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Don't Be A Buyback Sucker

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Corporations in America can't seem to get over themselves. They're buying back their own shares at lightning speed, as fast as they can amass the money in their corporate coffers. Can't you just picture the conversation at the board meeting: "We have a couple of extra million (billion), right? Dividends are so yesterday! We're lookin' good...let's buy back!"

In 2003, S&P 500 companies bought back $131 billion; last year buybacks increased by 50% to a record $197 billion, and this year's torrid pace should set another record. The sum for buybacks even exceeds the $181 billion spent on dividends in 2004. Clearly, buybacks are not only smokin', they're on fire.

But in *Barron's* on May 16, there was a report from the institutional brokerage firm **Rochdale Research**, which aims a fire hose at our buyback investing strategy. Rochdale says many shareholders who hold on to a stock during a buyback don't realize much benefit from holding, because, contrary to expectations, many buybacks don't reduce the number of shares in a company.

In fact, companies often issue additional shares for options and acquisitions at the same time they buy back shares, so the net effect is either a wash or sometimes even an increase in shares outstanding. Well, as Sir **John Gielgud**, the droll butler to **Dudley Moore** in the film *Arthur* said, "I'll alert the media."

We've been specializing in investing in companies that do buybacks for a decade, and it has always been true that just because a company authorizes a repurchase plan doesn't mean that plan will happen, or that it will result in fewer shares. Tech companies are a great example of how buyback announcements don't often result in a decrease in shares outstanding.

Microsoft (nasdaq: MSFT - news - people), for example, has certainly been among the noisiest buyback announcements in the past year. Its plan to buy back $30 billion worth of its own stock over four years--$7.5 billion a year--would represent 10% of its total shares outstanding. The problem is that so far, Microsoft doesn't show any decline in shares.

Tech companies often initiate buybacks to offset new shares issued from the liberal stock options granted to employees, or from acquisitions. Although not a tech company, nut-and-bolt maker **Fastenal** (nasdaq: FAST - news - people) falls into this category of companies that announced buybacks (380,000 shares, about 0.5% of the 76 million outstanding shares), primarily to cover employee options.

In fact, in 2004, high tech companies made almost 25% of total stock repurchases, most to cover stock options redemptions. Fewer than one-in-four S&P 500 companies reduced their share count, which is probably the most telling figure. We have repeated this mantra until we are hoarse from saying it: "A buyback program without a reduced share count is not a meaningful buyback, to us."

To be a meaningful buyback--not just a marketing gimmick--a company must show a reduced share count (comb the quarterly and annual financial statements, which list number of shares and how much a company has spent on buybacks). For us to invest, though, a company must also have a strong cash flow and trade at an attractive price-to-earnings multiple.

The Rochdale report also hit another nerve with its claim that most buybacks often occur when the market is high, because they tend to coincide with economic tops when companies have lots of spare cash. Therefore, lots of cash equals a need to spend it, rather than hoarding it, which equals repurchasing their own shares.

However, it makes intuitive sense that companies won't overpay for their own stock. Why should they? If their stock is overvalued, they can use the money more wisely by declaring a higher dividend or making a strategic acquisition to bolster their business in another way. The business of business is making money. Why should they take hard-earned money and spend it foolishly?

But even buyback stocks bought at a market peak can provide profits in the coming months and years, if those stocks are chosen wisely. Take a few examples from our own Stock Pickers Portfolio, for example. In December 1999, we bought **Washington Mutual** (nyse: WM - news - people), and in February 2002, we sold it for a gain of 108.95%. In March 1999, we bought **Spartan Motors** (nasdaq: SPAR - news - people) and sold it in July 2002, for a 156% gain. We bought **Office Max** (nyse: OMX - news - people) in October 1999, and sold in July 2003, for a gain of 82.5%. And **Ryder** (nyse: R - news - people) brought us a gain of 57.86% after we bought in February 1999, and sold in May 2004.

If you are a market timer or an active day trader, investing in buybacks probably isn't for you. If you're willing to take the longer view, you will see that a buyback stock that has room to grow can be a good value--even if bought at what looks like a market peak right now.

Longer term, you have only to look at our yearly records to know that investing wisely in appropriate buyback stocks can pay off. Since inception, all six of our Buyback Portfolios--which differ in turnover, number of stocks held, and purpose--are beating their benchmarks. Since inception, the Stock Pickers Portfolio is outperforming the S&P by 207.92% and our Buyback Dogs is outperforming the S&P by 108%. Even our Buyback High-Tech Portfolio is outperforming the Nasdaq by 84.71%.

Companies that announce buybacks usually get an immediate shot in the arm from the announcement. Investors take note and think, "Where there is smoke, there must be fire, so let's jump in." For example, **Citigroup** (nyse: C - news - people) shares rose 35 cents to $45.75 on the day of the $15 billion buyback announcement, **Merrill Lynch** (nyse: MER - news - people) rose 2% on the April afternoon it announced an additional $4 billion buyback. But those instant bumps are not sustainable if the buyback doesn't occur. The market will take note and share price will decline, naturally.

Are buybacks a sure thing? Of course not--nothing is. But researched well and chosen wisely, buyback stocks can be the foundation of a wealth-building strategy that can light a fire under your sluggish portfolio.