(BBO) An 80 Billion-Share Mystery Surrounds Buybacks: Stephen Gandel

---

An 80 Billion-Share Mystery Surrounds Buybacks: Stephen Gandel
2019-03-08 12:00:26.720 GMT

By Stephen Gandel
(Bloomberg Opinion) -- Here's a simple math problem for you: If the companies in the S&P 500 Index have 289 billion shares outstanding, and they repurchase 82 billion in a decade, how many shares will they have at the end of those 10 years? The answer, of course, is 294 billion, 5 billion more than what they started with. I'm guessing that's not the answer you came up with, right? But those are the real numbers for the past decade, and they point to the fact that investors, long thought to be the chief beneficiaries of buybacks, may not be.

There has been a lot of debate recently about the worth of stock buybacks, sparked by the fact that it appears companies plowed a good deal of the money that they saved from Donald Trump's corporate tax cut into repurchasing their shares. Buybacks, which have been rising for much of the past decade, jumped about 50 percent last year to nearly $800 billion for the companies in the S&P 500, a new annual high, according to S&P Global Inc.

To a lot of people, that seemed not only like a bad outcome of the tax cuts, but also a poor outlet for corporate profits in general, and the groundswell could even lead to new regulation. Last month, Democratic Senators Bernie Sanders and Chuck Schumer proposed legislation that would restrict companies' ability to buy back stock. Republican Senator Marco Rubio followed with his own proposal to limit repurchases by increasing the taxes on capital gains, leveling the advantage buybacks have over dividends, which are taxed as income.

What everyone seems to agree on, whatever their opinion on buybacks, is that repurchases are a way companies hand money back to shareholders. The mechanics of it are that buybacks reduce the number of shares outstanding and therefore boost the per-share value of future earnings. Selling shareholders benefit by getting a slightly higher price than they would have had the companies not been buying. For investors who stick around, a higher stock price should follow. But that basic story could be wrong.

Earlier this week, long-time stock strategist Ed Yardeni penned a mea culpa about buybacks, saying he was wrong to be a backer. Nearly all of the gains of stock repurchases, Yardeni now says, flow to top executives. “Buybacks are not designed ‘to return cash to shareholders’ as is widely believed,” he wrote in his regular newsletter.

Yardeni says the companies in the S&P 500 have spent roughly $4.5 trillion on buybacks over the past 10 years, yet by his calculation, which include some adjustments, the shares outstanding of those companies has dropped by just 2 percent during that time. What accounts for the difference? Employee stock compensation.

Buybacks haven’t returned cash to shareholders, or boosted share prices, Yardeni says. All they have done is bought back the shares that have been issued to employees, essentially enabling higher executive compensation by picking up the tab of stock options. Based on data from S&P Dow Jones Indices, the current members of the S&P 500 had 284 billion shares outstanding in early 2009, and have bought back bought 81.5 billion shares through the end of 2018. That means shares outstanding should have dropped by nearly 29 percent, instead of falling 2 percent, by Yardeni’s calculations – or rising slightly, as data from S&P show.

Even after accounting for equity issuance and share-count changes due to acquisitions, I calculate that roughly two-thirds of what companies spent on buybacks appears to have gone toward offsetting executive compensation. And there’s more to the story.

The tale usually told about buybacks is that companies have this pot of profits and they are choosing to use it to prop up their stock with buybacks. But back in 2005, the Financial Standards Accounting Board began forcing companies to expense the cost of option grants, even though they aren’t a cash outlay. That means buybacks aren’t really funding stock grants. Corporate bottom lines already include the cost of stock options. By the time you get to the bottom line, that money has effectively already been “spent.” Repurchases are just a way of squaring that accounting. Without buybacks, shareholders would effectively be paying for stock compensation twice – once when they are expensed and a second time from the dilution of additional shares. Executives get the options either way. And indeed, the growth of buybacks in the past decade-and-a-half

correlates pretty closely with the 2005 accounting change for options. There is even some research to suggest causation.
So do repurchases benefit executives or shareholders? They are like marketing or rent or any other expense. Spent on the right executives, stock buybacks benefit shareholders. More likely, the spike in executive compensation has probably led to some pretty wasteful buybacks. It also suggests that all of us, myself included, are spending a lot of time on the symptom, not the cause. Executive compensation is the issue, buybacks are just coming along for the ride.

To contact the author of this story:
Stephen Gandel at sgandel2@bloomberg.net
To contact the editor responsible for this story:
Beth Williams at bewilliams@bloomberg.net