Adviser Soapbox

Don't Buy Buybacks Blindly

David Fried, The Buyback Letter, 01.11.05, 6:35 PM ET

Deciding not to invest in buyback stocks because you are wary of the way companies might misuse buybacks is like throwing out the baby with the bathwater. Buybacks had a banner year in 2004. Buyback for companies in the S&P 500 totaled $45.7 billion last year, up from some $26.4 billion in 1998. Some of the best, most well-managed companies on the planet are robust repurchasers of their own stock.

A recent Associated Press (AP) article warned that in today's current boom in company buybacks, investors need to be wary of companies buying back stock to mask a slowdown in earnings growth. How would this work? Often there is at least a short-term uptick in the stock price after a buyback announcement, and certainly there is often a bounce up after the buyback itself is actually accomplished.

So, some companies might like to divert attention away from a revenue problem by being able to show an increase in the stock price. Why would there be such an increase? Because a company usually buys back its own shares when it knows the market has seriously undervalued them. After the buyback, the company is still the same company, but there are fewer outstanding shares, so each of them is worth more. And, by decreasing the number of shares outstanding, earnings per share gets a boost. Yes, if repurchasing is a tactic used to divert attention from faltering fundamentals, then that is a specific buyback stock to avoid. But, there are plenty of examples of companies that bought back stock not to delay the discovery of or to hide problems, but because company management knew the stock was undervalued.

We currently hold **Pepsi Americas** (nyse: PAS - news - people) in our Stock-Pickers Portfolio; we bought it in September 2003 and, as I write this, it has gained 44%. **K-Mart** (nasdaq: KMRT - news - people), which we bought in July 2004, is currently posting a 27% gain. Similarly, we locked in a 338% gain when we sold **Altria** (nyse: MO - news - people) in February 2004, and a 448% gain when we sold **American Express** (nyse: AXP - news - people) in August 2000. The buybacks these companies undertook--and the resultant share price hikes--were legitimate. Plain and simple.

The same AP article also warned against companies that launch buybacks using borrowed funds, terming that tactic "a risky move." Using retailer **Limited Brands** (nyse: LTD - news - people)--parent of **Victoria's Secret**, **Bath & Body Works** and the **Express** store chains--as an example, the article noted that Standard & Poor's downgraded the credit rating on the company's bonds after it announced a $2 billion stock buyback funded through cash and $1 billion in new debt. But, not all buybacks financed by debt are bad buybacks. In the case of **Limited**, the company borrowed that money at a cheap rate, and the company's earnings easily cover the debt service. That's why we hold LTD in our Buyback Stock-Picker's Portfolio, along with 27 other stocks.

A recent *USA Today* article warned investors to be skeptical of companies that announce buyback plans, and months or a year later, show no decrease and sometimes even an increase in the number of shares outstanding. Why would this happen? Because they may have issued more shares to accommodate employee options, they may have bought another company and funded the purchase by using stock, or they may simply have decided not to follow through on the buyback. "Buybacks are often hocus pocus, smoke and mirrors," said one fund manager at Citigroup Asset Management. Well, yes, frankly sometimes they are, just as some companies' announcements of expansion or acquisition plans ends up being so much baloney.

Investing wisely is all in the details--and part of the due diligence required of any investor--is to sift through the rhetoric to find the truth of the matter. The buyback stocks we recommend for purchase have all been winnowed so that liars and laggards are left behind. Only after we see a decline in outstanding shares does a buyback stock hit our list for careful review. That's why we haven't yet recommended **Microsoft** (nasdaq: MSFT - news - people). Yes, MSFT announced in July 2004 that it planned to purchase up to $30 billion in stock over the next four years, to help reduce excess cash holdings (the kind of problem we would all like to have!), but we're waiting for it to actually happen. Show us reduced shares outstanding, and we'll consider opening our wallets.

I find that buyback stocks make good investments for several reasons:

- Buybacks anticipate higher share prices. Buybacks are a sign that corporate owners and company management--the ultimate insiders--are confident--even optimistic--about the future and believe the current share price is not only too low, but represents a bargain.
- Buybacks increase earnings and the value of shares. A buyback lowers the total number of shares outstanding, which increases the price of every share you own as well as earnings.
- Buybacks cut your taxes and maximize your investment. Unlike dividends, buybacks increase your wealth without any immediate tax obligation.
- Buyback stocks can act as a safety net. A company that holds a large number of its own shares has a strong incentive to step in and purchase more shares when prices decline.

The bottom line is that no matter what strategy you use to choose your stocks, you simply must do your homework. With buybacks or with any other strategy, the well-prepared investor is the one with a smile on his face at the end of the day.