	16.4%
2013	46.6%	48.8%	33.5%
YTD 2014	9.7%	13.4%	11.0%



CONCLUSION

- The study shows clear evidence of the relationship between reduction in total shares outstanding and excess returns.

- To capture the excess returns, investors must construct their portfolio using relevant market data (reduction in TSO instead of dollar amount spent on buybacks)

THANK YOU

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