

SHAREHOLDER YIELD

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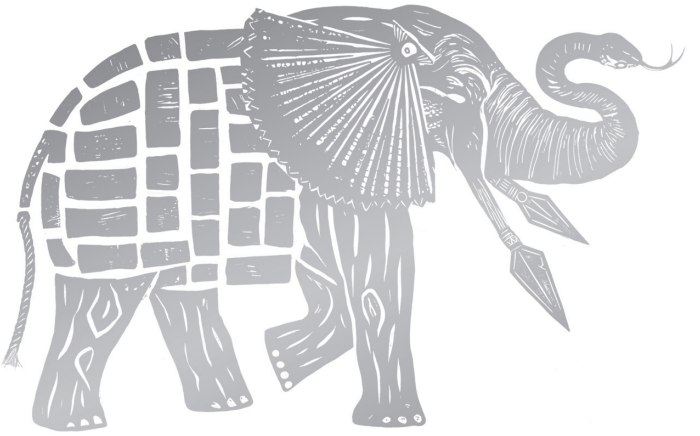
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Second Edition

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NEW AND UPDATED DATA

SHAREHOLDER YIELD



A BETTER APPROACH TO DIVIDEND INVESTING

MEB FABER

UPDATES IN THE 2ND EDITION

A decade has passed since the book's first edition was published in 2013. In this second edition, we update the strategies' performance over the ensuing years and extend the historical simulation another decade into the past.

We even review some academic literature that examines similar portfolios back to the 1800s!

You can find more information and links to resources at www.shareholderyield.com.

You can find more information on shareholder yield ETFs at www.cambriafunds.com

BOOKS BY MEB FABER

The Ivy Portfolio: How to Invest Like the Top Endowments and Avoid Bear Markets

Shareholder Yield: A Better Approach to Dividend Investing

Global Value: How to Spot Bubbles, Avoid Market Crashes, and Earn Big Returns in the Stock Market

Global Asset Allocation: A Survey of the World's Top Asset Allocation Strategies

Invest With the House: Hacking the Top Hedge Funds

The Best Investment Writing Volumes I and II

Every owner of a physical copy of this book can download the eBook for free at mebfaber.com/books

To Anton

CONTENTS

Updates in the 2nd Edition iv

Introduction xi

1. Reinvesting Dividends Has Worked Well Over Time . . 1

2. Investing in High-Dividend Yield Stocks Has Worked Even Better 5

3. Dividends are Only Part of the Picture 7

4. What Are Stock Buybacks? 13

5. Common Buyback Misconceptions 25

6. Stock Buyback Case Studies 55

7. Shareholder Yield 77

8. A Longer Look – Nearly 100 Years of Shareholder Yield 91

9. Shareholder Yield Across Sectors and Industries . . 97

10. Why Does Dividend Brand Persist? The Pepsi challenge 101

11. Practical Implementation – Investing Using Shareholder Yield 105

12. Summary 107

APPENDIX: Stock Factors Mentioned in the Book . . . 111

Acknowledgments 113

About the Author 115

INTRODUCTION

"The Blind Men and the Elephant"
It was six men of Indostan
To learning much inclined,
Who went to see the Elephant
(Though all of them were blind),
That each by observation
Might satisfy his mind.

The *First* approach'd the Elephant,
And happening to fall
Against his broad and sturdy side,
At once began to bawl:
"God bless me! but the Elephant
Is very like a wall!"

The *Second*, feeling of the tusk,
Cried, -"Ho! what have we here
So very round and smooth and sharp?
To me 'tis mighty clear
This wonder of an Elephant
Is very like a spear!"

The *Third* approached the animal,
And happening to take
The squirming trunk within his hands,
Thus boldly up and spake:

"I see," quoth he, "the Elephant
Is very like a snake!"

The *Fourth* reached out his eager hand,
And felt about the knee.
"What most this wondrous beast is like
Is mighty plain," quoth he,
"'Tis clear enough the Elephant
Is very like a tree!"

The *Fifth*, who chanced to touch the ear,
Said: "E'en the blindest man
Can tell what this resembles most;
Deny the fact who can,
This marvel of an Elephant
Is very like a fan!"

The *Sixth* no sooner had begun
About the beast to grope,
Then, seizing on the swinging tail
That fell within his scope,
"I see," quoth he, "the Elephant
Is very like a rope!"

And so these men of Indostan
Disputed loud and long,
Each in his own opinion
Exceeding stiff and strong,
Though each was partly in the right,
And all were in the wrong!

MORAL.
So oft in theologic wars,
The disputants, I ween,
Rail on in utter ignorance
Of what each other mean,
And prate about an Elephant
Not one of them has seen!

JOHN GODFREY SAXE'S (1816–1887) VERSION OF THE FAMOUS INDIAN LEGEND.

This parable originated in India, and while different versions exist in various Buddhist, Hindu, and modern traditions, the general story remains the same. Each blind man touches a different part of the elephant and responds differently when asked to describe his feelings. In the end, the king conveys the moral that, while each opinion may represent a piece of the truth, in isolation from one another, no single perspective reveals the whole story.

What does this have to do with investing? In many cases, whether evaluating a stock or some macro influence on the economy, we must diligently seek other perspectives and consistently question what we are "seeing." Often, only after the fact (and after much devastation to the value of a portfolio) do we realize that we only saw a small piece of the overall picture.

Most research analysts focus on a company's operations – the exciting and sexy part. What new services or products

are companies launching? Consider the excitement around an Apple or Tesla new product reveal, for example.

While operations are certainly important, the role of capital allocation in the company's future success is often overlooked. A book that Warren Buffett recommends examines this understudied topic - *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success* by Thorndike. A quote from the book:

> "CEOs need to do two things well to be successful: run their operations efficiently and deploy the cash generated by those operations. Most CEOs (and the management books they write or read) focus on managing operations, which is undeniably important.
>
> Basically, CEOs have five essential choices for deploying capital – investing in existing operations, acquiring other businesses, paying down debt, or repurchasing stock – and three alternatives for raising it – tapping internal cash flow, issuing debt, or raising equity. Think of these options collectively as a tool kit. Over the long term, returns for shareholders will be determined largely by the decisions a CEO makes in choosing which tools to use (and which to avoid) among these various options. In fact, this role just might be the most important responsibility any CEO has, and yet despite its importance, there are no courses in capital allocation at the top business schools."

This book exposes the reader to certain presuppositions about investing and examines overlooked capital allocation decisions that deserve closer attention. We examine how a company uses its cash flows and the resulting impact on its stock and ponder the question concerning dividends: "Is this the whole picture, or am I only holding the elephant's trunk?"

CHAPTER 1

REINVESTING DIVIDENDS HAS WORKED WELL OVER TIME

Dividends and their reinvestment represent a major portion of a stock investor's total return over time. An examination of equity returns in the United States from 1871 illustrates this property. An investor in US stocks would have realized a 9.16% compound return from 1871 – 2023. However, excluding dividends and their reinvestment would have reduced the portfolio's compound return to 4.67% a year, demonstrating that reinvested dividends represent over half of an investor's annualized returns over the period. While most investors focus myopically on stock price gyrations, dividends are the slow but steady engine that drives returns over time.

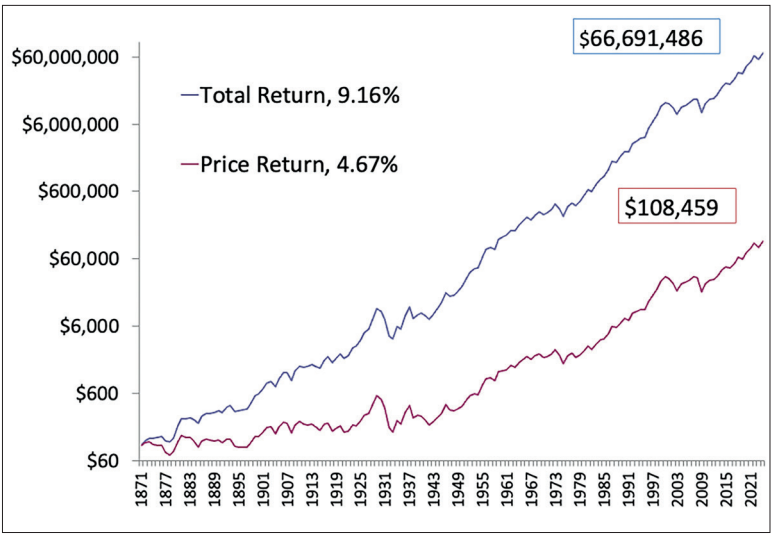
Analyzing the final value of a portfolio invested in US stocks since 1871 reinforces this view. Figure 1 demonstrates that if one had invested $100 in 1871 in the price return index, by the end of 2023, it would have compounded to $108,459 (gross of fees, transaction costs, and taxes). When we consider the total return portfolio, which reflects price return and dividend reinvestment, the ending value jumps to $66,691,486, a 600-fold improvement!

Many investors fantasize about sitting on a beach, sipping pina coladas, and letting the passive income streams flow in. However, this total return for stocks requires the investor to reinvest all dividends. Academic research reveals that most investors use their dividends for other purposes (like vacationing and slurping pina coladas), reducing the portfolio's total return.

If companies didn't pay dividends, the entire return would be reflected in the price return and should match the total return of 9.16%. But this scenario is hypothetical and not the world we live in.

The takeaway is simple: Reinvest your dividends if you want to realize total equity returns!

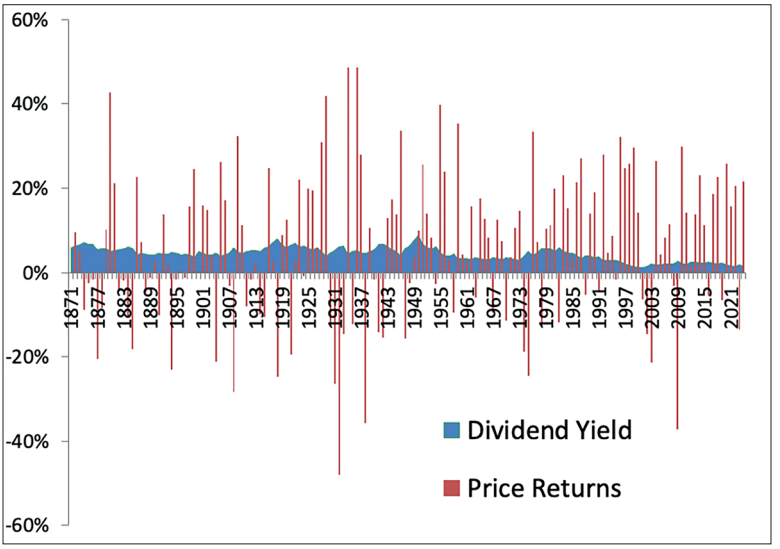
FIGURE 1 – US Stocks, Total Return vs. Price Return, 1871–2023.



Source: Shiller. Data before 1926 are based on Cowles "Common Stock Indexes". Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results.

While reinvested dividends have historically proven to be a major factor in determining a portfolio's final value over long periods, price movements dominate the volatility of the returns in the short term. Large price swings have enormously impacted returns for time frames ranging from one year to a decade. Figure 2, below, shows price returns (red lines) and the dividend yield (blue line) by year since 1871, and the variability of the price returns swamps the steady dividend yield returns.

FIGURE 2 – US Stocks, Dividend Returns vs. Price Returns, 1871–2023.

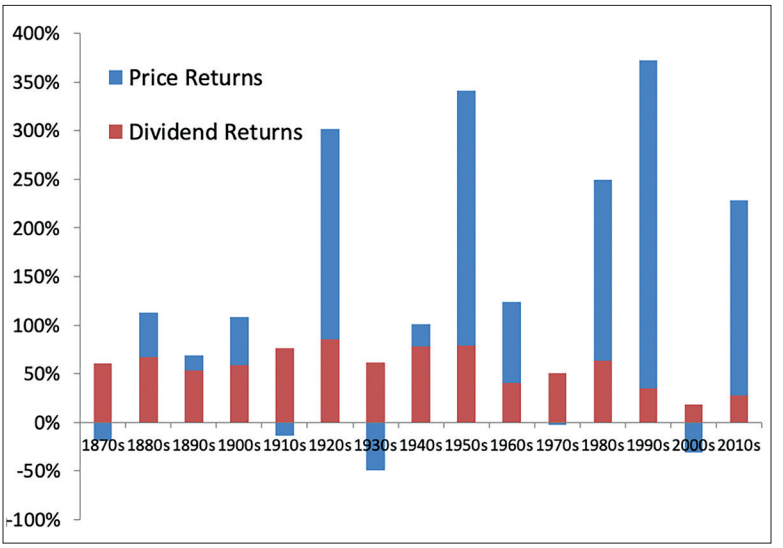


Source: Shiller. Data before 1926 are based on Cowles "Common Stock Indexes". Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results.

In Figure 3, price movements still dominate total returns even at longer time frames. Price-to-earnings (P/E) ratio expansion positively impacted total returns in the 1920s

and 1990s, while the reverse occurred in the 1930s and 2000s. Even the steady contribution of dividends could not prevent the equity markets from experiencing negative total returns in the 1930s and 2000s.

FIGURE 3 – US Stocks Dividend Return and Price Return by Decade, 1871–2020.



Source: Shiller, Author, Data before 1926 are based on Cowles "Common Stock Indexes". Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results.

Many investors go a step further and select stocks based on their dividend characteristics. The next section will examine strategies for selecting dividend stocks and their historical performance.

CHAPTER 2

INVESTING IN HIGH-DIVIDEND YIELD STOCKS HAS WORKED EVEN BETTER

While reinvested dividends contribute a major portion of stock market returns over time, research also indicates that higher-yielding dividend stocks have performed better than stocks with little to no yield.

Elroy Dimson, Paul Marsh, and Mike Staunton published "Global Investment Returns Yearbook 2023", in which they studied US stocks from 1927 to 2023. They found that the highest 30% of dividend yielders returned 11.2% vs. 9.7% for low yielders and 9.0% for no yielders.

They completed an even longer study on UK stocks. They sorted the 100 largest UK stocks from 1900-2023 into high- and low-yield portfolios and found that the compound returns were 10.4% and 7.8% per year, respectively.

Historically, dividend stocks outperform the broad stock market likely because they provide a value "tilt." This means that, on average, high-yield dividend stocks trade at a valuation discount to the broad stock market. High dividend-yielding stocks also come with some other characteristics and,

on average, are "junkier" companies with more debt. The characteristics can wax and wane over time, but on average, high dividend-yielding stocks usually come with cheaper valuations. (Perhaps equally important, narrowing stock selections to this subset of cheaper stocks, by definition, avoids investing in the more expensive stocks.)

Much more ink has been spilled across academic and professional publications validating similar findings that can be found on shareholderyield.com.

There are countless websites and groups devoted to dividend investing. Many readers will have heard of strategies such as "Dogs of the Dow" or the "Dividend Aristocrats."

In their recent report, "Searching for Great Dividend Funds," Morningstar estimates that 348 open-end mutual funds and ETFs manage over $1 trillion focused on dividend strategies. That's cuatro commas for those counting at home.

Investors may love dividends, and high-yielding dividend stocks have historically outperformed the market. So why are we about to slay this sacred cow?

Because the world has changed.

CHAPTER 3

DIVIDENDS ARE ONLY PART OF THE PICTURE

Now that we have demonstrated the long-term evidence that reinvesting dividends is crucial and that investing in dividend-paying stocks has led to outperformance, we want to shift gears and caution investors not to consider dividends in isolation, contently believing the elephant to be a rope.

