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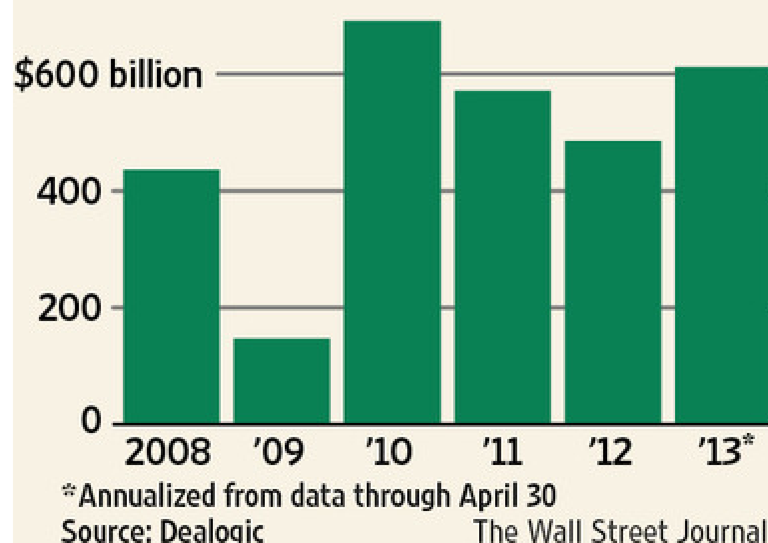
How Investors Should Play Stock Buybacks

By MARK HULBERT

International Business Machines this past week became the latest in a wave of companies announcing that they will be repurchasing their shares in the open market. The week before, it was Apple announcing the largest buyback program in U.S. history. Both stocks rose smartly after the announcements.

We shouldn't have been surprised. A significant body of academic research has found that the average stock not only rises immediately after the announcement of a repurchase program but continues to outperform the market for several additional years as well.



One real-world gauge of buybacks' market-beating potential comes from an investment advisory service called the Buyback Letter, which is edited by David Fried. Investing only in stocks of companies that have announced repurchase programs, this service has returned more than twice what the market did over the last 15 years.

According to the Hulbert Financial Digest, its model portfolios have produced an average annualized return of 9.4% over this period, in contrast to the Standard & Poor's 500-stock index's 4.4%. (Both returns include dividends.)

An additional feature that makes buyback strategies compelling: Their success doesn't depend on investors reacting immediately to a buyback announcement. That's an important advantage, since many of Wall Street's favorite strategies perform poorly if followers aren't paying close attention to the markets during each trading session and taking action quickly.

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International Business Machines became the latest in a wave of companies announcing that they will be repurchasing their shares in the open market.

Buyback strategies aren't nearly as time-sensitive, according to David Ikenberry, dean of the Leeds School of Business at the University of Colorado, Boulder, and an expert on stock buybacks. In an interview, he said that he has found in his research that the average buyback stock outperforms the market in each of the four years following the company's announcement of its share-repurchase program.

To be sure, buybacks aren't universally praised by shareholders and analysts. One concern some have expressed is that buybacks can reduce a company's "book value"—what accountants calculate the firm would have left if it paid off all its debts.

Book value will decline whenever a company pays a premium over per-share book value when repurchasing its stock, which is often the case. And as book value declines, the price-to-book ratio rises, pushing the company further into "growth stock" category—which historically has produced lower returns and more volatility.

Still, numerous studies over periods extending back more than three decades have found that the average buyback stock proceeds to outperform the market.

Mr. Ikenberry says there also are theoretical reasons not to be too concerned about the effect of buybacks on book value. That's because an asset's book value is something calculated by accountants and isn't the same as its value to the business. As an illustration, he cites Coca-Cola, which last October added 500 million additional shares to its existing share-buyback program.

The patent for Coca-Cola's signature recipe is valued on the books at its original cost from a century ago, which Mr. Ikenberry says is minuscule, even though it's worth billions to the company. So even though the company has a relatively high price-to-book ratio (currently 4.9-to-1, double the S&P 500's 2.4-to-1), he believes the firm's buyback program is creating value, not destroying it.

The market apparently agrees: Since Coca-Cola announced its expanded buyback program last October, its stock has risen by 12%, versus 11% for the S&P 500.

One low-risk way to take advantage of buybacks' potential is to invest in those companies that actually do repurchase their shares. To be sure, this requires you to sit on your hands when a company announces a buyback program and wait for quarterly filings to find out whether the firm has followed through.

Though this means you will miss out on any immediate spike after that announcement, the stock should still have plenty of upside potential, according to research by Mr. Ikenberry and others.

Consider, for example, an index constructed by San Diego-based Ford Equity Research. It consists of companies that, over the trailing year, have reduced by at least 5% the number of their shares outstanding. Called the Buyback Achievers Index, Ford reports that it has produced a 14% annualized return since the beginning of 1998, more than double the S&P 500's 6.8%.

Since 2006, PowerShares has offered an exchange-traded fund that is benchmarked to this Ford

index, called the PowerShares Buyback Achievers fund. It has an expense ratio of 0.71%, or $71 per $10,000 invested. Since inception it has beaten the S&P 500 by an annualized rate of 5.3% to 3.5%.

AdvisorShares also offers an actively managed ETF that invests in companies that have recently reduced their shares outstanding: the TrimTabs Float Shrink ETF . It has a 0.99% expense ratio, or $99 per $10,000 invested. Since inception in October 2011, the fund has beaten the S&P 500 by an annualized rate of 29% to 27%.

You may also choose to invest in buyback stocks directly. Among the stocks that the Buyback Letter's Mr. Fried has added in recent weeks to his model portfolios are Everest Re Group, Goldman Sachs Group, Lincoln National and WellPoint .

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