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Adviser Q&A

Buys Among Buyback Stocks

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David Fried*, editor in chief of Pacific Palisades, Calif.-based* The Buyback Letter*, has been tracking and investing in the stocks of companies that buy in their own shares for the last six years. Fried is convinced that the stocks of these companies outperform their peers. His record, according to* The Hulbert Financial Digest*, seems to bear this out. According to HFD, Fried's Buyback Index portfolio has gained 131% since inception in 1997, beating all other stock letters on a risk-adjusted basis. His value-oriented picks have held up well during the recent downturn: Year to date, this Index portfolio is down 1%. Ironically Fried's Buyback High Tech Index, is up 11% since its inception in February 2000, compared to a 58% drop in the Nasdaq Composite since that time. Fried is a Cornell graduate who owned a company in the garment industry before starting the Buyback Letter in 1997. He also uses his strategy to manage private accounts in buyback stocks through his investment advisory firm,* **Fried Asset Management***.*

Forbes: How did you come up with the idea for a letter devoted solely to companies that are buying back their shares?

DF: In 1994, Mark Hulbert wrote a column for *Forbes* where he talked about an indicator that worked: how companies that have announced stock repurchases had outperformed the market. His research was cited from the *Journal of Finance* and that research said that there was a market underreaction to open market share repurchases. In that same article, he talked about how companies that issued stock underperformed the market. So from that I developed what I call my share supply theory, which simply states that an increase in shares is bad for shareholders and a decrease in shares is good for shareholders.

That's pretty straightforward...

Because, in the aggregate, the captains of industry who run our companies know when to hold 'em and when to fold 'em. When their shares are overextended or overvalued, they can be counted on to issue shares as a source of cheap money for future growth. And when their shares are undervalued given the future earnings prospects of the company, whether that be internal growth or acquisitions or products or whatever, they buy back stock. What I have done is taken the academic research to the next step, focusing on companies that actually do repurchase their stocks. Of course, there's a lot of white noise in buybacks.

What kind of white noise?

The white noise that I'm talking about is the main criticism of buybacks. They don't happen. Companies announce them and they don't happen. Another criticism is that companies buy back shares, but they're only offsetting dilution of options and things like that.

So how do you cut through the white noise?

We look at the actual share count after each quarter and look for reduction. The number is published in the quarterly statement.

What are your criteria for choosing a good buyback candidate for your portfolios?

Well, we've been quite successful focusing on companies that have a negative year-over-year share count of at least 3%. After we find stocks that fall into this category, we rank them according to other value-oriented fundamental criteria.

Let's talk about one of your most popular portfolios, the Buyback Dogs.

The thesis on that is as follows. Most investors are familiar with that, the Dogs of the Dow, which says that the ten Dow stocks with the highest yield will outperform the market and the Dow Jones and so on. And since I'm a buyback practitioner, I have taken the ten Dow stocks that buy back the most shares, that have the biggest year-over-year reduction in shares. From those ten companies, we select five.

So once they are screened for buybacks, you look more closely at the fundamentals, things like earnings and book value, price-to-earnings ratios?

Right. It is absolutely a value-oriented approach. It is not a momentum approach. In fact, I would go so far as to say that, in some circumstances, you could argue it's almost a negative-momentum approach because some of these companies have been beaten up and are out of favor.

And how has your Dogs of the Dow portfolio done?

We introduced it in March of 1997, and since then it has outperformed the Dow and the S&P by about two-and-a-half times. Since then, we are up 78.44% versus 32% for the S&P. Two stocks we own in that portfolio are Boeing, which has been a heavy buyer of its own stock, and [Hewlett-Packard], which has recently picked up its share-repurchase program after its stock sunk after announcing the Compaq deal.

You have another portfolio called the Buyback Index?

Yes, this is 20 stocks, and we rerun our screens quarterly and it was also incepted on March 5, 1997. These companies typically have at least $1 billion in market cap. This has been our best since inception, up 131%. Some of its holdings include Sara Lee, Bear Stearns and GTECH Holdings.