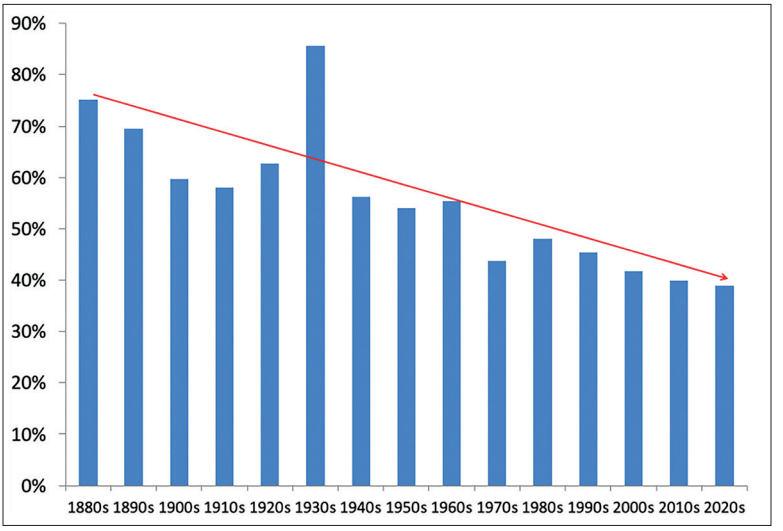
One of the most essential qualities of a successful investment analyst is the ability to adapt to change. Far too many investors adhere to their approach with a religious zeal, whether it is value investing, crypto trading, or good old buy-and-hold indexing. For those investors who are proponents of investing in dividend stocks, we ask you to keep an open mind.

It is very important to be cognizant of structural changes in markets. While some truths seem inherent to the market's nature (highly volatile, large outliers, bubbles, booms, and crashes), others can change based on government policy updates and macro factors.

Investors love to quote John Maynard Keynes, who famously stated, "When the facts change, I change my mind. What do you do, sir?"

One structural change in the stock market is that companies currently pay out a lower percentage of their earnings in cash dividends than in the past. As seen in Figure 4, while companies historically paid out, on average, over 60% of their earnings as dividends, this figure has been declining consistently for the past seventy years and currently sits around 40%.

FIGURE 4– US Stocks Dividend Payout Ratio per Decade, 1880–2020.

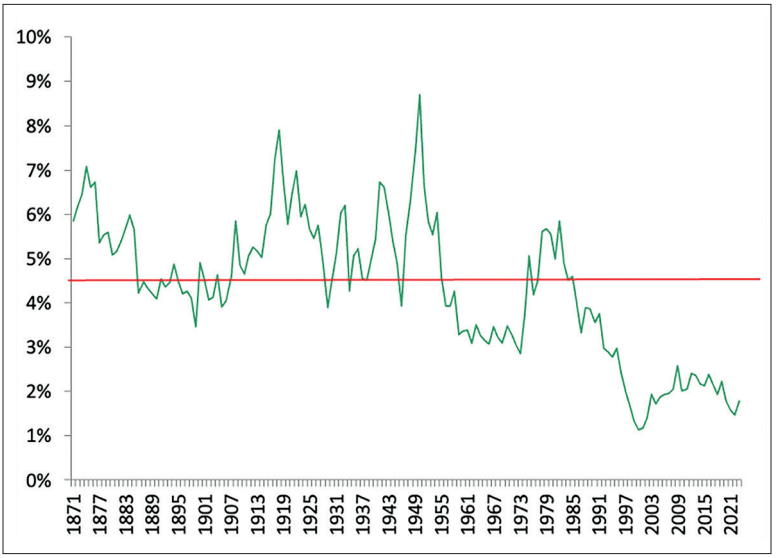


Source: Shiller. Data before 1926 are based on Cowles "Common Stock Indexes". Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results.

This trend has resulted in the dividend yield on stocks declining to all-time lows in the past decade, as seen in

Figure 5. The red line represents the average yield over the period, approximately 4.5%. The current yield of approximately 1.3% is not too far from the all-time low yield of 1.1% during the dot-com bubble.

FIGURE 5 – US Stocks Dividend Yield, 1871–2023.



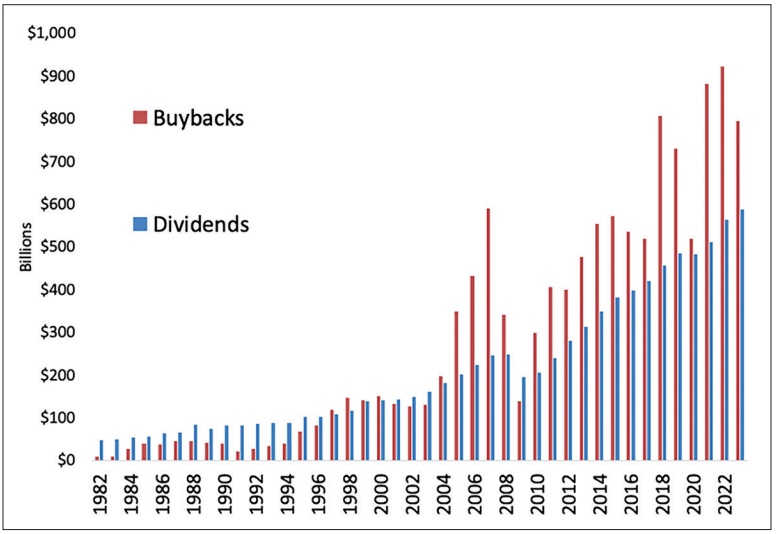
Source: Shiller. Data before 1926 are based on Cowles "Common Stock Indexes". Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results.

When examining any fundamental shift in markets, we must analyze why the change occurred. Why are companies paying out less in cash dividends?

One reason is the SEC instituting rule 10b-18 in 1982, which provided a safe harbor for firms conducting repurchases from stock manipulation charges. A noteworthy paper on

trends in corporate payout policy is "Dividends, Share Repurchases, and the Substitution Hypothesis" (2002) by Grullon and Michaely. Once the government made it easier for companies to buy back their stock, buybacks became increasingly prevalent. Figure 6 below details how stock buybacks went from nearly nothing to equaling or surpassing cash paid out as dividends in the late 1990s.

FIGURE 6 – US Stocks, Dividends and Buybacks, 1988 -2023.

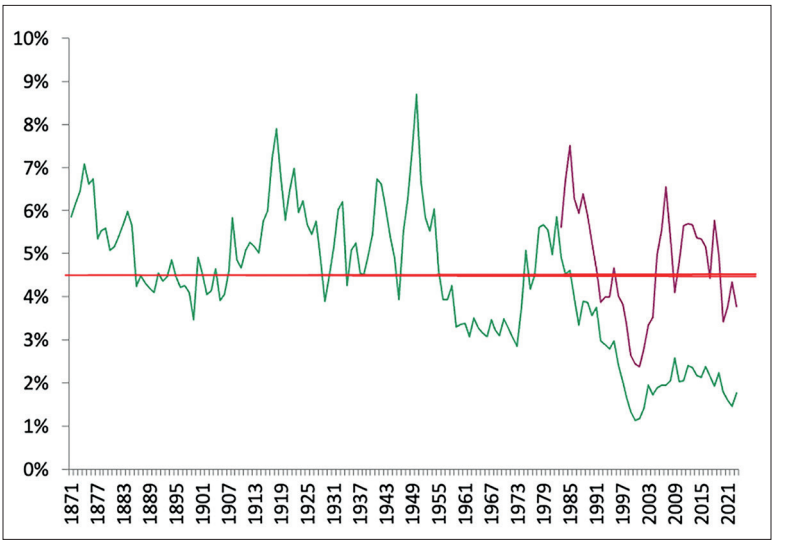


Source: Standard and Poor's.

While companies have paid out less in cash dividends, when including stock buybacks, it becomes clear that the aggregate amount has stayed relatively constant. If you chose to ignore stock buybacks you may come to incomplete conclusions by focusing on dividends alone.

In Figure 7 we show the dividend yield plus buyback yield on stocks.

FIGURE 7 – US Stocks, Dividend Yield vs. Dividend + Buyback Yield, 1871 – 2023.



Source: Standard and Poor's.

Once you examine the combination of dividends and buybacks, then the picture shifts significantly. Rather than paying out any less aggregate cash flows to their shareholders, companies have changed the distribution method to include both.

While it is obvious that share buybacks began outpacing dividend payments in most years beginning in the late 1990s, we need to understand why.

Why might companies choose to buy back stock rather than payout cash dividends?

First, let's pause for a moment. Stock buybacks are one of the most emotional investing topics.

NYU Professor Aswath Damodaran calls dividends and buybacks "perhaps the most misunderstood and misplayed element of corporate finance."

Even Warren Buffet has described those who opposed buybacks as "economic illiterates" and "silver-tongued demagogues."

Before we move on, let's take some time to understand exactly what stock buybacks are and how they work.

CHAPTER 4

WHAT ARE STOCK BUYBACKS?

Professor Ken French comments that "buybacks are divisive. They divide those who understand corporate finance from those that don't."

Let's ensure we're all on the same page before continuing. We'll start with a simple example.

Let's say you have a company worth $100. If the company pays a 10% cash dividend, it gives the shareholders $10. The shareholders now have $10 cash and a company worth $90.

Makes sense. Let's repeat with buybacks.

Let's say you have a company worth $100. If the company buys back 10% of the stock, it gives the selling shareholders $10. The selling shareholders now have $10 cash and a company worth $90.

It's the exact same thing.

If a stock trades at its intrinsic value, then a cash dividend and a stock buyback are identical.

Full stop. That is finance 101. Many investors do not fully grasp this very basic truth.

What about the shareholders who chose not to sell any stock? Post-buyback, they now own a larger percentage of the company, and we discuss this further below.

One way to test if you are biased against stock buybacks is to read a newspaper article or quote, but every time you see the word "dividend," replace it with "buyback" or vice versa. Does it change how you feel? It shouldn't.

So, if there is no difference, why have share buybacks outpaced dividend payments beginning in the late 1990s? Why might companies choose to buy back stock rather than payout cash dividends?

Let's examine a few reasons.

STOCK BUYBACKS CAN BUY A DOLLAR FOR $0.80.

The key difference between buybacks and dividends boils down to one phrase.

What is the stock worth?

No one understands stock valuation and capital allocation better than Warren Buffett. Berkshire Hathaway only paid a dividend once in its history, in 1967, and Buffett famously

said that he "must have been in the bathroom when the dividend was declared."

When asked in 1998 about paying another dividend in the future, Buffett responded to the audience at the University of Florida, "The question is about evaluating Berkshire when it doesn't pay any dividends. And it won't pay dividends, either. That's a promise I can keep. All you get with Berkshire stock is that you can stick it in your safe deposit box, and every year you take it out and fondle it."

Presumably, Buffett believes that he has better capital allocation skills and investment opportunities than returning money to shareholders through dividends, and he has remained true to his word.

In times when the underlying stock trades at a discount to intrinsic value, buybacks are a favorable use of cash.

He penned in a 1984 letter to shareholders, "When companies with outstanding businesses and comfortable financial positions find their shares selling far below intrinsic value in the marketplace, no alternative action can benefit shareholders as surely as repurchases."

This insightful quote is particularly impressive when you note it was from 40 years ago!

One more recent quote, this time in the 2023 Berkshire annual report, reads as, "All stock repurchases should be

price-dependent. What is sensible at a discount to business-value becomes stupid if done at a premium."

Warren's late partner Charlie Munger was also a fan of buybacks. In his typical witty fashion, Munger advised investors to "look for the cannibals"—meaning companies eating themselves with a consistently declining share count.

While Berkshire has avoided paying dividends, Warren and Charlie have bought back boatloads of stock over the years.

CNBC just reported in the summer of 2024 that "Over the past five and a half years (22 quarters), [Berkshire Hathaway] has repurchased nearly $75 billion worth of its common stock, eliminating more than 10% of the company's total shares outstanding, according to Greggory Warren, Berkshire analyst at Morningstar."

Buffett shared more thoughts on stock buybacks in his 2021 annual letter to shareholders, writing, "Through that simple act, we increase your share of the many controlled and non-controlled businesses Berkshire owns. When the price/value equation is right, this path is the easiest and most certain way for us to increase your wealth."

The entire discussion of stock buybacks would be easier if this stock fair value metric was known with certainty. If you could say that one stock is 50% undervalued and another is 150% overvalued, the debate would be simple. For a moment, let's assume we can tell an overvalued stock from an undervalued one with reasonable confidence.

If a company buys back shares and the stock is *overvalued*, the company and the remaining shareholders transfer value to the selling shareholder. If the stock is *undervalued*, the person selling shares transfers value to the company and the remaining shareholders.

Warren Buffett has a better way of saying it in his 2021 letter to shareholders:

"Indeed, disciplined repurchases are the surest way to use funds intelligently: It's hard to go wrong when you're buying dollar bills for 80¢ or less."

We believe a great CEO should do the opposite as well. If they believe their stock is wildly overvalued, they should consider issuing shares to the market. They should consider buying shares if they believe their stock is a screaming bargain.

Surprisingly to many, it turns out that is exactly what CEOs do on average. They are pretty good at valuing their company and acting in their best interest. For example, Buffett has a good, objective process: He originally stated that he would buy back stock if Berkshire traded below intrinsic value measured at around 1.1-1.2 times book value. A quantitative, systematic process is preferable to a megalomaniac CEO who always believes their stock is cheap. We'll cover this in more detail in an upcoming chapter.

Returning to our conversation about why share buybacks have outpaced dividend payments in recent years, another reason is taxes.

STOCK BUYBACKS ARE TAX EFFICIENT DIVIDENDS

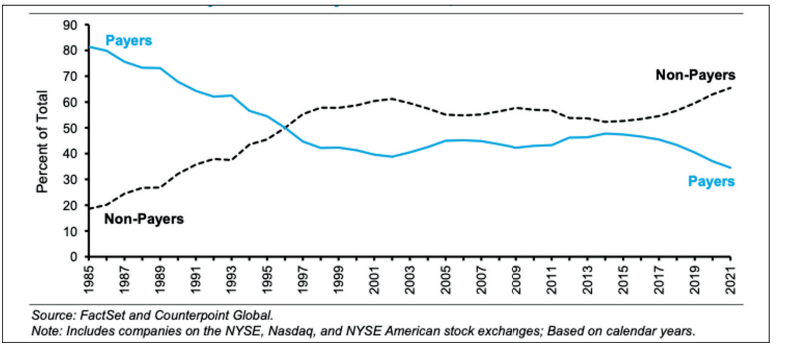
Hypothetically, investors shouldn't care whether their returns come from dividends or capital gains (the Modigliani-Miller theorem). This approach assumes a tax-neutral investor when most investors are highly sensitive to tax treatment. While tax rates fluctuate with the political seasons, it has often been the case that dividends taxed as ordinary income have had inferior tax treatment to long-term capital gains that historically carry lower rates.

If you're a shareholder and love the business and the stock, the last thing you want is for the company to return your money. Even worse than that is the company giving you your money back AND having to pay taxes on the dividend.

This is one reason Damodaran has stated that you could rebrand buybacks as "tax-efficient dividends."

In about half of the past fifty years, dividends have been taxed at higher rates than long-term capital gains, apart from 1988-1997 and 2003- present. While this disadvantage was improved by the Bush tax cuts and 2013 update, and while some foreign countries do not have inferior tax treatment for dividends, the number of companies paying dividends has, nonetheless, declined from nearly all to around 30%.

FIGURE 8 – Dividend Payers and Non-Payers in the U.S., 1985–2021.



Source: Michael Mauboussin, Capital Allocation, Morgan Stanley, 2022

A paper by Jacob and Jacob (2011), "Taxation, Dividends and Share Repurchases: Taking Evidence Global," examines 6,416 companies across 25 countries and finds that relative tax rates are hugely important. They state, "Our results show that dividend and shareholder taxation are important determinants of corporate payout internationally in the past 20 years. In countries and years where dividends are taxed favorably relative to capital gains, firms are more likely to pay dividends, and the amount of dividends is greater. Conversely, in countries and years in which capital gains receive preferential tax treatment over dividends, firms are more likely to repurchase shares to pay out cash to investors." Another concise summary of dividend-paying stocks is the 2001 French and Fama paper "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?"

