GURU ECONOMICS

New bull market? So what?

Commentary: Buy the companies that buy themselves

By Craig Tolliver, CBS.MarketWatch.com
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LOS ANGELES (CBS.MW) -- Excitement over a new bull market leaves David Fried rather cold. Refusing to take a market perspective, the money manager and newsletter editor invests in good and bad markets -- a strategy that seems to work for him.

"What the market is going to do is not necessarily an issue for us. We like to focus on what our stocks are going to do," Fried said.

Five model portfolios in Fried's Buyback Letter have averaged respectable gains in five of the six calendar years that the Hulbert Financial Digest has been tracking his flagship publication. While last year produced a nominal loss of 2 percent, it still beat the nearly 21 percent drubbing endured by the Wilshire 5000 Index (97199001:

12,288.21, **-5.39**, **0.0%**) in 2002.

His Buyback Premium Portfolio newsletter, spun off in 2001, had a standout year last year, delivering a nearly 33 percent gain to those who followed his advice -- and were willing to pony up the hefty $948 yearly subscription fee.

As the names of his newsletters imply, Los Angeles-based Fried searches for companies buying back their stock -- a hopeful sign that at least the company believes in its stock even if the rest of the investing community hasn't caught on yet.

CBS MarketWatch spoke with Fried to better understand his strategy and to look at some companies that are currently buying back their stock.

Q. So what is the strategy exactly?

A. We find companies that have recently repurchased their shares in the open market. As a result, the number of shares available to the public decreases.

A company can buy back stock and their total number of shares can stay the same if they issue an equal number of shares for stock options. Or the number of shares can actually go up in the face of a buyback if they issue more than the number of shares that they buy back.

So we look not just for a repurchase, but a repurchase that's big enough to give us a negative share count on a year-over-year basis.

There are a number of benefits to buybacks. They improve price-to-earnings ratios and price-to-sales ratios; increase shareholders' ownership in the company without additional investment; buffer share prices after a market decline; and allow tax-free appreciation to remaining shareholders.

Buybacks make each share more valuable.

Q. Are you concerned about buybacks where the intention appears to be more of a tactic to raise share price rather than any real belief in growth prospects?

A. As opposed to being concerned if they're doing it for this reason or that reason, we like to look at it and see if we agree that this stock is a good value.

We start with the companies that have repurchased their stock. Then we try to compare them to each other and see which ones are stronger financially, see which ones are undervalued historically.

We take a look at the different metrics and try and pick the best of that universe.

Q. And when do you sell?

A. When buyback wanes.

Q. How timely is the buyback information and where do you generally get it?

A. The information about how much stock has been bought back can be had in any of the annual and quarterly reports, because every annual and quarterly report has one figure, and that's "shares outstanding."

That figure is either positive, negative or flat with the prior quarter and the prior year for the same quarter. So that's how we get the share amount.

Q. Sometimes people confuse company buybacks with insider buying and selling. Do you even consider insider buying in your strategy?

A. When an insider buys or sells, it doesn't change the number of shares outstanding. Insiders can buy and sell for a lot reasons.

But when the company buys back a stock, there's usually an overriding reason -- and that is that the entire management of the company, from the board of directors on down, feel that's a good use of corporate cash.

An insider is saying this might be a good use of my *individual* cash for some reason. Also, I think you get a lot of false selling data because an insider can have a great deal of stock in the company that they work for. Then if they want to buy a house, or they want to go on a trip, perhaps they'll sell stock and that's got nothing to do with the value of the company perhaps.

What's the difference between your two newsletters?

A. The Buyback Letter (see HFD data) offers six portfolios. We have a 20-stock portfolio, which we call our Buyback Index. We have the stock pickers portfolio. We offer an income index. And we offer three small portfolios with five stocks each -- two sector portfolios, one for the health and biotech sector and one for the high-tech sector, and a five-stock Dow Jones portfolio, which we call the Buyback Dogs.

In the Premium Portfolio (see HFD data), it is simply from any sector -- what I feel are the top five picks for that month. That's more of a trader's strategy, trading 60 percent to 100 percent every month.

The other portfolios are much more sedate.

Q. Do you have some buyback examples that investors should be aware of?

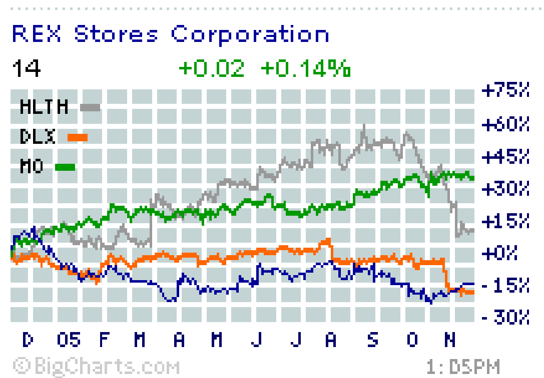
A. One of our stores, Rex Stores (RSC:

14.00, **+0.02**, **+0.1%**) , sells for about five times earnings, has recently bought back 9 percent of their shares, and they've continued to buy back shares. They have a very unique business strategy. They buy first quality but overrun merchandise and sell in markets that are too small for Best Buy and Circuit City. So we like that story.

Another story we like still is Altria (MO:

73.49, **-0.90**, **-1.2%**) , formerly Philip Morris, which is still buying back stock -- they suspended it temporarily, but as soon as the smoke clears from these other lawsuits, they'll be back buying -- and they have a 6.2 percent dividend yield.

Another one we like is Deluxe Corp. (DLX:



33.19, **-0.28**, **-0.8%**) . Deluxe Corp. prints about 50 percent to 60 percent of all the checks and check forms in the country, yet their P/E of 14 is a below market multiple P/E. If you could imagine a McDonald's or a Wal-Mart having 50 percent to 60 percent of their market and what kind of P/E they command for that position, for some reason Deluxe Corp. doesn't get this respect -- but we think it will over time. Over the past year, they bought back 4.2 percent of their shares.

WebMD (HLTH:

8.00, **+0.06**, **+0.8%**) , simply put, they are the EDI (electronic data interchange) for the health-care industry. There are about $30 billion in transactions a year in the health care industry and less than 15 percent of them are currently processed electronically. It's just a huge growth area. And they bought back about 3.4 percent of their stock.

For a profile summary of **Buyback Letter**, click here.

For a profile summary of **Buyback Premium Portfolio**, click here.

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