Stock Buybacks:

In the Crosshairs of the SEC
-or-
The Canary in the Coal Mine?

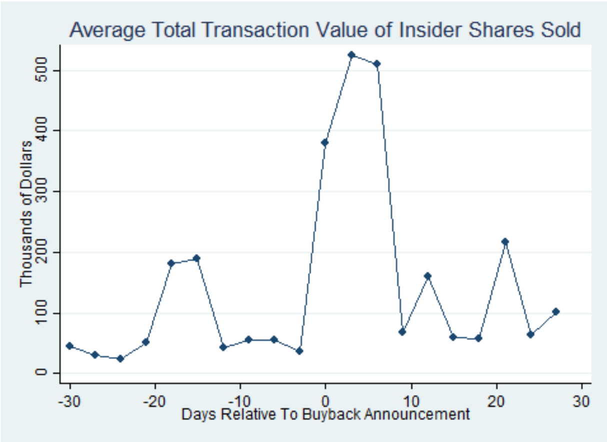
By: Dave Lavigne

Just recently SEC commissioner Robert J. Jackson Jr. gave a speech to the Center for American Progress wherein he questioned the current rules regarding corporate stock buybacks and perhaps the practice in general, even calling for an open comment period regarding the issue. Specifically, for the policy wonks, he referred to Rule 10b-18, which the SEC adopted in 1982. As the Commission notes:

In 1982, the Commission adopted Rule 10b-18, which provides that an issuer will not be deemed to have violated Sections 9(a)(2) and 10(b) of the Exchange Act, and Rule 10b-5 under the Exchange Act, solely by reason of the manner, timing, price, or volume of its repurchases, if the issuer repurchases its common stock in the market in accordance with the safe harbor conditions. Rule 10b-18's safe harbor conditions are designed to minimize the market impact of the issuer's repurchases, thereby allowing the market to establish a security's price based on independent market forces without undue influence by the issuer.

Just to edify, 10b-18 was established as a framework to allow corporations a "Safe Harbor" from violations of Rule 10b-5 when repurchasing their shares in the public market. I believe, Rule 10b-5 was adopted in the early 1940's following the Commission's recognition that the *"employment of manipulative and deceptive practices"* might apply to *the purchase* of securities as opposed to just *the sale* of securities. As a result, Rule 10b-5 is often the hook for insider trading violations.

In his speech Jackson went on to point out a handful issues regarding corporate stock buybacks. (By the way, I provided **a link to the context of the speech at the end of this article). Two of the more salient points he stressed were that first, much like the corporate tax holiday of 2004 the recent Trump tax reductions provided cash to corporations that (perhaps contrary to the hopes and/or assumptions of some) were/are largely used for stock repurchases rather than to make investments into the companies' futures and presumably by extension the underlying economy. Of course, the degree to which that may or may not be true is open for debate, but its hard to argue that some portion, likely a large share did in fact end up in stock repurchases. Secondly, and perhaps more importantly from some vantage points, he argued that according to the SEC's studies of the matter, it was "*commonplace for executives to use buybacks as a chance to cash out*". To that end, he noted that "*in half of the buybacks we studied, at least one executive sold shares in the month following the buyback announcement. In fact, twice as many companies have insiders selling in the eight days after a buyback announcement as sell on an ordinary day. So right after the company tells the market that the stock is cheap, executives overwhelmingly decide to sell. And, in the process, executives take a lot of cash off the table. On average, in the days before a buyback announcement, executives trade in relatively small amounts—less than $100,000 worth. But during the eight days following a buyback announcement, executives on average sell more than $500,000 worth of stock each day—a* *fivefold increase. Thus, executives personally capture the benefit of the short-term stock-price pop created by the buyback announcement".* He provided the following graphic to support his argument:



In the meantime, CNNMoney just reported that *"flooded with cash from the Republican tax cut, US public companies announced a whopping $436.6 billion worth of stock buybacks, according to research firm TrimTabs. Not only is that (the) most ever, it nearly doubles the previous record of $242.1 billion, which was set during the first three months of the year. Apple alone announced plans for $100 billion in buybacks. Big banks such as Wells Fargo (WFC), JPMorgan Chase (JPM) and Bank of America (BAC) each said they would buy back at least $20 billion of their own stock after the Federal Reserve gave them a clean bill of health late last month".*

Of course, the aggregation of these datapoints have lead to progressive law makers calling for reforms, and on the other hand, to CEO's like Jamie Dimon (JP Morgan Chase) suggesting that "c*ritics of corporate stock buybacks prompted by the GOP tax law are ignorant about the way capital markets work*". He opined further that, *"companies return money to investors when they don't have a good use for it. Then, investors are able to put the money to a higher and better use."*

I have some observations.