However, both cash dividends and stock buybacks are taxed multiple times. Cash dividends are taxed when the

company makes a profit, then when the cash dividend is issued, plus the 3.8% Medicare tax. Buybacks are taxed when the company makes a profit, then when the buyback is made (as a shareholder is selling the stock), plus the 1% surcharge buyback tax, plus the 3.8% Medicare tax. They're both often taxed at the state level too. Uncle Sam will not be denied!

In general, investors want to avoid paying taxes if they can. Stock buybacks give investors that choice.

STOCK BUYBACKS ARE FLEXIBLE DIVIDENDS

In our example above, the investor received a $10 cash dividend whether they wanted to or not. If the investor liked the stock, which is a safe assumption given ownership, he/she would most likely reinvest the dividend (after paying Uncle Sam). This would be annoying at best and a value destroyer at worst.

However, if the company were instead doing a share buyback, the investor would have the choice to take the payout. The investor will receive the same $10 as the cash dividend investor if they sell the stock. If they like the stock, they don't have to sell and instead increase their ownership stake. The key is choosing when to take the cash.

For taxable investors, this matters. If a company never pays a cash dividend or buys back stock, investors can always

create their own "synthetic dividend" by selling the same percentage of the stock—in this case, 10%.

Dividends tend to be steady from year to year, whereas buybacks, on aggregate, bounce around a lot more and are about five times more volatile. Cutting or eliminating a dividend is seen as a signal to investors that all is not right at corporate headquarters. CEOs can be more tactical with stock buybacks.

STOCK BUYBACKS NEUTRALIZE OPTIONS DILUTION

Another reason CEOs buy back stock is to reduce the dilution from options issuance. In his book "Stock Buybacks: The True Story," Ed Yardeni speculates that most stock buybacks are intended to offset the dilution from employees exercising their stock options.

This pushes back against the anti-buyback narrative, suggesting that buybacks are engineering intended to artificially inflate a stock price (more on this in the next chapter). Yardeni suggests that most buybacks by S&P 500 companies are intended not to goose earnings per share for optics but to offset this type of employee compensation. As such, these buybacks are an effective way to retain top talent for the company while maintaining a stable earnings per share number that isn't artificially lowered by the stock issuance.

In this discussion, it's important to recognize how employee compensation packages have increasingly included stock options over the last 20 years. A 2023 paper from Morgan Stanley titled "Stock-Based Compensation Unpacking the Issues" concluded: "Public companies in the U.S. have increasingly switched from paying their employees in cash to paying them with stock. Stock-based compensation (SBC) in 2022 was nearly 5 times what it was in 2006, measured as a percentage of sales, although total SBC remains less than 10 percent of total employee pay."

"There are sensible motivations for this shift. SBC helps finance the firm by substituting equity for cash, can provide an incentive for employees to deliver results, is a tool for retaining workers, and can be a means to foster an overall sense of ownership. Companies can use SBC appropriately or inappropriately, as is true of all capital allocation decisions."

Meanwhile, in his 2024 paper "Which One Is It?" Michael Mauboussin writes, "Stock-based compensation has been the second largest source of equity issuance in the last quarter century. SBC as a percent of sales for companies in the Russell 3000, an index that measures the performance of roughly 3,000 U.S. stocks and represents nearly all of the investable equity market…went from 0.2 of sales in 2006 to 1.3 of sales in 2023. The compound annual growth rate was 15.3 percent for SBC and 3.8 percent for sales. The dollar sum of SBC rose from $26 billion in 2006 to $290 billion in 2023."

Through this lens, share buybacks can effectively balance the shifting landscape of corporate culture, shareholder interests, and a dynamic labor market in which competition for top talent is fierce and stock-based compensation is often expected.

STOCK BUYBACKS CAN HELP PREVENT BAD BEHAVIOR

Quick question – what do you do with the dividend income you receive? Do you spend it on vacations and travel, or perhaps you view it as a supplemental income to your day job?

As mentioned previously, the historical long-term average of roughly 10% per year stock returns are only realized if you reinvest your dividends. Academic research shows that the average individual does not reinvest their dividends.

One benefit of buybacks is that they are golden handcuffs for mom-and-pop investors, potentially keeping more money invested. It's a lot harder to actively sell an investment to generate cash than to receive an automatic dividend, and it's a lot easier to spend money in the bank if it's there in the first place.

Now that we have defined stock buybacks and discussed why they've become popular with corporate managers in recent decades let's clear up some confusion and popular myths.

CHAPTER 5

COMMON BUYBACK MISCONCEPTIONS

Over the last decade, criticisms against share buybacks have intensified.

It's understandable. The broad public largely misunderstands share buybacks, so they're an easy lightning rod for politicians, journalists, and investment gurus who benefit from an "us versus them" dichotomy.

But how many of these attacks are true or rooted in truth compared to those that are purely myth? Below are a handful of the most common buyback myths. Let's take some time to walk through them and find out.

MYTH: BUYBACKS WERE ILLEGAL BEFORE THE 1980S.

"Prior to 1982, stock buybacks were considered illegal stock manipulation, but President Reagan's Securities and Exchange Commission implemented a rule to exempt them... It's time to put a stop to this greed." – California Congressman Ro Khanna.

The idea that corporate stock buybacks were illegal before the SEC's Safe Harbor Rule 10b-18 in 1982 is a popular myth. Yet, it's wholly inaccurate.

As Jason Zweig wrote in *The Wall Street Journal*, "To call this argument baloney would be an insult to cold cuts. When American companies began repurchasing shares from their investors, Alexander Hamilton was treasury secretary—and corporations have been buying back stock, often a little and sometimes a lot, ever since."

Zweig walks through examples showing how share buybacks have dotted the American corporate landscape for 200+ years. As one illustration, in 1798, the Pennsylvania Legislature granted a corporate charter to the Germantown & Reading Turnpike Road Co. based on the condition that the company would buy back as many shares of its stock as possible if profits remained after a 9% annual dividend.

In the late 18th and early 19th centuries, stock buybacks weren't just legal, they were required in some cases. As Zweig explains, "[Mandatory stock buybacks] appear to have been intended to keep management from pocketing or wasting the public's wealth.

"Anything that kept profits from piling high in a company's coffers could help deter managers from stealing, squandering, or abusing their power. That would have made buybacks beneficial—a view many investors, analysts and economists still hold today."

We can also debunk this myth from a media perspective. If share repurchases were illegal prior to the early 1980s, why did the *Harvard Business Review* publish a series in 1965 debating share buybacks?

Because they weren't illegal. Between 1954 and 1963, more than half of the companies on the New York Stock Exchange (53%) bought back shares.

For more evidence, here's Leo Guthart from *Financial Analysts Journal*, Vol. 23, No. 2 (Mar. – Apr., 1967): "The number of large, well-known companies listed on the New York Stock Exchange that have been buying back their own common stock has been increasing rapidly in the recent past."

The below quote is from a 1971 review of the book *The Repurchase of Common Stock* by Charles D. Ellis:

"Repurchasing of common stock is undertaken with such frequency and volume that it is sure to impact corporations, individual investors, and the securities market. To ignore repurchasing is to omit a significant element of corporate financial policy."

While share buybacks weren't as popular with corporate managers in the late-1960s and 1970s, that doesn't mean they didn't occur. Zweig points out that between 1971 and 1984, Teledyne Inc. bought back 90% of its stock. This happened under Chief Executive Henry Singleton, also known as "the smartest businessman I ever knew" by Charlie Munger.

Bottom line: Though the myth that share buybacks were illegal before the early 1980s remains popular today (especially amongst politicians), it's false nonetheless.

MYTH: CEOS ALWAYS THINK THEIR STOCK IS CHEAP AND WASTE MONEY BUYING BACK SHARES WHEN IT IS OVERVALUED.

"*Investors should be furious: 3 blue-chip stock buybacks that went horribly wrong*" – *CNBC* headline, 2018

The media and politicians love to focus on CEOs who buy back stock only to see the share price decline.

Somehow, such a mistimed purchase is supposed to reflect poorly on the concept of a share buyback itself. Of course, that's about as logical as characterizing a vehicle as nothing but a tool of destruction, ignoring the inexperienced teenage driver who steered it into the telephone pole.

Nevertheless, many people respond with glee when corporate stock buybacks appear to be mistimed. One illustration is the *CNBC* article from 2018 cited above, "Investors should be furious: 3 blue-chip stock buybacks that went horribly wrong."

From the article: "Now with stocks off their highs and many in bear market territory — a decline from an all-time high of 20 percent or more — it is becoming clearer that corporate treasurers are as bad as everyone else is when

it comes to market timing. In fact, the buyback effect on stocks is waning, as evidenced by two popular exchange-traded funds that track buyback indexes."

You can always find an example of a stock buyback that, with the benefit of hindsight, appears poorly timed. But here are five points on this.

First, from the investor's viewpoint, this myth is funny as we usually respond with the simple question: "Why are you buying overvalued stocks in the first place?"

Second, most CEOs know when their stock is selling at attractive or unattractive prices for buybacks, and they act accordingly. As just one example, take JPMorgan Chase's CEO Jamie Dimon, from May of 2024:

"I want to make it really clear, OK? We're not going to buy back a lot of stock at these prices. Buying back stock of a financial company greatly in excess of two times tangible book is a mistake. We aren't going to do it."

Now, a skeptic might argue that Dimon is an outlier. And according to surveys most CEOs believe their stock to be cheap.

But that brings us to our third and weightiest point - Is it a case of "watch what I say" or "watch what I do"? Do studies conclusively show that corporate managers consistently mistime their share buybacks, paying high prices that destroy value in the process?

No.

Let's begin with the study, "Do Firms Buy Their Stock at Bargain Prices? Evidence from Actual Stock Repurchase Disclosures" from Ben-Rephael, Obed, and Wohl, as published in the *Journal of Financial Economics*, 2011. In the paper's abstract, the authors' write, "Using new monthly data we investigate open-market repurchase executions of US firms. We find that firms repurchase at prices which are significantly lower than average market prices. This price discount is negatively related to size and positively related to market-to-book ratio. Firms' repurchase activity is followed by a positive and significant abnormal return."

The same conclusion is corroborated by the study, "Can managers time the market? Evidence using repurchase price data" from the *Journal of Financial Economics*:

"Using a data set of all U.S. repurchases from 2004 to 2011, we compare the actual average price paid monthly in a repurchase with the average market price for the same stock over various horizons. We find that firms repurchase stock at a significantly lower price than the average market price in all sample years. Less frequent repurchasers, firms that repurchase when insiders buy on their own account, and firms that experience low stock returns prior to the repurchase obtain significantly lower prices. After controlling for risk factors, repurchasing firms earn positive returns. Infrequent repurchasers earn a significantly higher return up to three years following the actual repurchase."

Now, an astute reader might argue, "The prior two studies merely suggest that repurchases tend to transact at prices lower than average market prices. However, that doesn't mean those prices are actually discounted prices that create value for shareholders. They can be lower than average market prices and yet still be too expensive for buybacks to be a wise use of capital."

That's a fair point, and at the heart of it is the concept of intrinsic value that we've discussed in prior chapters. Of course, intrinsic value isn't a clean, black-and-white calculation that's easily quantified for every firm. So, as a proxy, let's look at buybacks through the lens of "cheap" to "expensive" quintiles. To helps us with this, we'll turn to O'Shaughnessy Asset Management (OSAM).

In 2015, OSAM published the research piece "High Conviction Buybacks." A low conviction buyback represented times in which management bought back only between 0% and 5% of its shares in any given year. High conviction buybacks reflected when management purchased more than 5% of its shares in a single year, sometimes even greater than 10%.

OSAM's study finds, "A common criticism levied against buybacks is that corporate managers mistime their repurchases, buying back stock at expensive prices. But this hasn't been true for the high conviction buyback firms."

"Since 1987, roughly half of all high conviction buybacks conducted by large U.S. firms were conducted when the

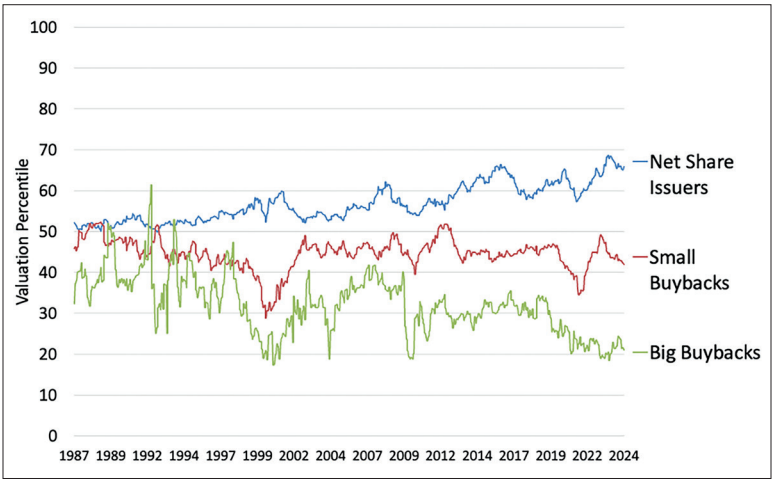
firm's stock was in the cheapest quintile of all large stocks; fewer than ten percent of high conviction buyback firms bought back shares when they were in the most expensive quintile of the market."

"The same numbers for low conviction firms? Only 28 percent bought back shares while their stock was in the cheapest quintile and roughly 20 percent bought back shares in the most expensive quintile."

Translating this, there simply isn't a valid argument that CEOs are routinely overpaying for their own shares – especially when conducting a high-conviction buyback.

Here's the visual of O'Shaughnessy's data.

FIGURE 9 – US Stocks, Average Valuation Percentile, Net Share Issuance & Buyback Conviction, 1986–2024



Source: OSAM, 2024

Now, might a select few CEOs pay too much? Absolutely. We'll look at an example in our following chapter on buyback case studies.

Yet, that in no way makes it fair, let alone accurate, to generalize and claim that most stock repurchases are executed at lofty, value-destroying prices.

Moving on, for our fourth point, proponents of this myth are forgetting something important: there's no shot clock or "game over" in investing. This means that what might appear to be a poorly timed stock buyback today could prove to be a brilliantly timed buyback tomorrow.

For example, let's return to *CNBC*'s polemic from earlier: "Investors should be furious: 3 blue-chip stock buybacks that went horribly wrong." One of the companies it attacked for its buyback timing was IBM. The article reads, "IBM spent an eye-popping $83 billion on buybacks after the Great Recession, according to S&P Dow Jones Indices. A lot of those purchases were funded with cheap debt..."

"With IBM's stock down over 20 percent this year and having been stagnant for years, the company could have used its cash much earlier during a difficult transition from mainframe technology to open-source software, cloud computing and artificial intelligence."

CNBC published this article on December 11th 2018. So, did IBM's price continue to "stagnate" as the author lamented?

No. As of the summer of 2024, IBM's total stock return has risen over 100%.

Through this lens, the argument of the anti-buyback crowd weakens substantially. Repurchasing shares prior to a bull run that doubled IBM's stock seems to be rather fortuitous timing. At a minimum, it opens debate as to whether the timing was awful.

Now, one could argue that IBM's managers could have transacted at lower purchase prices in the years that followed the Great Recession. But the core issue isn't about nominal price. It's about valuation. So, you'd also have to make the point that the transactions occurred at inflated, value-destroying prices.

However, if we use IBM's price-to-earnings ratio as a loose guide, that's not what we find. For context, IBM's average P/E ratio over the 10 years leading up to 2018 was 13 according to YCharts.com.

