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Holding Back On Buyback Big Boys

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Big buyback announcements from some of the nation's biggest companies are coming fast and furious. But before you buy some of these stocks, it pays to do a little digging.

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Merrill Lynch (nyse: MER - news - people), with a market cap of $51 billion, just announced a $4 billion buyback--or nearly 8% of its shares outstanding. Another financial titan, **Citigroup** (nyse: C - news - people), announced on April 15 that its board of directors authorized a $15 billion buyback. Add that to the $1.3 billion left under a previous repurchase program, and you have a whopping $16.3 billion buyback plan that the company hopes to execute over the next 18 months on top of one that's already been in effect. If Citi carries out its buyback, it would represent about 6.2% of the outstanding shares of the world's largest financial services company.

So, as the editor and publisher of the Buyback Letter--the only investment newsletter devoted to finding opportunities among companies that repurchase their own stock--am I rushing out to buy Citigroup or Merrill? The short answer is no.

Just like **Microsoft** (nasdaq: MSFT - news - people)--the other super-size buyback announcement that made waves last year in investment circles--Citigroup doesn't yet meet our criteria for inclusion in any of our six guided portfolios, because it has yet to reduce its share count. And Merrill's share count is down just 1.4%--below a level I'd consider significant.

I'm also not warning you against buying, if you are so inclined. If you like Citigroup (or Microsoft or Merrill Lynch, for that matter) and have been waiting for a reason to invest, consider yourself alerted that the time is nigh.

In general, I find buyback stocks make good investments for several fundamental reasons:

--Buybacks anticipate higher share prices and 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 the value of shares by lowering the total number of shares outstanding, which increases earnings (and eventually price) of every share you own.

--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.

For these reasons, we applaud buyback announcements by big companies. Some of the biggest and best companies in the world, such as **Home Depot** (nyse: HD - news - people), **Wal-Mart** (nyse: WMT - news - people), **Exxon Mobil** (nyse: XOM - news - people), **American Express** (nyse: AXP - news - people)and **IBM** (nyse: IBM - news - people), are robust

repurchases of their own stock.

There are many reasons to like Citigroup, too. For the first quarter, Citigroup posted a 6% revenue increase (to $21.5 billion) and a 3% increase in both income from continuing operations (to $5.17 billion) and earnings per share (to a record $1.04), helped by growth in retail banking, credit cards and international operations. They also consistently pay a healthy dividend, just declaring the latest quarterly $0.44 per share payable on May 27.

Citi Chief Executive **Charles Prince** said on a conference call that the buyback program allows Citigroup to return capital efficiently to shareholders rather than "sit on it." Citigroup said it ended the quarter with more than $25 billion in cash. While we are not yet "Citigroupies," we respect and appreciate that sentiment of returning capital to shareholders, both by dividend and buybacks.

We had a similar sit-up-straight moment in July 2004 when Microsoft announced it was going to buy back $30 billion worth of its own stock over the next four years. That amount--$7.5 billion a year--would represent 10% of its total shares outstanding.

Microsoft company executives, long criticized by shareholders for allowing $60 billion in cash to pile up unused while the share price remained flat, decided the time was right to share the wealth. Some quick math tells us that assuming even modest growth, Microsoft should be generating cash faster than it can spend it on dividends and buyouts. That's a good problem to have.

So what's not to like with Microsoft? Why haven't we bought it, either? The problem, as we have learned from many years of investing wisely in buyback stocks, is that not all companies actually reduce their outstanding shares.

Some companies like the short-term uptick in the stock price they get after a buyback announcement (Citigroup shares rose 35 cents to $45.75 on the day of the buyback announcement) but have no intention of actually buying back. Some companies may have suffered a financial setback after the buyback announcement and have quietly shelved it. Some companies may have bought another company and funded the purchase by using stock, so their share count increased, not decreased.

And some companies (Microsoft, perhaps?) may issue more shares to accommodate employee options, and so, even though they may be buying back, their share count has not actually declined.

Our disciplined strategy demands an actual decrease in shares before we plunk down our money. Show us a reduced share count, and we'll consider showing you our wallets.

David Fried is publisher and editor of the Buyback Letter *and* Buyback Letter Premium Edition

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