First, while I have spent plenty of time being critical of the SEC and some other regulatory folks, Commissioner Jackson's research and assertions are disturbing. Again, I urge people to read over the discussion. Arguing that stock buybacks are good for the investors and the Company, begs the question that if they are so good why are insiders selling around the news? As he suggests, that may not be illegal, but it certainly seems contrary. I agree insiders should be afforded liquidity for their efforts, but its hard to decouple the timing of insider selling and corporate buyback decisions. Presumably, lower share counts give remaining shareholders a bigger piece of the remaining pie, which would imply holding onto the stock not selling it. But again, I don't begrudge insiders right to liquidity, but they should be more cognizant (less deliberate) about the timing and it does make one wonder if they believe their own mantra about the "benefits" of buybacks.

Second, I have also suggested in these columns in the past and as Mr. Dimon notes, companies give money back to shareholders when they don't have good use for it. I think that is appropriate. However, given the elevated levels of stock valuations these days, it makes me wonder how companies that don't have better ways to reinvest that cash back into the business (and buy back shares instead), are somehow trading at growth multiples that would imply the opposite. I don't think the notion that a company doesn't have anywhere to invest their cash is congruent with high multiples. Further, the smokescreen in that process is the EPS comparisons that go along with buybacks don't really give us a good relative comparison of past operating performance. I would argue, and the chart below from Financial Times (through 3Q C2017) corroborates, S&P price performance has been far better than operating profit performance for the past several years now. However, stock buybacks have made that same divergence using EPS in place of operating profit far less stark. I think investors need to pay particular attention to the growth in operating profits amongst aggressive stock buyback companies, especially in the context of their multiples.

Third, and as an extension to the prior point, I understand companies buying back shares when they believe they are undervalued, but again, given the elevated levels in the S&P I am having a hard time believing that the highly educated and intelligent members of many of these public boards are actually concluding that their stocks are trading at low, attractive, undervalued levels. I don't know what all those decisions entail, but I don't think undervalued dominates the discussion. What is perhaps more disturbing is that many of these companies have taken on a fair amount of debt to make these repurchases. There again, I have no problem swapping low cost debt for undervalued equity, as long as its **undervalued** equity.

Moreover, Goldman Sachs recently reported that *"since Trump's election companies that emphasize stock buybacks and dividends have trailed the S&P 500 by two percentage points. Heavy buyback stocks have essentially matched the broader market"*. Similarly, FactSet recently reported that "*57% of the more than 350 companies in the S&P 500 that bought back shares so far this year are trailing the index's 3.2% increase. The S&P 500 Buyback index, which tracks the share performance of the 100 biggest stock repurchasers, has gained just 1.3% this year, well underperforming the S&P 500.* More specifically, General Electric provides the real life example of poor capital management spending $21.4 billion buying stock back in 2016 at an average price of $30.30 and $2.6 billion in 2017 at $19.65. Incidentally, they did a considerable portion of those repurchases with debt. Today, the stock trades at around $14 and the debt load is becoming an issue. Clearly, they were not buying back undervalued shares and they did not maximize shareholder value…at least not for those who stuck around waiting for the long term benefits of stock buybacks. I suspect there may be others like General Electric unfolding out there.

Share buybacks are like many financial strategies; there are times they make sense and others they do not. I don't think that environments with elevated valuations generally fit in the "makes sense" bucket. Moreover, at the macro level, they may be sustaining a market that probably needs some correction if we want to avoid a more abrupt scenario. To that point, there is a bit of this that is like "*Déjà vu all over again*…". An article in SentinalSource.com notes, *"When it comes to stock buybacks, corporate leaders have mastered the game of doublespeak. At the same time, they're touting the advantages of repurchasing shares on their investors' dimes, some are cashing out of their own stock holdings"*. That sounds familiar, but the trouble is, that article was in written in late 2006, and we all know where we went from there.

**https://www.sec.gov/news/speech/speech-jackson-061118