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SUNDAY MONEY: INVESTING; At the Buyback Mall, It Pays to Shop Around

By BARRY REHFELD

BUYBACKS have never been more popular. Two-thirds of the Standard & Poor's 500 companies have bought back a record $430 billion of shares in the 12 months ended in September -- more than three times the total just three years ago.

How have the investments done? Microsoft, Exxon Mobil, General Electric and Citigroup have been the biggest buyers, and their stocks are trading at or near their 52-week highs, while the S.& P. has been on a tear since the end of July, with a gain of better than 10 percent.

Stock buybacks are often followed by rising share prices, but investors need to do their homework. Not all stocks with buybacks are worth buying.

On a basic level, a buyback can make a stock look attractive by giving an immediate boost to earnings per share, simply by spreading profits over fewer shares. If a share is more valuable, it stands to reason that its price on the open market should be bid up -- and very often it is.

Still, hold the rush. Investors who randomly sweep up shares in companies that are buying back stock with the goal of beating the market are likely to be disappointed. According to a recent study of the S.& P. 500-stock index by Birinyi Associates, a research firm in Westport, Conn., companies that had buybacks outperformed those that didn't by a mere percentage point over the period from 2000 to 2005.

Zero in on the right stocks, though, and the gains can be significant. This is seen in small undervalued companies -- those with high book-to-market-value ratios -- where management says it is buying back shares because they are bargains. Theo Vermaelen and Urs Peyer, professors at Insead, the French business school, tracked the 50 stocks that best met those conditions in every year from 1992 to 2002 and found that they produced gains 65 percent greater than those of the S.& P. 500 index over the next four years.

How much stock is being bought, and how often, can influence the share price. Bigger purchases are generally thought to be better, and the flexibility of long-term regular buying is often seen as a more confidence-building signal for the market than buying back shares all at once.

Still, Microsoft made a powerful statement this summer with a one-time $20 billion buyback, with $20 billion more to come. The results have been impressive: the stock, which dropped sharply in the spring, has returned nearly 30 percent since the buyback announcement.

On the other hand, Exxon has been buying back stock through 25 consecutive quarters, spending more than $60 billion, and its shares have gained better than 60 percent during the stretch. (Of course, the rising price of oil during much of that period has helped enormously.)

How a company finances a buyback is worth considering, too. Free cash flow generally trumps debt, but again, it depends on business conditions. The Tribune Company recently did a buyback with borrowed funds, but for Tim Fidler, director of research at Ariel Capital Management, it was only one more reason to invest in the company, whose share price was battered in the previous two years.

"We're contrarians," he said, adding, "money is still relatively cheap, and we thought the balance sheet could handle it." He also said that he thinks the company's earnings potential justifies a higher stock price. If the price doesn't rise on the public market, he said, there is plenty of private interest in a purchase of the company, or individual parts of it.

In general after buyback announcements, potential investors should check that the companies are actually buying back stock. "They don't have to and they may not," said Robert Leiphart, a Birinyi analyst. "Or they may buy less than they said they would or they buy all they say they would, but do a secondary stock offering at the same time that's bigger than any buyback."

There are darker issues in this numbers game to consider, too. Buybacks may serve only as a cover for senior executives to exercise their options, buy their shares at a huge discount and sell them at market value. Such transactions can be a net loss for the company, with the number of shares remaining unchanged in the end.

Indeed, with so many ways to shuffle shares, it's not surprising that Birinyi also found that, taken together, the S.& P. index companies issued 133 percent more stock than they bought for the 10 years ended in 1995. Two professors at Georgetown, Allan Eberhart and Akhtar Siddique, found in a study of more than 7,000 buyback announcements from 1981 to 1995 that the number of shares in the companies making the announcements actually increased by 24 percent, on average.

Still, David Fried, president of Fried Asset Management and editor of the Buyback Letter, said, "the announcement of a buyout is a good place to start" investigating a stock. "I like companies with good stories," those with compelling reasons for an investment, he said.

Three companies that appeal to him are Intuit, TJX Companies and Big Lots. They have bought back between 3 and 5 percent of their shares during the last year, and investors who bought when management started have already made money.

Big Lots is a closeout retailer whose stock collapsed after a meteoric rise in the 1990s. It has recently come back with the help of a new chief executive and strong sales.

TJX, operator of T. J. Maxx, is another low-priced retailer. Lately, the company has had 6 percent growth in same-store sales, a strong figure for a mature large-cap business. Intuit, which produces tax preparation materials, has been putting up better-than-expected numbers. For 2006, it expects revenues to rise as much as 11 percent.

Michael Mauboussin, chief investment strategist at Legg Mason Capital Management, favors Amazon.com, whose shares were driven down after it reported in July that margins had shrunk. At the same time, the company said that it was building for the future and that the expenditures would eventually pay off. As a demonstration of its confidence, the company said in August that it would buy back shares. Since then, the stock price has risen sharply.

A less time-consuming alternative to focusing on single stocks is investing in an appropriate basket of securities containing a high proportion of companies that are buying back beaten-down shares. Finding such a basket can be tricky, though, because no index fund specifically tracks companies engaging in buybacks.

Charles Biderman, the chief executive of TrimTabs Investment Research, suggests XLK, an exchange-traded fund that tracks an index made up of technology stocks. At the moment, he said, "the stocks of technology companies are down and they're buying back shares."

For example, in the second quarter, the information technology sector of the S.& P. 500 was off 9.8 percent, and the companies in that sector were the biggest buyers of their own shares. "There's a leveraging effect in management's buying," Mr. Biderman said. "First come the institutions, then individual investors, each driving the stock up more, so if you get in with management you'll beat the market by a wide margin."

Of course, it helps if you're smart, diligent and lucky enough to bet on the right management.