At a minimum, we can conclude that IBM wasn't aggressively and consistently purchasing its own stock at valuations that were sky high.

Might IBM have better-timed its share repurchases?

Potentially. But if that's your position, your primary grumble is that IBM's managers don't have perfect clairvoyance. Who does?

Let's move to our fifth and final point.

To the extent that corporate managers have, in fact, bought back shares at the alleged "wrong time," consider one likely explanation – and then consider an alternative.

When the economy is performing strongly, businesses usually generate more free cash flow to allocate to various business initiatives and/or dividends, buybacks, debt reduction, etc. At such robust points in the business cycle, the stock market often trades at higher relative prices, reflecting the healthy condition of the economy and the more optimistic sentiment of the consumer/investor.

But fast forward to a downturn. When the economy stumbles, businesses usually generate less free cash flow. Meanwhile, the stock market typically pulls back, reflecting the reduced earnings generated during the challenging business conditions, as well as bearish investor sentiment.

Through this lens, it makes sense that some corporate managers would buy back shares at higher prices – not because they're incompetent or intentionally manipulative – but because that's when these managers have more cash flow on hand to make such purchases. Likely, more stock-based options will be in the money and implemented as well.

But here's the question to the anti-buyback crowd about to pounce on this as "no excuse!".

If that corporate manager chose to stuff the extra free cash flow under the proverbial mattress, waiting to execute a share buyback until the economy and market had pulled back substantially, would the anti-buyback camp applaud that as a wise decision?

Or would they villainize the CEO for allocating cash to buybacks during a down economic cycle in which workers were likely being laid off, bonuses suspended, and/or new hiring frozen?

We have our suspicions.

In any case, the idea that corporate managers always buy back shares at the wrong time is unfair, highly generalized, and unfounded.

MYTH: COMPANIES ARE SPENDING SO MUCH BUYING BACK STOCK THEY'RE NOT REINVESTING IN THEIR BUSINESS OR HIRING MORE PEOPLE OR PAYING THEM MORE.

"Stock buybacks create a sugar high for the corporations. It boosts prices in the short run, but the real way to boost the value of a corporation is to invest in the future, and they are not doing that." – Senator Elizabeth Warren

Are U.S. corporations opting to enrich their shareholders at the expense of growth and/or their workers?

You would arrive at this conclusion if you listen to many of our politicians. But here again, this is a myth that might offer some emotional appeal, yet crumbles when honestly investigated.

Proponents of this myth are forgetting something: Companies are generating more profits and cash than they have in years past, so R&D is getting its fair share of the pie.

As we dig into the data surrounding this, let's begin with Goldman Sachs' 2019 paper, "Buyback Realities". It reads, "To start, William Lazonick, professor at University of Massachusetts, lays out several concerns about buybacks driving the public debate. At their core is the notion that returning cash to shareholders comes at the expense of investment. This, in turn, harms innovation as well as American workers, who, Lazonick argues, should be getting a much larger share of company profits than shareholders..."

"But, when looking at the numbers, GS US portfolio strategists David Kostin and Cole Hunter find many of these arguments don't hold up in reality. In particular, they emphasize that even as companies return a large amount of cash to shareholders, there is sizable reinvestment; in fact, growth investment at S&P 500 companies has accounted for a larger share of cash spending than shareholder return every year since at least 1990, with the largest share repurchasers far outpacing market averages in growth of R&D and capex spending."

Goldman goes on to point out that capital expenditures and R&D have also been stable over time. In the three decades prior to the timing of Goldman's study, corporate cash allocated to capex and R&D consistently equaled about 8% of sales.

Goldman Sachs isn't the only outfit arriving at the conclusion that buybacks aren't crowding out growth initiatives or spending on capex. Here's Cliff Asness, co-founder of AQR Capital Management, with "Buyback Derangement Syndrome" as written in *The Wall Street Journal*:

"The lead accusation against buybacks is that they 'starve investment.' We can look at aggregate investment directly, examining the investing section of the statement of cash flows for all companies in the Russell 3000. Normalized by either total assets or total market capitalization (debt plus equity), net investment is lower than it was in the 1990s but positive and much higher than during the 2008 financial crisis. Yet the lack of a precipitous decline in investment doesn't stop critics from complaining about 'investment-less growth.'"

Next up, the Man Group tackled this "crowding out" myth in 2018. After debunking it for private companies, it turned to public corporations and their allocation to capital expenditures.

From its report, "Stock Buybacks: Freeing the Invisible Hand, or Legitimising the Fat Finger":

"In the realm of public markets, the data also argue against this criticism. We show the typical representation of recurring capital intensity, capex to sales. The latest data point as of December 2018 is 6.3%, only marginally below the average of 6.6% from 1990 (longest time horizon of available data)."

"Bottom line: We see no consistent, sustained evidence that money that would be allocated R&D and cap ex spend is being redirected to share buybacks, at the expense of corporate growth."

Finally, how does this discussion look through a global lens? Is the US woefully lacking in R&D spending relative to the rest of the world?

Quite the opposite. The US remains the world leader for corporate R&D spend at 42% of the global total, vs. Europe (18%), China (18%), and Japan (9%). The US was at a third of global R&D spend a decade ago.

Yet again, there's very little meat to this attack on buybacks.

Now, there's a different yet related point to make in this discussion.

A return of capital to investors through share buybacks is a more efficient way to help move capital around the economy – *from* where its return is less productive *to* where its return is more productive. Is that not an overall benefit which the anti-buyback crowd should consider?

For more on this idea, let's return to the Goldman Sachs research piece from earlier:

"Aswath Damodaran, professor at New York University School of Business, agrees that buybacks aren't coming at the expense of investment. Rather, he argues that large, mature companies returning cash to shareholders allows that cash to be put to more productive uses; so, it's not that companies are investing less, it's that different companies—with better growth opportunities—are investing instead."

Is it better for our economy to see, say, a massive consumer goods company make a R&D investment that might have an ROI of 1%?

Or would it be better for that massive consumer goods company to buyback its stock, therein putting money in the hands of its investors who might then invest in smaller, more dynamic companies where that investment might have a 100X ROI comparatively?

Steven Davis, professor at the University of Chicago Booth School of Business suggests, "Trapping resources in larger and older businesses not only inhibits the overall size of the pie...but also tends to reinforce the unequal distribution of the pie."

The anti-buyback crowd seems to miss the reality that R&D investment – just for the sake of R&D investment – isn't always a productive thing, let alone equally productive across all sectors and all businesses.

On this point, Cliff Asness writes, "Investors generally do not spend the money paid out in buybacks on champagne bubble baths or other forms of consumption. Rather, they reinvest it in other stocks and bonds. Buybacks thus facilitate a movement of capital from companies that don't need it to those that do. That's how markets are supposed to work."

But what about workers? Is the money allocated to buybacks coming at the expense of higher employee wages?

Noah Smith in *Bloomberg* writes, "If the link between buybacks and investment is weak to nonexistent, then the link between buybacks and wages must be weak as well. In fact, that's exactly what we saw in the mid and late 2010s. Buybacks soared to their highest point ever, but wages also grew at their fastest rate in decades.

"This wasn't a story of rising pay for chief executive officers pulling up the average; in fact, wage growth in the late 2010s was fastest at the bottom of the distribution.

"If buybacks stole money out of workers' pockets, we probably wouldn't be seeing that happen. Of course, it's possible that if buybacks had been banned, companies would have raised wages even more. But there are reasons to doubt that's how it would have shaken out. Companies have proven over the years that they're just fine sitting on piles of cash; forcing more money into the tank doesn't mean more will be put into workers' pockets."

Bottom line: Corporate stock buybacks as a destroyer of R&D and/or employee wages is yet another easily debunked argument.

MYTH: BUYBACKS MANIPULATE EARNINGS PER SHARE HIGHER SO THAT CORPORATE EXECUTIVES CAN INCREASE THEIR COMPENSATION.

"At a time of huge income and wealth inequality, Americans should be outraged that these profitable corporations are laying off workers while spending billions of dollars to boost their stock's value to further enrich the wealthy few." – Senators Chuck Schumer and Bernie Sanders

"Last year, [Big Oil] made $200 billion in the midst of a global energy crisis. It's outrageous...They used those record profits to buy back their own stock, rewarding their CEOs and shareholders." – President Joseph Biden

This myth holds that stock buybacks are little more than accounting gimmicks to inflate earnings per share with the purpose of making corporate fat cats even fatter.

Now, there is the potential for this to be true because the mathematics are accurate.

When stock is repurchased by corporate managers, the same amount of profit is allocated over fewer shares. This increases the earnings-per-share of those fewer remaining

outstanding shares. So, all else equal, buying back stock will inflate an earnings per share figure.

But the first issue is that "all else equal" is often just a theoretical exercise. Cliff Asness explains, "Another criticism is buybacks 'artificially' raise earnings per share. This is certain only if the rest of a repurchasing company's business is unchanged and the cash used for the buyback was completely idle. Otherwise, the true long-term effect on EPS growth will be determined by the return to the company had it retained and employed the cash. Again, this is how it's supposed to work. If the returns to a company using the cash for a buyback are low, the company is supposed to give the cash back."

But theory aside, what's at the heart of this issue isn't the mathematics of how buybacks increase earnings per share, but rather, the motivation of corporate managers and the frequency of this type of "for optics only" buyback.

If you listen to many politicians, they'd have you believe that corporate managers are nearly exclusively driven by greed, and the purpose of buybacks is almost always to artificially goose earnings for selfish reasons (usually hitting an earnings-per-share target that unlocks a bonus).

So, here again, does the research suggest this is true?

No. Beginning with Jason Zweig in *The Wall Street Journal*, he writes, "Research does suggest that companies may sometimes use share buybacks to manipulate earnings or to

give insiders a chance to cash out at higher prices. But the claim that corporations are repurchasing shares to goose short-term stock prices instead of investing in projects to boost long-term growth is just rubbish. Corporate spending on research and development is at all-time highs, and S&P 500 companies lavished a record $713 billion on capital expenditures in 2018."

Alex Edmans is professor of finance at London Business School. The UK government commissioned Edmans and PwC to study the alleged misuse of share buybacks in the UK. Based on his findings, Edmans notes, "Over 2007-2017, we found that not a single FTSE 350 firm used buybacks to hit an EPS target that it would have otherwise missed."

And don't make the mistake of thinking it's different in Europe than the United States. Goldman Sachs reached a similar takeaway:

"Executives whose compensation depends on EPS did not allocate a greater proportion of total cash spending to buybacks in 2018 than companies where management pay was not linked to EPS. The 247 companies in the S&P 500 with incentive compensation programs linked to earnings per share—a metric that would benefit from accretive share buybacks—actually spent a smaller share (28%) of their total cash outlays on repurchasing stock compared with the 253 firms without a performance metric linked to EPS (31%).

"Moreover, the 49% of S&P 500 firms with EPS-linked compensation accounted for just 45% of total 2018 buybacks

($362 billion). We also found no relationship between how management teams with compensation incentives tied to total shareholder return (TSR) spent cash relative to those firms with no shareholder return incentive."

But there are other substantive holes in this argument's logic. The first of which is that it's only corporate managers who benefit from buybacks.

According to the Federal Reserve's 2022 Survey of Consumer Finances, 58% of US households owned stocks, whether directly or indirectly. *The Wall Street Journal* writes, "That is up from 53% in 2019 and marks the highest household stock-ownership rate recorded in the triennial survey."

Stock buybacks – to the extent they goose earnings per share, helping support a stock price – don't solely benefit a small cabal of greedy C-suite executives. According to the Federal Reserve's data, they help enrich more than one out of two American households.

Of course, this assumes that the benefits of buybacks aren't short-lived, fading away soon after upper management receives their fat bonuses. Unfortunately for the anti-buyback crowd, the research points toward long-term outperformance of companies that buy back their shares.

Edmans writes, "What about the long-term effects of buybacks? A seminal paper found that firms who buy back stock subsequently outperform their peers by 12.1% over the next

four years. This finding is surprisingly robust—while it was on US firms in the 1980s, a recent study investigates 31 other countries and finds that the results hold in most of them. This evidence contradicts the 'sugar high' concerns, but is conveniently ignored in claims that buybacks destroy long-term value."

We can corroborate Edmans' findings with the study "Share Repurchases on Trial: Large-Sample Evidence on Share Price Performance, Executive Compensation, and Corporate Investment" by Guest, Kothari, and Venkat.

The researchers hypothesized that if unaware retail investors were being duped into buying repurchased shares, their study would reveal short-term stock price bumps followed by longer stretches of poor stock price performance. But that's not the data's conclusion:

"We find no widespread evidence to support this hypothesis. That is, regardless of whether or how intensely and frequently firms repurchase shares, we find no evidence that firms significantly outperform in the quarters with repurchases. While we find some marginal evidence that firms that intensely repurchase do outperform slightly in the quarter after repurchases, we find no evidence of future reversals in the short- or long-term. This pattern of outperformance is more consistent with firms using repurchases to signal undervaluation rather than to manipulate the market."

Now, a skeptic might argue that any benefit to ordinary investors and/or households (even if on a longer-term

timeframe) is purely an unintended collateral benefit from selfish CEOs acting in their own financial best interest. And even if a rising stock price benefits all shareholders, corporate managers are the ones who enjoy the lion's share of the payoff, cashing in with multi-million-dollar bonuses.

However, this belief is quickly debunked. Researchers at the University of Wisconsin and the University of Kentucky evaluated dual-(share) class firms with active trading in both share classes. They sought to isolate the magnitude and duration of the demand-drive price impact of stock buybacks.

From their study, "The Price Effect of Stock Repurchases: Evidence from Dual-Class Firms," they write, "The average repurchase in our sample, 0.30% of outstanding shares within a month, increases the stock price by 40 to 70 basis points relative to the non-repurchased class of stock. The effect dissipates completely over the subsequent month unless extended by continued repurchases. This small, short-lived price effect leaves little scope for CEOs to benefit from value-destroying repurchases motivated by self-interest..."

"A back-of-the-envelope calculation suggests that the average CEO could create an additional $12,500 a year in direct benefits from repurchases, a trivial fraction of a CEO's $5.6 million average annual compensation."

Meanwhile, the study we referenced moments ago from Guest, Kothari, and Venkat arrives at a similar takeaway. The authors speculated that if using repurchases to reward

insiders were a common, systematic abuse, CEOs who use repurchases would receive abnormally high pay. However, that's not what the study found:

"We estimate that CEOs of firms that make large positive repurchases earn a statistically and economically insignificant amount of excess pay that is only $51K more than CEOs of firms that do not repurchase shares. The difference is even smaller, $4K, when we compare CEOs of firms that repurchase frequently to firms that do not repurchase. These differences are economically tiny in relation to the average CEO's pay."

There's also plentiful anecdotal evidence against this myth.

One such illustration comes from the research paper, "Which One Is It?" from Michael Mauboussin. He tells the story of meeting with a CEO in 1999 who was struggling with a capital allocation decision.

This CEO had issued significant stock-based compensation (SBC) grants to employees, yet had promised the financial community that he would offset the dilution by buying back stock in order to maintain roughly equal share count. The problem is that the stock price of this CEO's company had soared thanks to the Dot Com bubble, and was now overvalued. The CEO recognized this and felt torn.

Mauboussin writes, "He had painted himself into a corner, and the question was whether he should continue to buy back

stock at a premium to maintain his pledge, or limit buybacks and allow the number of shares outstanding to rise."

If this CEO was thinking purely about his own self-interest, this decision wouldn't have been difficult or stressful. Instead, he would have wasted zero time buying back the stock – valuation be damned – to hit his numbers, goose the earnings-per-share, and cash in that fat bonus check.

