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How sweet it is

Commentary: It's bullish when companies buy back their shares

By Mark Hulbert, MarketWatch
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ANNANDALE, Va (CBS.MW) -- Shareholders of two blue-chip companies, as well as investors generally, were treated Monday to a bit of good news that carries potentially bullish long-term consequences.

First, Johnson & Johnson (JNJ) announced that its board of directors had authorized the repurchase of up to $10 billion of its common stock. (Read full story.)

Then, later in Monday's trading session, ConocoPhillips (COP) announced that its board had approved a $15 billion share buyback program, representing an increase of $13 billion above and beyond the $2 billion that remained in a previous buyback program. (Read full story.)

These announcements are good news because the average company that repurchases its shares outperforms the market by an annualized average of 3.1% over the four years following the announcement of its share repurchase program. That's the finding of perhaps the most comprehensive academic study of repurchase programs, which appeared in the Journal of Financial Economics. (Read study.)

Why would repurchases carry such bullish potential? One theory explains it in terms of simple supply and demand: Repurchases reduce the supply of a company's stock outstanding, which according to Economics 101 should increase the price of those shares that remain.

Another theory: Companies that repurchase their shares are so confident about their future prospects that they are willing to commit corporate resources to buying them. This is worth paying attention to, since a company's executives and Board of Directors have access to insider information that the rest of us do not.

In this way, at least, repurchase programs are analogous to corporate insiders purchasing their companies' shares for their own accounts. Both phenomena signal confidence in the company's future prospects. The difference, of course, is that in the one case the insiders are spending their own money, whereas in the other they are spending the company's cash.

To be sure, insiders don't always do the same thing with their own money as they do with their companies' cash. So, when interpreting a firm's repurchase announcement, it's important to take a look at how its insiders have been behaving.

One service that keeps track of whether a company's insiders are behaving bullishly or bearishly is the Vickers Weekly Insider Report, published by Argus Research. Each week, Vickers calculates an index that "rates each company's insider transactions for the past six months, taking into account numerous factors that are weighted according to relative importance. Factors include, but are not limited to, the number of buy and sell transactions recorded for each company, the percentage changes that occurs in an insider's holdings with each transaction, unanimity among insiders at a given company, the dollar value of a transaction, and reversals in transaction patterns (from buying to selling or vice versa)."

A positive insider index value mean that Vickers' algorithm considers the behavior of a company's insiders to be bullish on balance, while negative values mean just the opposite. According to the latest Vickers Weekly Insider Report, received Monday night, the Vickers insider index for Johnson & Johnson is 10, while for ConocoPhillips it is minus 22.

How can you make sense of these conflicting signals? One solution might be to subscribe to an investment newsletter that focuses on companies' repurchase programs. It is The Buyback Letter www.buybackletter.com, edited by David Fried. Before recommending a company that has announced a share repurchase program, however, Fried takes a number of other factors into account -- such as whether its insiders are buying or selling for their own portfolios.

The Hulbert Financial Digest has been tracking The Buyback Letter since the beginning of 1997. Since then (through this past June 30), its several model portfolios have produced an average annualized gain of 16.4%, vs. 9% for the Dow Jones Wilshire 5000 index (97199001) . Better yet, this market-beating gain was produced with slightly less volatility, or risk.

As of Monday evening, Fried had not indicated to his subscribers whether he intends to add either Johnson and Johnson or ConocoPhillips to any of his model portfolios. But the rest of the newsletter arena clearly favors the former. Among those several dozen newsletters that have beaten a buy-and-hold over the past decade on a risk-adjusted basis, Johnson & Johnson is favored over ConocoPhillips by a ratio of 10 to 3. ■

Mark Hulbert is the founder of Hulbert Financial Digest in Annandale, Va. He has been tracking the advice of more than 160 financial newsletters since 1980.