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Buybacks Vs. Dividends: Who's Better?

John Dobosz, 04.29.05, 6:00 PM ET

A rebound in profits over the past two years has swelled cash levels on corporate balance sheets, and boards of directors seem eager to return some of that bounty to shareholders, both through stock buybacks and cash dividends.

According to numbers from Standard & Poor's, stock buybacks among S&P 500 companies in 2004 grew 51% to $197 billion, which is $16 billion more than the $181 billion S&P 500 companies spent on cash dividends last year. Dividends are hardly slumping, though. Through April 26, 2005, 135 companies in the index raised dividend rates an average of 21.1%. There have only been four decreases or suspensions of dividends. Some high profile companies, like **IBM** (nyse: IBM - news - people) and **Merrill Lynch** (nyse: MER - news - people) to name two, have both jacked up their dividend and announced multi-billion dollar buybacks.

So which method of returning cash to shareholders is superior: paying dividends or buying back stock? The question may seem a bit like starting a debate on the competing merits of comic book and cartoon superheroes: Superman can fly, but Batman has a really cool car, although both fight evil. Nonetheless, we put the question to some of the top-performing newsletters that keep track of buybacks and dividends and use them as criteria in selecting investments.

"I like dividends and buybacks, but if I had to choose one, I would opt for a buyback," says John Buckingham of the top-rated Prudent Speculator newsletter. "When a company buys back shares, my ownership percentage rises ever so slightly without any tax consequences, even though dividends are now taxed at the 15% rate, assuming they qualify. A share repurchase is tax free."

One stock Buckingham is buying now that pays a generous 3.8% dividend and has announced a big share buyback is **Citigroup** (nyse: C - news - people). Two other companies buying back shares that the value-oriented Buckingham is buying: **Keynote Systems** (nasdaq: KEYN - news - people) and **Avaya** (nyse: AV - news - people).

David Fried, editor of the Buyback Letter and Buyback Letter Premium Edition, predictably, is a big fan of buybacks, which he says offer companies more flexibility than dividends.

"Once a dividend is put in place, it is a big negative if the dividend is reversed, decreased or ceased in the future," says Fried. "On the other hand, if a company slows down or stops repurchasing shares, it is hardly noted. The buyback company can simply shift its spending, while the dividend company has to 'take something away' from its shareholders." Furthermore, he adds, the company buying back its shares can wait until an advantageous time to repurchase."

In choosing his investments, Fried insists that a company actually reduce the number of outstanding shares following a buyback announcement. Reducing outstanding shares makes each dollar of earnings more valuable on a per share basis. Many times, however, companies fail to reduce share count due to new issuance of stock to redeem employee stock options.

Three buyback companies Fried is currently buying include **Home Depot** (nyse: HD - news - people), **Dell** (nasdaq: DELL - news - people) and **Merck** (nyse: MRK - news - people).

Even though buybacks may be more tax efficient than dividends (even after the reduction of the tax rate to 15%), Kelley Wright and Joseph McKittrick of Investment Quality Trends, urge investors not to discount the power of dividends to drive shareholder returns. Depending on which study you look at, anywhere from 45% to more than 70% of the total return from stocks has come from dividend yields and real dividend growth. The third component of returns has been the expansion of multiples of earnings investors are willing to pay to own a stock--multiples which even today are substantially above historical norms.

"Dividends are real, and you can't fake cash money," says Wright, who also notes that dividends continue to be valuable indicators of whether a stock or index is undervalued or overvalued. For example, the Dow Jones Industrial Average, which currently yields 2.4%, is in the middle of being undervalued at a 3% yield and overvalued at a 1.5% yield.

Which stocks are undervalued now? Wright points to **Washington Mutual** (nyse: WM - news - people) with a 4.58% yield, and **UST** (nyse: UST - news - people), the smokeless tobacco and cheap-wine maker that now yields 4.9%, after "getting taken out and shot" on Tuesday when it revised full-year earnings per share downward by 3%.