But that type of blatant disregard for important capital allocation decisions isn't what we find.

Here again, the myth doesn't hold up to serious, honest evaluation.

Stepping back, we're sympathetic to the argument that CEOs are paid too much. But that question and discussion is a board issue and largely has nothing to do with the stock buyback decision.

If a board gives a CEO a giant pay package with options tied to earnings per share, then that poor decision is on them. But realize that such a compensation package achieves the exact opposite result: share issuance. Historically, owning companies with consistent share issuance has been a bad idea.

Bottom line: The myth that stock buybacks are regularly executed to artificially inflate earnings per share so that corporate executives can receive higher compensation

makes for a powerful political talking point, but it's baseless. The research and studies simply do not validate it.

MYTH: BUYBACKS WEAKEN ALREADY DISTRESSED COMPANIES.

"When companies do these buybacks, they deprive themselves of the liquidity that might help them cope when sales and profits decline in an economic downturn." – William Lazonick, Mustafa Erdem Sakinç, and Matt Hopkins

This myth holds that share buybacks exaggerate the economic challenges facing distressed companies. One illustration of this argument can be found in the quote above. It comes from the article "Why Stock Buybacks Are Dangerous for the Economy," by Lazonick, Erdem Sakinç, and Hopkins.

To what extent is this true? Are ailing corporations turning a blind eye to prudent uses of capital and instead weakening themselves further by conducting stock buybacks?

Now, as we've seen with prior myths, this is possible. We could find select examples of CEOs allocating cash to buybacks when it should be directed elsewhere (we'll look at one such example in the following chapter). However, for this charge to be considered seriously and hold any weight, it must be happening on a widescale, consistent basis.

But this idea raises an eyebrow from the get-go. Framed differently, it suggests that corporate buybacks are impossible

to resist even for incredibly well-educated, high-performing men and women who have beaten all the competition and made it to the top of the corporate hierarchy. Yet, for all their intellect and discipline in becoming captains of industry, these C-level business leaders are no match for the siren song of a good 'ole buyback. This makes buybacks an existential problem for the ailing businesses of weak-kneed managers who should know better.

Here again, the data don't support this conclusion. Instead, we find that buybacks are most often conducted by healthy companies. This makes sense – buybacks are an outgrowth of a well-run business that's spinning off free cash flow, making such buybacks possible. But let's look at the research so you can see for yourself.

Here's Two Sigma, from their article "Share Buybacks: A Brief Investigation":

"Stocks announcing a share buyback tend to have significantly stronger fundamentals than average, with higher scores on Earnings Yield (i.e., lower price-to-earnings ratio), Earnings Quality (i.e., more cash earnings), and Profitability (i.e., higher return on equity and return on assets). These firms also tend to be larger (positive Size and Mid-Cap loadings), with lower Leverage and lower market-implied risk (both lower Beta and lower Residual Volatility)."

These results suggest that corporations buying back stock are exactly those with the greatest ability to return cash to shareholders while still supporting future growth. The

research provides little evidence that the firms are consistently endangering themselves through excess leverage to fund the capital returns.

Speaking of excess leverage to fund corporate stock buybacks, that's mostly just a boogeyman. After highlighting, "Criticism 4: Firms Are Borrowing Unsustainably to Buy Back Stock," the Man Institute writes, "We have little to say on this argument other than, in aggregate, it appears factually wrong, according to our analysis."

Bottom line: Whether we look at the fundamental strength of companies performing share buybacks, or evaluate the stock prices of such companies, we don't find a consistent, widespread pattern of abuse wherein the corporate managers of ailing companies are hollowing out their businesses through share buybacks.

As we wrap up this chapter, it seems curious to us why buybacks would be so villainized. They are neither good nor bad – they simply are. Perhaps some CEOs might occasionally use them inappropriately, but if so, wouldn't that reflect poorly on the CEO and not the buyback itself?

We believe Michael Mauboussin hits the nail on the head in his article, "Share Repurchase From All Angles," when he states:

> "The purpose of a company is to maximize long-term value. As such, the prime responsibility of a

> management team is to invest financial, physical, and human capital at a rate in excess of the opportunity cost of capital. Operationally, this means identifying and executing strategies that deliver excess returns. Outstanding executives assess the attractiveness of various alternatives and deploy capital to where its value is highest. This not only captures investments including capital expenditures, working capital, and acquisitions, but also share buybacks. There are cases where buying back shares provides more value to continuing shareholders than investing in the business does. Astute capital allocators understand this."

However, while "astute capital allocators understand" many politicians do not.

As one example, we have President Joseph Biden's Inflation Reduction Act of 2022 that imposed a 1% excise tax on the value of corporate net share repurchases.

Charlie Munger was not shy about expressing his displeasure for the idea, saying "I think it's insane. Literally insane...It's so irrational, and I think it sort of destroys the whole system, once you start tinkering from Washington."

As we referenced in Chapter 3, Buffett also had an interesting take on this blanket villainization of buybacks. Rather than our prior annotated version, here's his full quote: "When you are told that all repurchases are harmful to

shareholders or to the country, or particularly beneficial to CEOs, you are listening to either an economic illiterate or a silver-tongued demagogue (characters that are not mutually exclusive)."

So, how do we end this section on buyback myths?

By going straight to the Oxford Dictionary definition of myth: "A widely held but false belief or idea."

That's exactly what we have here.

CHAPTER 6

STOCK BUYBACK CASE STUDIES

The anti-buyback crowd seems to miss or downplay a core truth.

Being a CEO is hard.

Every day, CEOs face tough decisions as they do their best to navigate fierce competition and economic conditions that are nearly always in a state of flux.

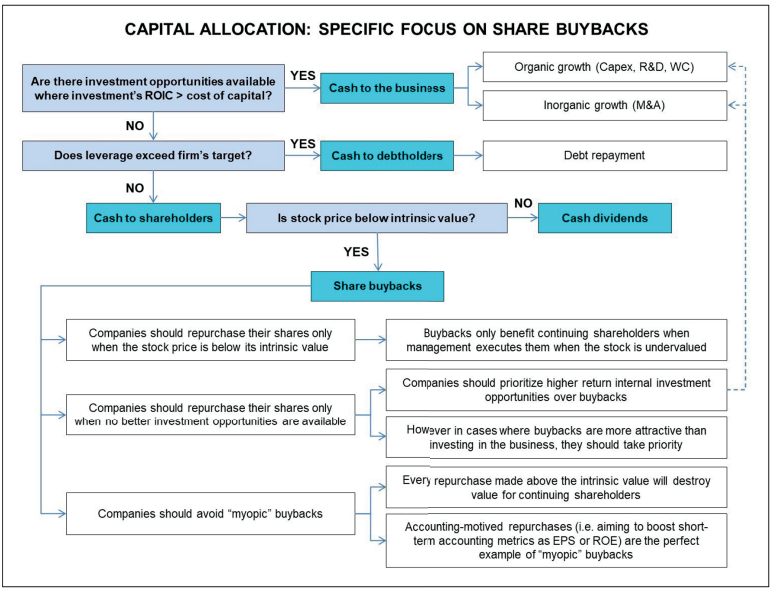
To succeed in this cut-throat, ever shifting climate, CEOs have only five choices for how to deploy their company's cash:

1. Reinvest in the business directly
2. Buy another company
3. Pay down debt
4. Pay a cash dividend
5. Buy back stock

That's it. There are zero other options.

Here is a nice flow chart courtesy of Josh Wolfe of Lux Capital on how a CEO may optimize their cash flow to various projects and distributions.

FIGURE 10 – Capital Allocation: Specific Focus on Share Buybacks.



Source: Josh Wolfe

What we want to answer in this chapter is, "When is buying back stock the right use of a company's cash, and what does that actually look like?" To do this, we'll use historical case studies as our guide.

But after walking through three such examples, we'll round out our discussion by looking at a case of buybacks gone wrong. After all, we're not here to make the argument that "all buybacks are good, no matter what." That would be too

simplistic and reductionist – the foil to the anti-buyback crowd's attack of "all buybacks are bad, no matter what."

Instead, we believe buybacks can be good – exceptionally good at times – yet also poorly considered, even injurious, at other times. Of course, as noted in the last chapter, it's our belief that this potential for variable success should put the spotlight on the CEO wielding the buyback, not the institution itself.

So, with this as our introduction, what are some examples of buybacks done right?

Before we're able to investigate, we must clarify what defines a successful buyback. The kneejerk answer might be something like, "The stock price climbs materially higher in the subsequent weeks, quarters, or years following the buyback campaign."

However, while we do agree this is a criterion, it's not complete. After all, a rising stock price in the wake of buybacks could be little more than lucky timing. A clumsy corporate manager might repurchase shares at a wildly overpriced valuation, yet benefit from a "rising tide lifts all ships" market environment that camouflages the poor timing. So, materially higher stock prices alone can't be the answer.

We believe a second, key component to success is "a predetermined, well-thought-out methodology that's carried out according to plan."

So, what does this look like in the real world?

BERKSHIRE HATHAWAY

"When stock can be bought below a business's value it is probably the best use of cash." – Warren Buffett, CEO Berkshire Hathaway

Warren Buffett is a huge proponent of stock buybacks. He's also had much to say on the topic over his multi-decade investment career. One such comment came in 2016 at Berkshire Hathaway's shareholder meeting when the Oracle of Omaha said, "Anytime you can buy stock for less than it's worth, it's advantageous to the continuing shareholders...but it should be by a demonstrable margin."

While this idea is simple, the application is often more challenging. That's because the definition of a stock's "worth" is seldom obvious. As we pointed out in Chapter 4, there's no single metric or indicator providing a black-and-white number that accurately identifies intrinsic value. Even Buffett himself has said that calculations of intrinsic value "are far from precise."

However, a moment ago, we suggested that a buyback done right occurs when a CEO has a predetermined, well-thought-out methodology that's carried out according to plan.

So, what does this look like for Buffett, factoring in his resolve to purchase shares at a price below intrinsic value,

while recognizing that identifying intrinsic value can be challenging?

As we pointed out in Chapter 4, Buffett's buyback methodology was simple: "1.1X - 1.2X book value."

In other words, when Berkshire Hathaway's stock traded at or below 1.2X its book value, Buffett considered it an attractive price relative to Berkshire Hathaway's intrinsic value. So, he would repurchase shares with the confidence that he was creating value for shareholders.

Now, this 1.1X – 1.2X book value guideline hasn't been perfectly followed. Buffett has repurchased Berkshire Hathaway shares at slightly higher levels in recent years, but the concept remains his guiding principle.

Generally, when price-to-book is elevated, Buffett repurchases zero shares or their volume is small. Conversely, when price-to-book nears 1.2X or below, Buffett ramps up the buybacks sharply.

Now, we can check the box on our second metric for "buyback success." Buffett obviously has a predetermined, well-thought-out methodology that's carried out according to plan.

What about the first criterion? A stock price that "climbs materially higher in the subsequent weeks, quarters, or years following the buyback campaign"?

Any long-term chart of Berkshire Hathaway's stock shows that Buffett has accomplished this and more. For example, over the last 20 years – Berkshire has returned more than 600% compared to the S&P 400% gain.

In Buffett's tenure running Berkshire Hathaway, he has compounded shareholder wealth at 19.8% annual returns, nearly doubling the S&P's 10.2% return over the same period.

The most unbelievable statistic in all of investing? Berkshire's stock price could decline by over 99% and still be outperforming the S&P 500 since inception.

Bottom line: Given Buffett's fondness for and extensive use of share buybacks over the decades, it's hard to do anything other than agree with him as he once said, "Disciplined repurchases are the surest way to use funds intelligently. It's hard to go wrong when you're buying dollar bills for 80c or less."

TELEDYNE

It's an easy leap going from Warren Buffett to Henry Singleton, the visionary CEO of Teledyne. After all, Buffett once said, "Henry Singleton has the best operating and capital deployment record in American business." And Buffett's partner, Charlie Munger, was quoted as saying, "[Singleton's] results are a mile higher than anyone else... utterly ridiculous."

What made Singleton's results so ridiculous?

In short, he was a master at capital allocation. But a tremendous part of his genius came through his superb use of stock buybacks.

Stepping back, if you're less familiar with Singleton, he was the CEO of Teledyne Corporation from 1966 through his retirement in 1986. During the first part of Singleton's career, he used Teledyne's capital for acquisitions. By the end of the 1960s, Teledyne had acquired 130 companies, growing rapidly under Singleton's leadership.

But then came the bear market of the early 1970s, and two things happened. The first is that growth from acquisition was no longer the best use of corporate cash.

Singleton is quoted as saying, "In this climate, where tender offers mean overpaying by managements which want to grow at any price, I prefer to buy pieces of other companies or our own stock or expand from within. The price for buying an entire company is too much. Tendering at the premiums required today would hurt, not help, our return on equity, so we won't do it."

The second thing that happened is Teledyne's own stock crashed. As George Roberts and Robert McVicker describe in their book, *Distant Force: A Memoir of the Teledyne Corporation and the Man Who Created It*, Teledyne's stock fell from roughly $40 to less than $8.

And here's where we see Singleton's "predetermined, well-thought-out methodology carried out according to plan."

To be clear, Singleton wasn't as specific as Buffett and his "1.1X – 1.2X book value" guideline. But he was equally focused on the idea of value, once saying, "I don't believe all this nonsense about market timing. Just buy very good value and when the market is ready that value will be recognized."

Singleton possessed an instinct for value, so when Teledyne's stock crashed, he recognized the potential value-add for investors and acted immediately. From Roberts and McVicker in *Distant Force*: "One morning in May of 1972, Henry walked into my office at about 8:30 and said, 'George, we're going to make a bid for our stock at $20 a share.' I said, 'Are we really going to do that?' I was totally amazed, as he hadn't even hinted about that to me before... This was an excellent example of how Henry made all investment and stock decisions on his own..."

"They were all done when our stock was at a low P/E ratio. He believed that our stock was grossly undervalued and it was the first of a series of eight stock buyback offers..."

"The first six buybacks were all in the period from 1972 to 1976. The market reacted adversely to this at first, not understanding what Henry was accomplishing. But as the number of shares went down and the company's operating income continued to grow, the earnings per share increased

rapidly and dramatically. In 1970, net income per share was $1.64. By 1975 it was $6.09 per share; in 1976, $10.79; and in 1977, $16.23 per share."

So, what's the legacy of Singleton's legendary buybacks?

Well, there's much we could write, but let's focus on two aspects.

First, for the anti-buyback crowd that would prefer investing in, say, R&D and/or new acquisitions, recognize what Singleton was signaling to the market through his buybacks...

At its core, the message was, "Our own company has amazing growth prospects as it is. So, buying ourselves at this bargain basement price is the absolute best use of our cash."

Is this not the confidence and vision that we'd hope for from all our corporate leaders?

Well, yes, if Singleton was correct in his assessment of Teledyne's future and its bargain stock price at the time of the buybacks. So, was he?

As to a rising stock price, in *Distant Force*, Roberts and McVicker write, "Shareholders who had stayed with the company from the first buyback in 1972 had achieved a gain of some 3,000 percent by 1983."

For a bit more color, here's Christian Hald-Mortensen from his paper, "Teledyne Technologies—A Conglomerate

Phoenix That Rose from the Ashes with Henry Singleton's Corporate DNA Intact": "An investor who came across the founder Henry Singleton and put money into Teledyne stock in 1966 achieved an annual return of 17.9% over the next 25 years, or a 53X return on invested capital."

Clearly, our criteria of a stock price that climbs materially higher in the subsequent weeks, quarters, or years following the buyback campaign is met.

Meanwhile, through our other criteria of a "predetermined, well-thought-out methodology that's carried out according to plan," yes, Singleton checks the box, repurchasing shares when he believed he was doing so at value-add prices.

