

Summer 2014

Market Strategies



The Buyback Brigade

With stock **prices** reaching ever loftier levels, receiving less attention has been the **earnings** of publicly traded companies. The correlation between earnings and share prices is historically quite close. For 2014, the combined earnings of companies within the S&P 500 stock index are estimated to rise 8% over last year's figures. This advance in earnings is a combination of several factors: rising revenues, cutting expenses and fewer shares outstanding. In a slow-growth economy, increasing revenues is difficult and squeezing expenses can only go so far. Therefore, buying-back shares has been a popular use for idle cash to improve the earnings of corporate America justifying the rise in share prices.

The impact of buybacks is not insignificant on earnings. By removing shares from circulation, the denominator in "per share" calculation is reduced with every share removed. According to JP Morgan, of the change in S&P 500 operating earnings between the third quarter of 2011 and the first quarter of 2013, a stunning 60% or \$2.20, of the \$3.70 advance in earnings gains were the result of buybacks. This means reducing the amount of shares outstanding had a larger impact (\$2.20/share) than organic growth (\$1.50/share).

This isn't a short-term trend; the pace of buybacks has actually increased since the JP

Morgan study. Over the trailing twelve months, the amount of shares purchased exceeded \$535 billion and was over \$150 billion in the first quarter of 2014. This investment is nearing the record set in2007. Yes, the year the financial crises arrived, companies were spending wildly buying their own shares at what we can now say were inflated prices. So does the spending on shares forecast a market top? Or is this just more financial engineering by Wall Street? Our answer would be no to both concerns, although many savvy investors would prefer management to return profits via dividends instead of buybacks, we think the reduction in shares can be a good use of corporate cash. Dividends are taxed twice, at the corporate level and again as income to the shareholder, while profits spent on buybacks are only taxed once.

The actions of a firm like Apple buying back 3% of their outstanding shares in a *quarter* certainly suggests that management believes their shares are inexpensive. It also shows solid

In Memory of

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(10/16/1933—7/9/2014)

*Family Man, Entrepreneur, Friend,
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Top Companies by Dollar-Value Buybacks- First Quarter 2014

Company	Sector	First Quarter buyback (\$M)	% change in shares (QTR)	Dividends Paid (\$M)
Apple Inc.	Tech	\$18,556	-3.4%	\$2,661
IBM	Tech	\$8,324	-4.0%	\$990
ExxonMobil	Energy	\$3,860	-0.9%	\$2,732
Boeing	Industrial	\$2,585	-2.2%	\$540
Oracle	Tech	\$2,036	-0.5%	\$541
S&P 500		\$154,198		\$90,113

management prudence spending money on a known entity instead of growing blindly by overpaying for acquisitions. While we may want all companies to increase spending and hiring to boost the economy, if there isn't business to be had and cash-flow is high, buying back shares reduces the burden of paying dividends with fewer shares outstanding. We do have a concern with some firms borrowing money to fund share buybacks since this merely levers the balance sheet with debt and increases the credit bubble. Low interest rates have this unintended consequence.

Share repurchases alone are not the sign of a successful company. It can be one of many determining factors that suggest the value of a company will be higher in the future. We bought DirecTV earlier this year for certain portfolios because the company had proven their discipline managing their tremendous free cash-flow. Their primary competitor Dish Network has spent wildly purchasing broadband spectrum and making a bid for a wireless phone company. DirecTV stayed focused reinvesting in the company, adding satellites when necessary and with any excess cash buying back shares. In 2004, the company had 1.3 billion shares outstanding and today has fewer than 500 million shares. During this same period, revenues have doubled and earnings have increased from 24 cents/share to over \$5/share today.

Our focus has always been to build portfolios with the least risk necessary for clients. Identifying companies with strong brands, solid franchises and hubristic-free management tends to reduce price volatility. When a company is producing cash in excess of the capital necessary to operate the business, returning this to shareholders via a buyback guarantees a rise in earnings. Investing client capital into strong companies with high cash-flow and rising earnings historically pays dividends to shareholders. Sometimes those dividends are in the form of a share buyback. Bird in the hand, as the saying goes.



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