What about year to date? It's been a tough year for everybody.

Year to date, that portfolio is down 1.2%.

What about your Buyback High Tech Index?

That one's very interesting because our starting it probably signaled the end of the bull market in high technology. We started that on Dec. 3, 2000, and by the end of last month, our portfolio is up 10.93% versus a decline of 58.74% for the Nasdaq.

That's amazing. And what do you attribute that to?

You have to go back to my initial theory, the share supply theory. This is always invested in five stocks that management has been repurchasing shares. In the high-tech portfolio, we have screened in telecommunications, computers and software, electronics and semiconductors. Two examples from that portfolio are Sykes Enterprises and Paxar.

And it's only five stocks?

Yes, the goal is that by putting different indexes together in different sectors, the investors can achieve a diversified portfolio without purchasing tremendous numbers of stocks.

I noticed that you have a Buyback Stock Pickers portfolio. What are you focusing on now?

AutoZone is a buyback stock that has had a nice run, but that I think will continue. [It has] bought back double-digit amounts of shares, over 10%, and [it continues] to buy back, and [its] operations look very, very solid.

It runs auto-parts stores.

Yes. And we would expect them to do well in this slow economy.

What kinds of overall trends have you been seeing lately in terms of overall corporate buybacks? I assume that during the recent market bubble, as stock prices became inflated, buyback activity waned?

Actually, not true. You weren't seeing a lot of buybacks in the dot-com area, but you were seeing buybacks in a lot of other areas because, during that time, if you weren't a dot-com or a Sun Microsystems or a Microsoft, you were really shunned by the market.

So there were a lot of buybacks during the tech runup?

Yes, there were a lot of buybacks in '98 to '99, but not in those sectors.

What are you finding today? Is it changed now that the market's come back? Is there more of a broad-based trend in share repurchase?

You saw a big increase in buyback activity after Sept. 11, in part because stocks were cheaper and in part because of the relaxed rules by the [Securities and Exchange Commission]. The SEC relaxed buyback rules for public companies by making it easier for them to trade their own stocks for approximately a month after trading reopened. They did it two ways. The guidelines say that the companies shouldn't buy back more than 25% of the prior month's trading volume in a given day. That was waived and instead the companies could buy 100%. The other thing that was waived was that typically a company can't open or close trading, meaning companies can't buy or sell their own shares in the first and last half-hour. The rationale for that is that the SEC doesn't want companies making markets in their own stocks, which is very understandable. That was waived for approximately four weeks after trading reopened.

And the result was that you had a surge of buybacks?

Well, you had a lot of buyback announcements as a result of the decline in the market, but you won't know until after the companies are done reporting how many companies took advantage of the opportunity to buy more. We're in the process of finding out now. Again, we focus on the action, not the announcement.

So, based on your methodology, there could be a lot of undervalued stocks in the current environment.

Yes, but I would caution people who want to adopt this approach by themselves. Take a look at a couple of our companies like Gateway and Yahoo!, or companies like Oracle, [which] repurchased shares and the stock went down. The same for Winn-Dixie, which was in one of our portfolios. They don't all work out. Just like any other methodology, it's not foolproof. And that's why we take a balanced portfolio approach.

What about the argument that you shouldn't be buying into companies that buy back stock because it may be a sign that management is not really being creative or smart about employing their capital? Instead, they should be investing in new projects or growing their business.

Often the companies I invest in can do both: buy back stock, and invest in research and development. And sometimes their own stock is a better investment than anything else. The same people who make that criticism will go ahead and turn around and criticize the company for making a bad acquisition.

But aren't mature companies more likely to buy back stock than young growing companies that need every bit of capital they have to invest in things like software or expansion?

Yes, sometimes that's true. There is a lifecycle component. But it also makes our strategy a little less volatile.

Thanks.