But let's not miss Singleton's overall genius in recognizing the shift in the corporate landscape – away from acquisitions when price tags grew too expensive, toward buybacks. It's all but certain that Teledyne's 53X return wouldn't have been possible without this expert use of share buybacks. But it's an example of what's possible when a visionary CEO correctly and masterfully utilizes this powerful use of capital.

Summing up Singleton and Teledyne, consider this quote from the great Peter Lynch: "Buying back shares is the simplest and best way a company can reward its investors. If a company has faith in its own future, then why shouldn't it invest in itself, just as the shareholders do?"

That's exactly what Singleton did. And that's why he's one of the greater capital allocators of all time.

APPLE

So far, we've focused on buybacks that have been executed at low valuation multiples. But could buybacks ever be a value-add for investors when executed at higher prices?

Investors often assume that intrinsic value is best expressed through a low valuation multiple like the P/E ratio. Is a company trading at a P/E ratio of 10 cheap compared to another company trading at a P/E ratio of 20?

On average, the answer is probably yes, but simple valuation ratios often leave out a major input to an intrinsic valuation calculation: growth.

What if the cheap stock in this example isn't growing earnings, but the expensive stock is growing at 50% per year? Growth and value are tied at the hip when it comes to valuing a company.

Buffett illustrates this concept and has put his money where his mouth is by making Apple the single largest holding in Berkshire Hathaway's portfolio. This is accurate as of summer 2024, even after news has broken that Buffett has reduced his stake in Apple by nearly 50%.

When Buffet first started buying AAPL in 2016, it traded at a P/E ratio of about 10. Fairly cheap by historical standards. Since that time the stock has been a multi-bagger and is now one of the largest stocks in the world. The share price

growth has led Apple to a more richly valued P/E ratio of approximately 35 in the summer of 2024.

Apple started buying back stock in scale beginning in 2013. And while these buybacks have become legendary for their enormity, they're not renowned for their adherence to a "low P/E multiple" criterion. And yet, this doesn't seem to be a problem for the Oracle of Omaha. Let's rewind to this *CNBC* article from September of 2018 when Apple was trading around its then-all-time-high:

When asked whether investors should be worried about the stock market at a record level, Buffett said that buybacks make owning the iPhone maker a no-lose situation right now.

"I'd rather have it go down for one thing, if it goes down Apple is going to buy a lot of stock back, already buying stock back,' he said. "If it goes down 10 percent it means they get to buy 10 percent more shares and my interest will go up 10 percent more for spending that money."

The article contained no mention of Buffett referencing, let alone complaining about, Apple's buybacks transacting at a higher P/E multiple.

But let's not speculate about Buffett's thoughts on this matter. Instead, let's rewind to how he approached this exact issue with one of his favorite holdings, Coca-Cola, and its potential buybacks during a period of inflated P/E levels.

Years ago, a young Bill Ackman asked Buffett about Coke repurchasing its shares at a P/E of 40. Here's part of Buffett's response:

"It sounds like a very high price when you name it, in terms of a P/E, to buy back the stock at that sort of number. But I would say this: Coca-Cola has been around – what – 112 years now? And there are very few times in that 112 years, if any, when it would not have been smart for Coca-Cola to be repurchasing its shares...We love it when Coke repurchases shares...All I can tell you is I approve of Coke repurchasing shares. I'd a lot rather have them repurchasing shares at 15 times earnings, but when I look at other ways to use capital, I still think it's a very good use of capital. And maybe the day will come when they can buy it at 20 times earnings, and if they can, I hope they go out and borrow a lot of money to buy a ton of it at those prices."

Buffett's easing of his strict standards about buybacks relative to intrinsic value seems to relate to the quality of the underlying business. In this same response to Ackman, Buffett praises Coca-Cola's operational excellence while noting that most companies are not as well run. This makes an enormous difference when it comes to the efficacy of share repurchases.

But as he's done with Coca-Cola, Buffett has similarly praised Apple's business excellence. So, through this lens, it makes sense why he wouldn't have a problem with Apple buying back its shares at somewhat elevated prices. It

appears he'd rather own a great business that's buying back loads of stock than a mediocre business selectively repurchasing shares at low prices.

After Buffett answered Ackman, Munger chimed in, saying, "The really great companies that buy at high price-earnings – that can be wise."

This has shades of another of Buffett's famous quotes: "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

Returning to Apple specifically, when we look at its buyback strategy, we find something different than that of Berkshire Hathaway – a blunt force sledgehammer approach rather than a precision scalpel approach. But sledgehammers can be very effective.

In the spring of 2024, Apple announced the largest share buyback in U.S. history - $110 billion. This broke the prior buyback record of $100 billion from Apple, in 2018.

And let's not forget Apple's other recent share buybacks:

- 2019 - $75 billion
- 2020 - $50 billion
- 2022 - $90 billion
- 2023 - $90 billion

Over the last few years, Apple has generated roughly $100 billion in annual free cash flow – each year. When a company generates this much cash it's hard to reinvest it all in the business.

Now, let's tackle the most obvious objection up front: "That's no excuse! Apple should have invested its cash stockpile into R&D initiatives and/or new business ventures!"

They did. And they lost every dime.

The ill-fated project "Titan" was Apple's foray into the world of electric vehicles, beginning back in 2014. The "Apple Car" was supposed to take on Tesla head-to-head. Instead, in early 2024, Apple gave up on the project. That meant a decade of effort – and allegedly $10 billion of R&D expense – went down the drain.

With the gift of hindsight, it's clear that this $10 billion would have been put to far more productive uses had Apple returned it to shareholders, wherein they could have reinvested it into more productive ventures. This ties in with the point we highlighted in Chapter 5 from Goldman Sachs' research paper:

"Aswath Damadoran, professor at New York University School of Business, agrees that buybacks aren't coming at the expense of investment. Rather, he argues that large, mature companies returning cash to shareholders

allows that cash to be put to more productive uses; so, it's not that companies are investing less, it's that different companies—with better growth opportunities—are investing instead."

When you're the biggest company in the world, it's hard to find projects that have the potential to move the needle from a return-on-investment perspective. So why not follow Damadoran's advice and let shareholders find more productive uses for it?

Yes, that might mean transacting at higher P/E multiple prices, but to what extent is that really resulting in a destruction of value if the company is growing?

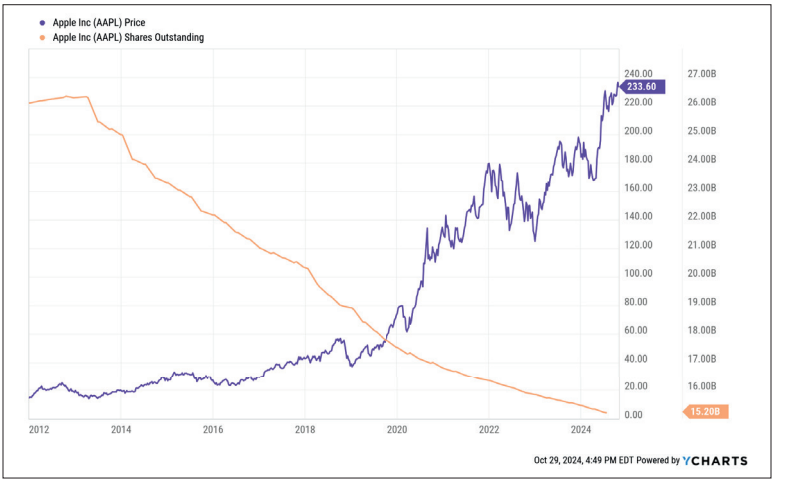
In 2012, Buffett revealed that the late Steve Jobs had once asked his advice on Apple's cash management strategy.

Buffett responded, "I asked him the question, I said, 'I would use it for buybacks if I thought my stock was undervalued.' And I said, 'How do you feel about that?' He said, 'I think my stock is very undervalued.' I said, 'Well, what better to do with your money?'"

Jobs declined to initiate a buyback program, and it wasn't until May 19th, 2012, that Apple announced plans to initiate a dividend and share repurchase program for the first time in the 2000s. Since that date, Apple shares have climbed more than 1,320% and are trading around all-time highs as of summer 2024.

Below, we see how this looks with Apple's share count decreasing in purple against its stock price climbing in orange.

FIGURE 11 – Apple Stock Price vs. Shares Outstanding, 2013–2024.



Source: YCharts

Imagine the value creation had Jobs taken Buffett's advice.

Circling back to our analysis of the efficacy of Apple's buybacks and the criteria for success we're using, our criterion of a stock price that climbs materially higher in the subsequent weeks, quarters, or years following the buyback campaign is achieved – and then some.

But what of our second criterion of "buyback success," a predetermined, well-thought-out methodology that's carried out according to plan?

Well, it seems in recent years that Apple does, in fact, have a predetermined, well-thought-out methodology that's carried out according to plan: Buy enormous quantities of its own stock regularly, even if the price doesn't represent a bargain basement P/E multiple.

It seems it's working.

WHEN BUYBACKS ARE SUB-OPTIMAL

As noted earlier, we're not blindly championing all stock buybacks. They can be abused same as every other use of corporate cash.

Let's look at one such example with General Electric, one of America's best-known multinational conglomerates with a history dating back to its 1892 founding by Thomas Edison and J.P. Morgan (among others).

For decades, GE was venerated for its innovation and diverse portfolio of businesses initiatives. In more recent years, this lineup has included power generation, aircraft engines, healthcare, renewable energy solutions, and far more. GE's former CEO, Jack Welch, is widely regarded as one of the most influential CEOs in the history of corporate America. And for a period in 2000 under Welch, GE was the world's most valuable company. As recently as 2011, it held the title of fifth-largest company in the world.

But when the 2008/2009 Great Financial Crisis dealt a massive blow to GE Capital, cracks began showing.

As *The Week* wrote, "As entangled as it was in the mortgage bubble and the shadow banking sector, GE Capital toppled over. At the height of the 2008 crisis, literally no one would lend to it in the overnight markets. GE Capital was only saved by an emergency injection of $12 billion from Warren Buffet and other investors...For the first time in its history, GE had to slash its dividend payments, from 30 cents to 10 cents a share; a massive two-thirds reduction. In terms of total dollars going to shareholders, it was the biggest single dividend cut by an American company ever."

Additional dominos tipped over. There was the ill-fated purchase of Alstom...an SEC charge of "overall aggressive accounting" and false statements...and finally, poorly-time stock buybacks.

Here's CNN Business from March 2018:

"General Electric is seriously strapped for cash. The conglomerate has laid off workers, slashed its dividend and put long-held businesses up for sale."

"If only former CEO Jeff Immelt hadn't gone on a $24 billion spending spree in 2016 and 2017 to buy back GE's (GE) stock — at what turned out to be extremely high prices."

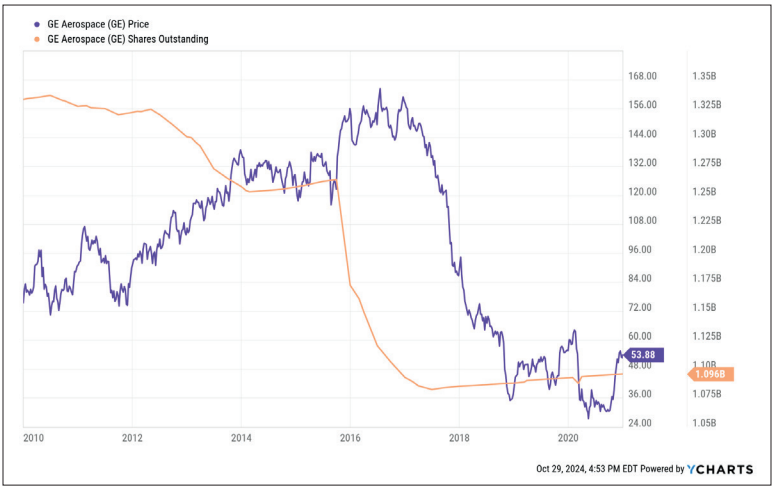
"The misguided buyback strategy underlines GE's failure to allocate its limited resources. It squeezed GE's cash haul and increased its debt."

"The root problem at GE — and why the stock is where it is — is poor capital allocation," said RBC Capital Markets analyst Deane Dray.

Below, we look at this poor capital allocation in a chart spanning 2010 to 2020. We're looking at GE's quarterly stock buybacks in blue and its stock price in orange.

You'll see how GE trafficked in what the anti-buyback crowd loathes – an increase in buyback volume that parallels an increase in stock price.

FIGURE 12 – GE Stock Price vs. Shares Outstanding, 2010–2020.



Source: YCharts

But as you're likely aware, "price" does not equal "value." Might GE shares have been selling for a higher price in 2017, yet due to increased earnings, that price represented a more attractive valuation?

The P/E ratio spiked from roughly 10 in early 2015 to 25 when General Electric was conducting the lion's share of its quarterly share buybacks in 2016.

Back to *CNN Business* from 2018:

"Using a combination of debt and cash, GE spent $2.6 billion [in 2017] on stock buybacks — at an average price of $19.65. [At the time of the article's publication in 2018], the stock is worth just $13.35, close to a nine-year low."

"GE's buybacks were much worse in 2016. It spent $21.4 billion at an average price of $30.30, more than double the current price [as of the article's publication in 2018]."

Our main determinant of a successful buyback has been: a predetermined, well-thought-out methodology that's carried out according to plan and that incorporates buying stock at a discount to intrinsic value."

Though its stock is now finally trading around its 2016-high level (as of summer 2024), the rehabilitation has taken the better part of a decade.

As for a predetermined plan, it's possible that then-CEO Jeff Immelt felt he had one, though if so, it's unclear what it was. Unlike Buffett and Singleton, Immelt didn't ramp up stock repurchases when GE shares were trading at bargain prices. And unlike Apple, GE didn't execute consistent buybacks year in, year out.

Overall, at the risk of being unfairly reductionist, it appears Immelt used GE's cash for stock repurchases at the wrong time. Given the financial and strategic stresses the company was under, plus its relatively rich valuation at the height of its buyback campaign, GE gives us an example of a flawed stock repurchase campaign.

As Marc Cohodes once said, "When your business is not doing well from a fundamental perspective, the last thing you're supposed to do is buy back stock."

We agree. And though GE provides us a powerful cautionary tale about ignoring this guideline, it is the exception rather than the rule.

CHAPTER 7

SHAREHOLDER YIELD

Let's get our bearings.

In our Introduction, we noted that the goal of this book is to investigate capital allocation decisions and how they impact stock prices and investor returns.

As noted in our last chapter, there are only five ways that managers can allocate their capital:

1. Reinvest in the business directly
2. Buy another company
3. Pay down debt
4. Pay a cash dividend
5. Buy back stock

In a perfect world, we'd be able to draw a direct connection between the amount of capital allocated to each of these five uses of corporate cash and their respective returns. Such a direct "yield" analysis would make this book's investigation far easier. Unfortunately, it's not that simple.

To illustrate why, consider reinvesting directly in the business and/or buying another company. The returns of these efforts can be difficult, if not impossible, to evaluate and quantify precisely.

After all, sometimes a business initiative pays off immediately; other times, it requires years, even decades. Meanwhile, some acquisitions might provide a robust return of capital at first, only to be followed by meager return streams in later years. A different acquisition might have the opposite result.

Then, how can a manager be certain that there's no collateral benefit from some other ancillary business initiative boosting returns? Or weighing on returns?

The challenges don't stop there. Imagine a business investment or acquisition that's fantastic for brand development or polishing a corporate image. Yet, how do you quantify that benefit specifically?

For reasons such as these, evaluating reinvesting in businesses directly and/or acquisitions from a "yield" perspective is rather quixotic.

Fortunately, we can achieve far greater success when evaluating dividends, stock buybacks, and debt reduction through this yield lens (which, as we'll discuss momentarily, leads us into a discussion of our titular "shareholder yield").

