MarketWatch

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No respect

Commentary: Share repurchase strategies are getting a bad rap

By Mark Hulbert, MarketWatch

ANNANDALE, Va. (MarketWatch) -- Advisers who pay attention to share repurchases are the Rodney Dangerfield of Wall Street right now.

They just can't get any respect.

Companies that have share repurchase programs, of course, are using some of their cash to buy back some of their own shares in the open market. Companies do so, of course, because they believe that their shares are being undervalued by the marketplace and that, as a result, investing in those shares is a better use of corporate capital than the alternative.

But, as Standard & Poor's pointed out earlier this week, corporations collectively were buying a lot fewer of their shares at the stock market bottom this past March than they were at the top of the bull market two years ago.

Commentators throughout the blogosphere seized on this as evidence that corporations don't know what they're doing. Barry Ritholtz of TheBigPicture.com headlined a story "Buy High Sell Low," writing "Corporate America loves buying its own stock -- but apparently, only at the worst of times, like when they are expensive or at the top of a bull market."

Floyd Norris of the New York Times penned a column saying much the same thing, entitled "Loving Your Stock Only When It's High."

These comments prompted me to check in with David Ikenberry, a finance professor at the University of Illinois at Urbana-Champaign, who co-authored the first major study into companies involved in repurchase programs. It turns out that he takes serious exception to the conclusions that these commentators have drawn from the recent data.

The first point that Ikenberry made was that it's hardly surprising that corporations last year started cutting back on their share repurchases. "Companies began to hoard capital, on the theory that they may not be able to access it in the future," he argued.

To be sure, credit markets have eased over the last six months. But it's not guaranteed that corporations individually, or the economy as a whole, are completely out of the woods. To engage in share repurchase activity in this environment, therefore, a company has to be extraordinarily confident that it won't otherwise need the cash for mere survival in the next couple of years.

So we shouldn't try to generalize from the recent past. Carrying far more statistical weight are patterns that have emerged from several decades of data.

And when Ikenberry has focused on that much larger dataset, he has concluded that "there is no doubt that companies are extremely adept at knowing how to purchase stocks when their stocks are undervalued."

That doesn't mean that a company involved in repurchasing its shares never strikes out, he hastened to add. But, on balance, over many years, they have been right far more often than they've been wrong.

Ikenberry therefore concludes that recent experience is not a good reason to conclude that share repurchase strategies should be avoided. On the contrary, given how rare share buybacks are right now, and how out of favor they appear to be on Wall Street, he says he wouldn't be surprised that the announcement of a share repurchase program is today an even more powerful bullish signal than history would otherwise suggest.

Relevant to this discussion is the performance of an investment newsletter whose foundation is a share repurchase strategy. It is The Buyback Letter, edited by David Fried. Not only is this service ahead of a buy-and-hold over the longer term, it is also ahead over the trailing 12 months as well. There is no evidence in the Hulbert Financial Digest's tracking of it that the letter has lost its touch.

The following are the stocks on Fried's September 2009 list of "Buyback Hot List," which he describes as containing "today's most compelling buyback stocks."

- Arch Capital Group Ltd
- Campbell Soup Co
- Cheesecake Factory Inc (The)
- The Chubb Corp
- CSS Industries Inc
- DSP Group Inc
- Endurance Specialty Holdings Ltd
- Foster Wheeler Ag
- FPIC Insurance Group Inc
- HLTH Corp
- Liberty Media Corp - Capital
- Lorillard Inc
- Odyssey Re Holdings Corp
- Pre-Paid Legal Services Inc
- Schawk, Inc.
- Sturm, Ruger & Company Inc
- Tech Data Corporation
- TFS Financial Corp
- Universal Corp
- Universal Technical Institute Inc
- USA Mobility Inc
- USANA Health Services Inc
- Valeant Pharmaceuticals