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Headline: Don't Give Up on Buybacks Just Yet

Don't Give Up on Buybacks Just Yet

Most of the time, buyback stocks don't pay off the way they used to, but there's still money to be made in some of them

GLORY DAYS | Stock buybacks were all the rage, and big news, throughout the 1990s. Now, many investors scoff at them. PHOTO: THE WALL STREET JOURNAL

By Mark Hulbert
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1 COMMENTS

Stock buybacks are no longer considered an unambiguously good thing, for companies or investors. But investors might still be able to profit from them.

As recently as the 1990s, the market typically celebrated a company's announcement that it would be repurchasing its shares in the open market. Numerous studies found that not only would the stock of the average company jump on the announcement of a buyback program, it also would continue to outperform the market for several years.

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Today, in contrast, the announcement of a buyback program is often met with cynicism if not outright criticism. Many believe that such programs have become little more than short-term financial engineering that sacrifices a company's long-term growth.

Recent studies have found that the stock of the average company engaged in repurchasing its shares performs no differently than the overall market.

What changed? One big factor is that, starting about 15 years ago, the stock market became more efficient—leaving fewer shares mispriced—for several reasons, including the increasing influence of big, sophisticated institutional investors, more information disclosure by companies because of increased regulation, improved market liquidity due to a decline in trading costs, and an explosion in algorithmic trading, according to research conducted by Fangjian Fu and Sheng Huang, finance professors at Singapore Management University.

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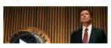

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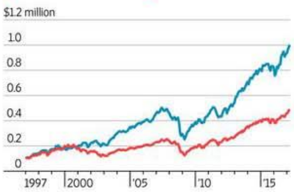
A more-efficient market leaves fewer opportunities for companies to buy back their shares at bargain prices with the goal of profiting from a rebound, so buybacks now tend to be done more for business reasons than purely market reasons, according to a study the professors published last year in the journal Management Science. That makes a jump in share price after a buyback less likely.

The net result of this and other factors, according to the study, is that on average companies have stopped experiencing any boost in the performance of their shares following the announcement of a buyback program. The data the published study was based on ended in 2012, but Dr. Fu says he has updated the study to include data through the end of 2016 and reached the same conclusion.

Opportunity knocks

But there is still the possibility that investors can exploit some repurchase announcements, according to Gustavo Grullon, a finance professor at Rice University. He says he has found from his research that among certain stocks the market continues to react favorably to a buyback announcement.

Still Beating the Market
Performance of the Buyback Letter versus the broad market (Wilshire 5000)



*Average of model portfolios
Source: Hulbert Financial Digest
THE WALL STREET JOURNAL.

These are so-called value stocks—shares that trade below the level that would be expected given a company's revenue, sales and other financial data—especially those of companies with the smallest market capitalizations. Their performance after buyback announcements gets lost in the aggregate data because their buyback programs are often tiny compared with those of the largest companies, Dr. Grullon says.

One reason these stocks are more likely to get a boost from buybacks is that the market for them is less efficient than the market for bigger stocks, Dr. Grullon says, in part because fewer sophisticated investors and Wall Street analysts follow the smaller companies. That leaves more room for significant price increases. And, Dr. Grullon adds, those increases tend to happen gradually because of that same inattention to these stocks, leaving time for investors to take advantage.

Another factor, he says, is that investors differentiate between companies that appear to be engaging in buybacks for short-term reasons and companies that are adding to their long-term value by repurchasing their shares.

Companies that fall into the first category tend to be so-called growth companies, which have plenty of opportunities to invest cash in their growth. The market frowns on such companies if they decide not to invest in those growth opportunities and instead spend their cash on buybacks, Dr. Grullon says.

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Counting on value stocks

The situation is different for value stocks, since they are out of favor and the companies have fewer opportunities to invest in their growth. In such cases, Dr. Grullon says, the action that promises the greatest rate of return may be for these companies to buy their undervalued shares and hope to profit from the market’s eventually pricing the shares more fairly.

Share prices won’t jump every time a company buys back a small-cap value stock, Dr. Grullon says, but his research has found that on average the price will rise.

Among the investment newsletters I monitor, the Buyback Letter (edited by David Fried) comes closest to pursuing this approach to buyback stocks. And, sure enough, its model portfolios have continued to beat the broad market, even as the average buyback stock has struggled in recent years to keep pace with a simple index fund.

Here are the smallest-cap stocks that Mr. Fried has recommended to clients in recent weeks that have particularly low price-to-book ratios, one of the major criteria for determining which stocks fall into the value category: Allscripts Healthcare Solutions (MDRX); Investors Bancorp ISBC -1.88% ▼ (ISBC); Kohl’s KSS -7.84% ▼ (KSS); Myriad Genetics MYGN -2.99% ▼ (MYGN) and PennyMac Mortgage Investment Trust PMT 0.69% ▲ (PMT).

To be sure, the Buyback Letter hasn’t beaten the market in recent years by as much as it has over a longer stretch. Mr. Fried’s average model portfolio has beaten the dividend-adjusted Wilshire 5000 index’s annualized return by 3.7 percentage points over the 20 years through April 30, but by only 1.6 percentage points over the trailing five years.

But that’s still much better than the average buyback stock’s performance. And a statistician cannot at the 95% confidence level conclude that the Buyback Letter’s deterioration in performance is due to anything more than random fluctuation in the year-by-year results. It’s worth noting in this regard that the Buyback Letter over just the past 12 months has beaten the Wilshire 5000 by 4.8 percentage points.

Mr. Hulbert is the founder of the Hulbert Financial Digest and a senior columnist for MarketWatch. He can be reached at reports@wsj.com.

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