Now, we've broadly discussed dividends and share buybacks at this point. But what about debt?

If we could go back in time, we would not include the debt paydown component in our discussion as it usually confuses people. However, since the original book incorporated the debt metric, we wish to stay consistent and retain the original definition.

But we'll offer brief commentary before we move in an effort to avoid any lingering questions.

The seminal paper "The Cost of Capital, Corporation Finance and the Theory of Investment" by Modigliani and Miller demonstrated that a firm's value was separate from how it is financed.

If a company decides to deleverage and pay down debt, it can be seen as a transfer of wealth from the debt holder to the equity holder. Another way to think about it is that if a company carries significant debt, then the bond holder is higher on the capital stack than the stock holder.

Compared with dividend payments and/or stock buybacks, debt reduction is a subtler form of rewarding shareholders. After all, the debt paydown doesn't flow directly to a shareholder. Yet, by reducing the amount of debt owed to bondholders who have a superior position in the capital hierarchy, debt reduction is inherently value additive for equity investors.

But as you might guess, drawing a direct line between debt reduction and a specific, quantifiable return to shareholders and/or a stock price is challenging. This is part of the

reason why, as noted a moment ago, we're including debt paydown in our discussion to remain consistent.

So, with all this as our background, does including this additional data on dividends, buybacks, and debt reduction – together, the basis for our shareholder yield calculation – improve the ability to forecast investment returns in equities?

Ample research answers this question in the affirmative, and we include a literature review at shareholderyield.com. We further provide our own research below, which validates the conclusions of the research completed to date.

In the first edition of this book, we examined US stocks from 1982 to 2011. In this new edition, we expand the dataset to include the out-of-sample decade since publication and a decade before the original start date.

The new period covers 52 years, 1971-2022, with over 20 years of new data.

Since various researchers have different conceptions of yield measurement, an investor must be careful to maintain a consistent definition. We define a few different cash flow metrics and methods of cash distribution to discuss the research on an apples-to-apples basis.

Dividend Yield = Trailing 12 months cash dividends / market capitalization.

(Basically, this means the total value of cash dividends the company paid out divided by the stock's market value.)

Net Buyback Yield = (Trailing 12-month stock repurchases – stock issuances) / market capitalization.
(Basically, this means the total value of stock buybacks divided by the stock's market value. The easiest way to track this is with shares outstanding.)

Net Payout Yield = Dividend Yield + Net Buyback Yield.
(Basically, this is the combination of the two above.)

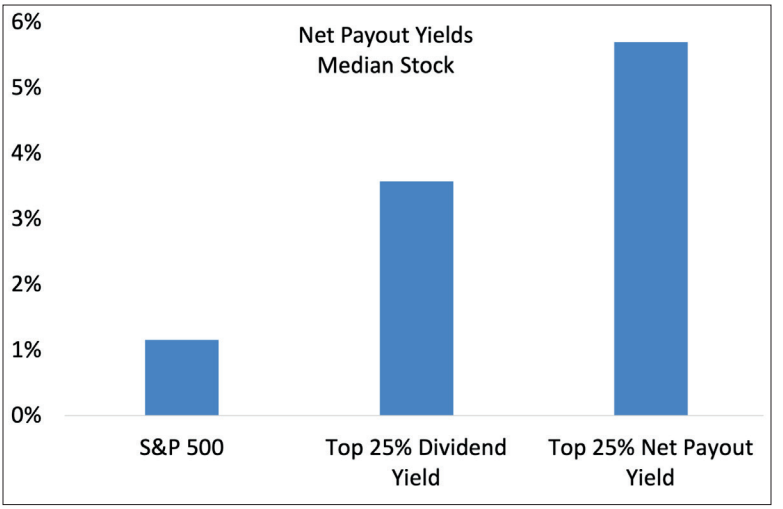
Net Debt Paydown Yield = Net changes in short- and long-term borrowing and debt / market capitalization.
(Basically, this means the total value debt a company has paid down divided by the stock's market value.)

Shareholder Yield = Dividend Yield + Net Buyback Yield + Net Debt Paydown Yield.

In evaluating stock repurchases and debt reduction measures, it is important to use *net* buyback and paydown statistics to account for companies issuing lots of shares or debt while buying back stock and paying down other debt. Otherwise, one risks overvaluing those companies that buy back stock with one hand but issue it to management with the other hand through executive stock option packages.

Below is a visual representation of stocks in the S&P 500 as of April 2024 and how their yields compare when combining dividends and buybacks.

FIGURE 13 – Various Yields.



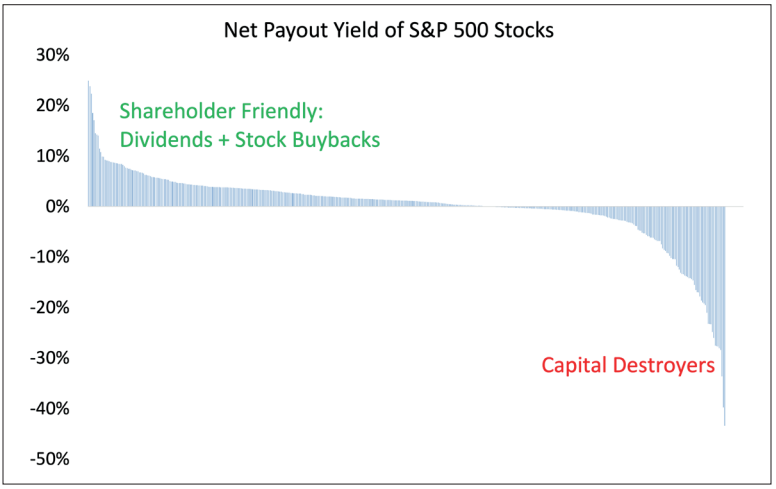
Source: Bloomberg

The median stock in the dividend yield portfolio has a respectable 3.7% net payout yield, over two percentage points better than the S&P 500's 1.15% total net payout yield. However, the top net payout yield portfolio yields 5.70%. Combining the two measures produces a net payout yield that is multiples more than the S&P 500 portfolio.

About 60% of all stocks in the S&P 500 have a positive net payout yield. Investors should avoid the bottom stocks as they dilute shareholders. (The bottom ten worst offenders were excluded so that the chart would still be readable.) Interestingly, over half of the companies with a negative payout yield had a positive dividend, including 20 companies with a dividend yield of over 3%. This demonstrates why it is so important to examine how companies use their cash, as investors may believe they

have a good dividend-paying stock when, in reality, the stock likely has a negative yield and is diluting your ownership by issuing new shares often to management.

FIGURE 14 – Net Payout Yield.



Source: Bloomberg

Below is a summary risk and return statistics table for the S&P 500 and portfolios divided into quartiles based on dividend yield and shareholder yield, market capitalization-weighted, and rebalanced yearly. Quartiles divide the universe into four buckets, where 25% of the universe, or 125 companies, fall into each bucket. Market capitalization weighting can result in more conservative returns to a portfolio than equal weighting and more conservative trading assumptions for very large portfolios.

A simple method of investing in the highest-yielding dividend stocks outperforms the S&P 500 by over a percentage

point a year, consistent with most academic research. Volatility aligns with the broad market, although drawdowns are higher, likely reflecting the increased risk to companies with higher, possibly unsustainable, dividend payments. (Drawdown is measured as the maximum monthly peak-to-trough loss in the portfolio.) Many investors can recall this property of high-yielding dividend stocks as recently as the 2008-2009 crisis, with many financials having seemingly high yields that were, in fact, not sustainable.

Combining all three measures into one factor – shareholder yield – results in a substantial increase in absolute returns. The simple shareholder yield portfolio outperformed the S&P 500 by about three percentage points yearly. While a $10,000 portfolio invested in the S&P 500 in 1971 would have been worth approximately $1.7 million at the end of 2022, the portfolio investing in the highest quartile of shareholder yield stocks (what we'll call "high shareholder yield" going forward) would have been worth $6.7 million.

FIGURE 15 – US Stocks vs Yield Portfolios, 1971–2022.

	US Stocks	Dividend Yield	Shareholder Yield
Returns	10.35%	11.51%	13.31%
Volatility	15.56%	13.99%	15.04%
Sharpe Ratio	0.38	0.50	0.59
Maximum Drawdown	-51.56%	-56.82%	-46.34%

Source: Gray, Vogel, Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

Other investment companies have started to take notice of the shareholder yield factor. Here is JPMorgan on shareholder yield:

> "The problem with dividend yield investing in the US has been that as dividends have gone out of favor with US corporates, the correlation between free cash flow and dividend payments has diminished. Even companies that do pay dividends typically distribute a much lower percentage of their free cash flow than what we see in other regions. Indeed. many US companies consider a dividend yield of say 4% or more to be insulting. Buybacks on the other hand have been a better indicator of strong free cash flow.
>
> Across the range of definitions, we find the single best measure of Value is arguably Shareholder Yield, which combines the effects of dividends, buybacks & net issues, with the familiar price to earnings ratio second."

The shareholder yield portfolio is also consistent. While the high dividend yield portfolio outperformed the S&P 500 in 48% of all years, the high shareholder yield portfolio outperformed in 71%.

Investors often want to try to understand when a particular strategy works best and when it might falter. After all, no strategy works all the time.

If you compare the historical returns of the shareholder yield strategy versus the overall market, there are a few data points that stick out.

Since 1972, in positive years for the broad market, the market averaged a 20.69% return versus a 22.55% gain for the shareholder yield strategy.

But in negative years, the broad market averaged -11.91%, almost twice as bad as the -6.87% return for the shareholder yield portfolio.

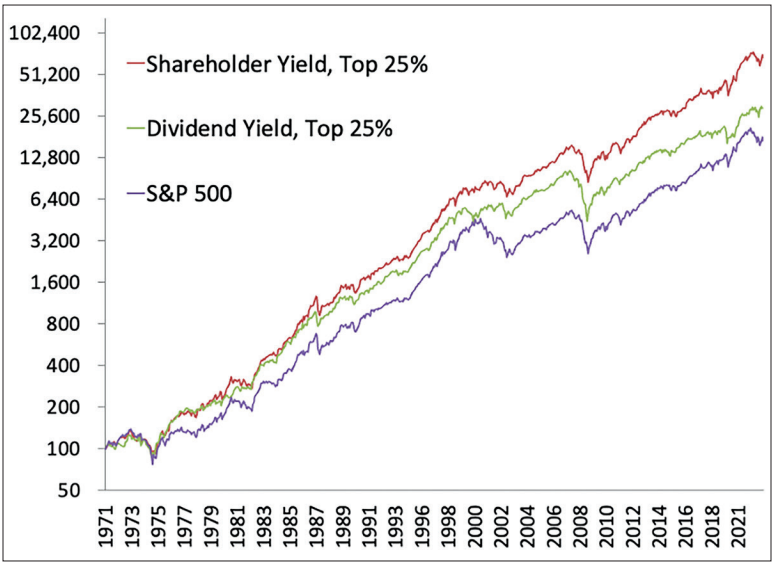
In the big down years, defined as greater than -10%, the broad market averaged a pullback of -20.77%, again nearly double the -10.91% losses for the shareholder yield portfolio.

The results make intuitive sense. A strategy like shareholder yield, which tilts toward value and quality, would be expected to do well in big bear markets. Two of the best years for the strategy versus the overall market were 2000 and 2002 in the aftermath of the dot.com bubble burst.

Meanwhile, what are two of the worst relative years for the strategy? You guessed it, 1998 and 1999.

Figure 16 below shows an equity curve depicting all three portfolios from 1971-2022: the S&P 500, the high dividend portfolio, and the high shareholder yield portfolio.

FIGURE 16 – US Stocks vs Yield Portfolios, 1971–2022.



Source: Gray, Vogel, "Enhancing the Investment Performance of Yield-Based Strategies" (2012) Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

CAN WE IMPROVE RESULTS BY FOCUSING ON DIVIDEND GROWTH? OR BY EXPANDING THE INVESTMENT UNIVERSE?

Some investors prefer the concept of dividend growth to high dividend yield. And what's not to like, the name sounds like the best of both worlds, you get reliable dividend stocks that are also growing too!

We replicated the same screens but added a column for top dividend growth stocks.

FIGURE 17 – US Stocks vs Yield Portfolios, 1971–2022.

	US Stocks	Dividend Yield	Shareholder Yield	Dividend Growth
Returns	10.35%	11.51%	13.31%	10.37%
Volatility	15.56%	13.99%	15.04%	14.99%
Sharpe Ratio	0.38	0.50	0.59	0.39
Maximum Drawdown	-51.56%	-56.82%	-46.34%	-51.95%

Source: Gray, Vogel, "Enhancing the Investment Performance of Yield-Based Strategies" (2012) Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

Many investors may be scratching their heads as they have likely seen some famous charts in the literature showing that dividend growth stocks outperform over time. However, these studies were based on faulty index construction but are still being published today.

An entire generation of funds were sold on the faulty premise of dividend growth outperformance.

Not sure if you believe this statement? Here's a great piece published by O'Shaughnessy "Dividend Yield vs. Dividend Growth" that adds detail to the same conclusion: dividend investors would do better by focusing on dividend yield rather than dividend growth.

What about expanding the investable universe?

If you decided to broaden your search to the top 3000 stocks, and only invest in the top 10% (or 300 stocks) equal weighted, your return would increase to 14.94%.

FIGURE 18 – Shareholder Yield Portfolios, 1971–2022.

	US Stocks	Dividend Yield	Shareholder Yield	Dividend Growth	Shareholder Yield EW
Returns	10.35%	11.51%	13.31%	10.37%	14.94%
Volatility	15.56%	13.99%	15.04%	14.99%	20.97%
Sharpe Ratio	0.38	0.50	0.59	0.39	0.50
Maximum Drawdown	-51.56%	-56.82%	-46.34%	-51.95%	-65.93%

Source: Gray, Vogel, Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

If you chose to add a value tilt to the portfolio – say by eliminating the top half of the universe by P/E ratios, you increase returns and Sharpe ratios even further. In fact it even works in expensive stocks.

Below is a table that examines the top 1000 stocks by market cap, divided into the 500 most expensive and the 500 cheapest stocks based on P/E. It then invests in the 100 stocks with the highest shareholder yield.

FIGURE 19 – Shareholder Yield Portfolios, 1971–2022.

	Top 1000 US Stocks EW	Expensive Shareholder Yield	Cheap Shareholder Yield
Returns	10.35%	13.38%	14.90%
Volatility	15.56%	17.78%	17.02%
Sharpe Ratio	0.38	0.50	0.61
Maximum Drawdown	-51.56%	-51.56%	-53.76%

Source: Gray, Vogel, Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

There are countless permutations on constructing a final portfolio, but the conclusion remains the same: focusing on shareholder yield has worked.

One of the biggest tests for any strategy is out of sample performance. This can include real time performance, as well as prior history that has not been examined. (The best test, of course, is real time real money performance net of all trading costs.)

In the next chapter, we examine research on shareholder yield that goes back another 100 years!

CHAPTER 8

A LONGER LOOK – NEARLY 100 YEARS OF SHAREHOLDER YIELD

Investigating any investment approach should produce results that work most places, most of the time. Nothing always works, but it would be concerning if a strategy only worked in one country, sector, market environment, or time frame.

For a longer analysis of combining cash flow metrics, we look to one of the most comprehensive studies on classic quantitative factor screening in the book by James O'Shaughnessy, *What Works on Wall Street*. There is a chapter on shareholder yield (but he does not include debt paydown, so under our definitions, it is net payout yield). He finds that high dividend-yielding stocks outperformed the CRSP large stocks universe by 1.18 percentage points per year from 1928-2009 and that including net buybacks increased the returns by another 1.92 percentage points per annum. He also finds that more concentrated portfolios can add another 1-3 percentage points per annum on top of this number.

