Registered Investment Advisor Firm

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## *If I Have Your Back – Do You Have Mine?*

The headline is a "metaphor" leading into this month's main topic of stock repurchasing plans or "buy-backs" by U.S. companies.

A significant number of U.S. companies have been on a share repurchase extravaganza in 2015, consuming their own shares at a record pace.

In April alone, companies announced $133 billion of new stock buyback programs, making it the highest level ever for a single month and an increase of 121% from April 2014.

If this pace continues, companies could hit $1.2 trillion of buybacks on the year!

By repurchasing their shares, they remove them from the open market which reduces the "float" – the number of shares available to the public and this process results in a return of equity to shareholders and boosts valuations.

We know reducing supply puts upward pressure on prices. No problem right?

In order to fully explore that question, it's necessary to examine just how share buybacks affect stock prices. It's not enough to just think that the company is reducing share supply and boosting return on assets.

One of the first things you should consider is the question of where else could the company spend the money?

When a company commits capital to share repurchases, it means potentially sacrificing other productive opportunities such as research and development, developing sales channels in new markets, expanding employment and raising wages.

If a company has experienced a notable drop-off in earnings growth, and delayed efforts to expand globally, share buybacks might be a way to distract investor attention away from deeper, structural issues.

In today's low interest rate environment, another question to consider would be was the cash used for the repurchases generated from operating income or was it borrowed?

If a company like Apple, Inc. wants to buyback a large percentage of shares, that's one thing. They're sitting on a pile of cash and they constantly innovate.

But many of the buybacks of late (including Apple) have been achieved with borrowed money, taking advantage of the historically low rates.

You, the investors stand to pocket the spread, if the return on equity is greater than the interest rate at which the capital is borrowed. But what happens when rates eventually begin to rise – will these companies be generating sufficient operating income to service their new debt?

This brings us to our next question. Is the company getting a good deal?

The market is in the 6th year of a rising "bull" market which means company valuations have been rising right along with the market

While the S&P 500 is presently trading at a little over 20 times earnings, there are plenty of well-thought-of companies out there trading at two and three times that multiple.

When a company decides to buy back shares at high valuations it means not getting a whole lot of bang for your buck as those shares are often too expensive in light of forward growth projections.

Another issue that merits consideration is the question of – are companies being pressured by "activist investors," potentially hedge funds?

Hedge funds and activist investors often push CEOs to raise their share buyback programs so they can cash out and report an immediate return on their devoted equity positions.

Investors must remain cautious of companies caught in the quagmire of pressure to generate a quick return. These efforts mean the focus isn't on long-term growth and development of the company.

What about the competition?

If a company decides to engage in a massive buyback program while their competition is innovating, scaling for growth and investing in new technologies, then it should give you as an investor a reason to think strategically.

You want to buy companies that are positioning themselves to be industry leaders 5, 10, and 20 years in the future.

While share buybacks are typically positive for stock prices, it isn't always the case and you should look at each company's programs closely before investing.

It should also be noted that share buybacks do little to provide a larger economic boost, since capital is typically being directed away from research, new projects, developing markets, new employment and wage increases.

If you are looking for evidence of a company's positive outlook and ability to return equity to shareholders, focus more on dividend consistency and increases than share buybacks.

Dividend increases say, "let's give our investors a raise, we've got plenty of extra cash flow to cover it."

At the end of the day, both actions are good for stock prices and, they are both being implemented widely in the market today.

Whether you decide to purchase stock from a company involved in recent buyback programs or not, there are a couple of additional things to be aware of.

**1. Buybacks normally draw investors to its shares because of the stocks' prices.** (Depending on some of the circumstances discussed previously, buybacks can be a good thing for you as an investor, but sometimes they can also be a sign of dilution or a struggling company, or a company that isn't making better use of their capital.)

**2. Buybacks are taxed at a lower rate than dividends.** (These tempting stocks can be similar to dividend-payers because money is being distributed to the shareholders through the companies. But before you buy shares, it would be wise to consider dividend strategies, so you can seek tax efficient total returns from both capital appreciation and dividend payments.)

No matter what you buy or sell it is important to have a diversified portfolio to prepare for market changes, economic downturns, excessive buybacks and fluctuating stock prices.

If you would like additional information or assistance, please reach out to Bob Davis or myself.

## *Answer Forum*

No questions this month, so class dismissed!

## *Davis Investment Group*

Davis Investment Group is a fee-based Registered Investment Advisor firm servicing the needs of clients across the United States.

Davis Investment Group custodies all client assets at Charles Schwab & Co. Davis Investment Group's home office is located at 714 Marin Street, Suite #C, Vallejo, CA 94590. The telephone number is (707) 648-2024.

If you have questions or would like further information on this month's topics or any other financial or investment related subjects, including Social Security claiming strategies, please contact me directly at (925) 360-6819 or through my email address at: Bud@DavisInvestmentGroup.biz