O'Shaughnessy finds that returns for the top decile of shareholder yield stocks were positive for every decade except for the 1930s. Indeed, the *excess* returns over large stocks have been consistent and positive every decade since the 1930s. Not surprisingly, with the advent of the SEC rule 10b-18 in 1982, two of the three decades with the largest excess returns were the 1980s and 2000s. Excess returns of shareholder yield above large stocks averaged 2.37% per annum from the 1930s through the 1970s, while the excess returns averaged 4.76% per annum from the 1980s through the 2000s.

Pim Van Vliet recently published the paper "The Conservative Formula: Quantitative Investing Made Easy" and the companion book *High Return from Low Risk*.

The paper examines net payout yield paired with two more factors, low volatility and momentum, and finds similar results.

From the largest 1,000 stocks, 500 with the lowest three-year volatility are selected. From this subset, 100 stocks with the best net payout yield and price momentum are selected.

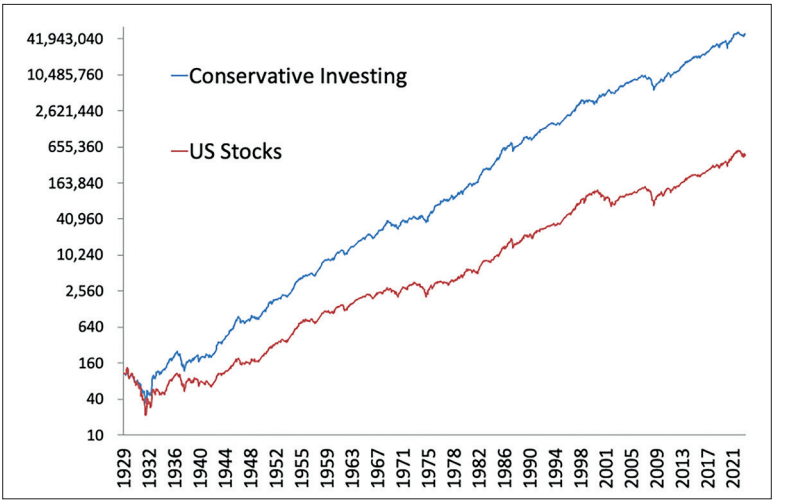
The resulting equally-weighted portfolio is then rebalanced on a quarterly basis. The portfolio returned 15% per year from 1929 – 2022.

FIGURE 20 – US Stocks vs. Conservative Investing, 1929–2022.

	US Stocks	Conservative Investing
Returns	9.42%	15.00%
Volatility	18.84%	16.49%
Sharpe Ratio	0.32	0.71
Maximum Drawdown	-83.66%	-71.29%

Source: Robeco, Pim Van Vliet, Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

FIGURE 21 – US Stocks vs. Conservative Investing, 1929–2022.



Source: Robeco, Pim Van Vliet, Index returns are for illustrative purposes only. Indices are unmanaged and an investor cannot invest directly in an index. Past performance is no guarantee of future results. Index returns do not reflect any management fees, transaction costs or expenses. This example is purely hypothetical.

But might US data skew the results? After all, US companies spend more on share buybacks as a percentage of earnings and market cap than other countries. Currently the US accounts for approximately 70% of global stock buybacks according to Janus Henderson.

From Janus, "The rapid growth in buybacks is not a one-year phenomenon. Astonishingly, buybacks have almost tripled in value since 2012 (+182%), easily outpacing the 54% increase in dividends over the same period.

Every region, almost every country and almost every sector have seen them grow strongly. The biggest jump came in 2018 and was mainly caused by US technology companies ramping up their buyback programmes.

The consequence of this rapid growth is a significant increase in the importance of share buybacks. In 2012, globally they were equal to just 52% of dividends, ranging from 3% in emerging markets to 102% in North America. In 2022 the global figure had jumped to 94%, ranging from 18% in emerging markets to 158% in North America."

This trend to more buybacks in foreign markets should continue as more companies embrace the tax benefits of buybacks as companies have in the US. Another piece that covers buyback and dividend investing in foreign equities is "The Importance Of Dividends And Buybacks: Ratios For Gauging Equity Values" by Jeremy Schwartz.

Second, even with international companies buying back less stock than US companies, this strategy still produces outperformance.

Robeco also found similar results when evaluating European and Japanese markets since 1986. And when tested in emerging markets dating to 1993, the strategy had performance of over 20% per year.

Van Vliet makes a strong case for the simplicity and outperformance of this market approach. First, his chosen three factors – low return volatility, high net payout yield, and strong price momentum – don't even require accounting data. This makes implementation easy even for non-professional investors.

Then, the results speak for themselves. The methodology showed a positive return every decade since 1929. Furthermore, it outperforms the market by a healthy margin while reducing downside risk.

Van Vliet concludes: "...This simple formula gives investors full and efficient exposure to the most important factor premiums, and thus effectively summarizes half a century of empirical asset pricing research into one easy to implement investment strategy..."

The returns are consistent over time, across international stock markets, and in US small/midcap stocks. In sum, this simple formula can be used by active investors to profit

directly from half a century of academic insights by applying one simple investment formula.

While these are just a few extensions to the simple concept of shareholder yield, shareholderyield.com includes a literature review with links to many more pieces on various yield investing strategies that will provide fruitful ideas for constructing stock portfolios.

CHAPTER 9

SHAREHOLDER YIELD ACROSS SECTORS AND INDUSTRIES

Some analysts claim comparing stocks from various sectors is inaccurate due to their structural differences. However, Richard Tortoriello has also presented backtests in his book *Quantitative Strategies for Achieving Alpha* (2009), demonstrating that shareholder yield portfolios would have generated alpha in all ten US equity sectors when examined independently.

We decided to test the idea with more up-to-date information. The research project was inspired by a conversation with a portfolio manager who focused on gold stocks. Gold stocks have notoriously underperformed the metal which has recently hit all-time highs.

Many gold companies are huge cash incinerators, so you want to own the companies run by CEOs who are thoughtful about capital allocation and treat their shareholders kindly.

It recalls what Mark Twain supposedly said: "A gold mine is a hole in the ground owned by a liar."

We once again partnered with Alpha Architect, who constructed most of the backtests in this book to examine the results at a more granular level.

And not surprisingly, it worked!

The equal weight returns for the mining industry were 6.79% per year from 1974-2020.

The high shareholder yield bucket was 11.61% per year. The middle bucket was 6.77% and the low bucket was 0.64%. The mining sector returned 6.29% for market cap weight and 6.79% for equal weight.

Does shareholder yield work in other sectors and industries, too?

Across all 12 sectors, a high shareholder yield strategy results in average outperformance of 2.91% over buy and hold. For market cap weight, the result is similar but lower at 2.22%.

The best part? It worked in all 12 sectors.

What if we go a little more granular and reduce it to 30 industries? (A warning here as you move to smaller subsets - some of these groups would have had low stock numbers 50 years ago...)

It turns out it worked in all 30. The result was even more pronounced here, where we saw a 3.35% outperformance

for equal weight and a 2.50% performance for market cap weighting.

These results are not earth-shattering, but the confirmation of research in diverse sectors and industries instills confidence.

CHAPTER 10

WHY DOES DIVIDEND BRAND PERSIST? THE PEPSI CHALLENGE

Over a decade ago, we set out to educate investors on shareholder yield. And yet, despite our best efforts, investors are still in love with dividends.

In their recent report, "Searching for Great Dividend Funds", Morningstar calculates 348 open-end mutual funds and ETFs with over $1 trillion focused on dividends. At a hypothetical 3% dividend yield, that $30 billion in cash dividends buys a lot of pina coladas.

A trillion is a lot of money. Clearly, investors still love dividends. But given all the research and evidence that the shareholder yield concept is a superior methodology, why does the dividend approach persist?

It's because dividends have a great brand. Old habits and narratives are hard to change.

Here's an example.

Beginning in the 1980s, Pepsi started running "Take the Pepsi Challenge" television commercials featuring taste

tests that would pit their soda against Coca-Cola. Tasters would take sips of each unmarked beverage and be asked to declare which soda they preferred. Invariably, Pepsi was the favorite choice. Coke conducted its own trials and, astonishingly, found similar results. The oft-cited reason was that Pepsi's formula was sweeter, and this led to the conclusion that Coke needed to change its formula, which resulted in the disastrous rollout of the abomination called New Coke.

However, even though people blindly preferred Pepsi, they still bought Coke to the extent that it commanded a much larger share of the soda marketplace than Pepsi (and still does today). In tests, researchers also found that foreknowledge of the brand altered the results—people's responses changed, and the majority preferred Coke when they knew the brand.

Why is this? Are people irrational? Or are there other factors at play – childhood memories of drinking a Coke with Grandpa on the front porch swing, or perhaps the warm fuzzy feelings you have from watching the polar bear commercials and the Super Bowl? Regardless, the simple conclusion is that there is more at work than taste or even logic alone. Brand means something, which applies to other items such as wine, automobiles, and clothing.

Do the same branding imprints impact investing and stocks? Certainly – for the older investors, think back to the EF Hutton commercials from the 1970s ("When EF

Hutton talks, people listen") or Smith Barney ("They make money the old-fashioned way, the earrrnnnned it"). For younger generations, the E*Trade Baby Commercials featuring a talking baby discussing investing became a cultural phenomenon in the early 2000s. There are also the great brands of Warren Buffett or Peter Lynch. The Pepsi challenge can provide a metaphor for high-yielding dividend funds as of late.

Dividends also have a great "story." You may have learned about them from your parents or taken an investing course in college. One could go as far to say dividends have a great *brand*. Much like Coke, thoughts of dividend stocks immediately conjure images of regular checks coming in the mail from profitable, established companies.

However, market valuations and stock and fund characteristics ebb and flow based on cycles and investor psychology. While it was nearly impossible to find someone wanting to invest in dividend stocks in the late 1990s, almost everyone was clamoring for dividend stocks in a desperate search for yield during the ZIRP environment.

But a beloved brand shouldn't blind us to the realities of observable data. And those data suggest that dividend investing alone faces its challenges.

So, with all of the evidence presented in this book why do investors still invest in dividend funds when they could be investing in something else?

Perhaps investors prefer the high dividend funds for the same reasons they prefer Coke – it feels familiar. Perhaps think back to being burned by non-dividend stocks in the 2000 tech bubble – or they recall talking to their parents around the kitchen table as a child. Making the best investment choice requires a separation of logic and emotions, which is very hard for most investors. After all, studies have shown that of all the things that get us emotional, our money is very high on the list.

CHAPTER 11

PRACTICAL IMPLEMENTATION – INVESTING USING SHAREHOLDER YIELD

If you've read this far and agree with our thesis, you may be asking yourself, "How can I screen for shareholder yield stocks? Is there a way to invest in shareholder yield portfolios?"

We have built a homepage that includes links to resources at www.shareholderyield.com.

For those looking to implement a do-it-yourself shareholder yield approach to investing in equities, a few additional resources are available to the investor.

STOCK SCREENERS

There are countless stock screening applications on the internet, ranging from somewhat limited free screeners to highly customizable professional screeners. There are too many websites to review here, but the investor needs to do their homework as the screeners have various levels of quality. Only a few sites have shareholder yield criteria as a preset screen that we can find. Below is a list of a few

websites to get you started:

- Ned Davis Research
- YCharts
- Bloomberg
- Portfolio123
- AAII
- Morningstar
- ETFdb

For those looking to allocate to shareholder yield funds, Cambria manages numerous shareholder yield strategies and more information can be found at www.cambriafunds.com.

CHAPTER 12

SUMMARY

When a market experiences structural changes, it is important to adjust the investment approach in a way that reflects and effectively responds to those changes.

As we detailed in this book, the investment market experienced such a structural change in 1982 with the SEC's Safe Harbor Rule 10b-18. Up to that point, dividends were perhaps the most hallowed of all the stock market's sacred cows.

However, even today, after vast mountains of new research have suggested that a shareholder yield approach to investing offers superior performance than dividend investing alone, many "blind men" can't see it. Instead, they cling tightly to their dividend gospel, either unwilling or unable to accept that the proverbial elephant has other characteristics.

Returning to the "The Blind Men and the Elephant" from our introduction...

> So oft in theologic wars,
> The disputants, I ween,
> Rail on in utter ignorance

Of what each other mean,
And prate about an Elephant
Not one of them has seen!

We believe it is vital to evaluate all the different ways a company returns its cash flows to investors – and what that means for total returns – rather than focusing on dividend yields alone.

In doing so, we hope to avoid the outcome of the blind men, who "each was partly in the right, and all were in the wrong!"

Below is a summary of the findings outlined in this book:

- Dividends and their reinvestment contributed a major portion of the stock market's total return over time.
- Portfolios that invested in high yielding dividend stocks have outperformed low yielding portfolios and broad market indices in the U.S. and in foreign markets.
- Dividends are only one use of a company's cash flow. Other uses include stock buybacks, debt paydown, acquisitions, and reinvestment in the company.
- Due to tax treatment and structural changes in the 1980's, U.S. companies have shifted their payout mix to include more stock buybacks.

- Accounting for other ways companies return cash to shareholders is vital to assessing a stock's attractiveness.
- Portfolios that invested in stocks with a more holistic cash flow distribution focus, such as high shareholder yield, have experienced a higher total return than dividend yield portfolios or the broad stock market.

APPENDIX

STOCK FACTORS MENTIONED IN THE BOOK

Debt/Asset
Total debt divided by total assets. This is a measure of financial leverage. Stocks with a lower debt/asset ratio tend to perform better.

Debt/Equity
Total debt divided by total common equity. This is a measure of financial leverage. Stocks with a lower debt/equity ratio tend to perform better.

Dividend Payout
Annual total amount of dividends declared on the common stock divided by income.

Dividend Yield
Annual dividend divided by price. A high dividend yield indicates greater value for every unit worth of stock.

Earnings Yield
Trailing 4Q EPS (basic excluding extraordinary items) divided by price (inverse of Price/Earnings). A higher

number indicates greater value for each unit of earnings, which tends to drive higher stock returns.

Enterprise Value/ EBITDA
Market value of equity plus debt (Enterprise Value) divided by earnings before interest, taxes, depreciation, and amortization (EBITDA). A lower value signifies that each unit of a stock's value is used to generate more EBITDA profits, which normally leads to higher stock returns.

Free Cash Flow Yield
Operating cash flow minus (cash dividends plus capital expenditures) divided by price (inverse of Price/Free Cash Flow). A higher number is typically a sign of undervaluation, based on the company's ability to generate cash.

Price to Book
Price divided by latest quarter book value. A lower number indicates greater value, and tends to drive higher stock returns.

Price to Sales
Price divided by 4Q sales. A lower number indicates greater value for unit of sales, and tends to drive higher stock returns

Shareholder Yield
Trailing 12-month net stock repurchases, cash dividends, and net debt reduction divided by market cap. A higher number indicates greater shareholder value per share, which normally leads to higher stock returns.

ACKNOWLEDGMENTS

Most financial writing owes a major debt of gratitude to the research that has come before it. In this case there have been many analysts and researchers that have examined the effects of selecting stocks based on various measures of cash flows and their distributions. While we mention a number of these pioneers in this piece, we would especially like to acknowledge William Priest, James O'Shaughnessy, Patrick O'Shaughnessy, Jacob Boudoukh, Roni Michaely, Matthew Richardson, Eugene Fama, Kenneth French, Michael Roberts, Michael Maubossin, Richard Tortoriello, Jason Zweig, Rob Arnott, Jason Hsu, Robert Haugen, Jeremy Schwartz, Wes Gray, Jack Vogel, Pim van Vliet, Aswath Damodaran, Cliff Assness, and Daniel Peris for their fine work.

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