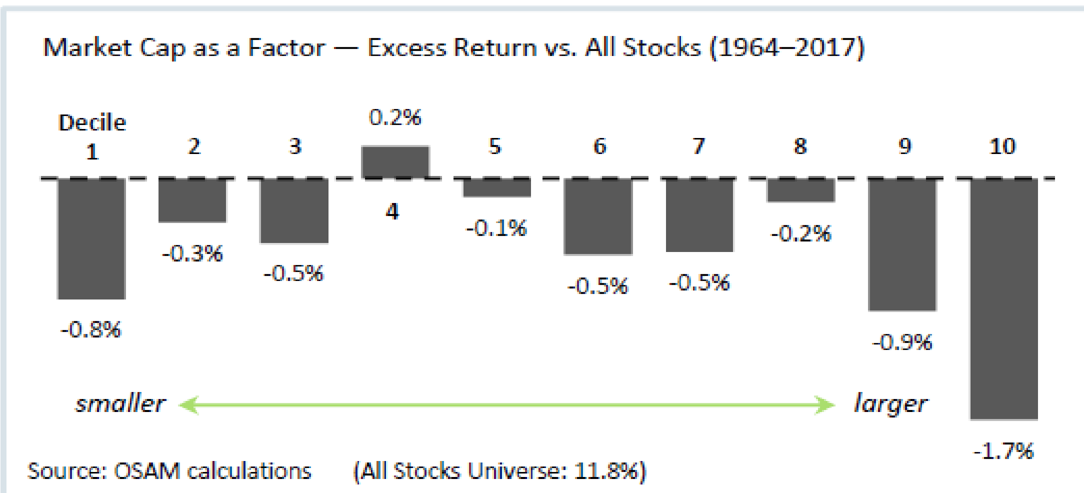
Shareholder Yield: A Differentiated Approach to an 'Efficient' Market – US Large Cap Value

BY OSAM RESEARCH TEAM: September 2019

Following the 2008 financial crisis, passive investing has gained popularity as indices designed to capture market beta have benefited from a record-breaking bull market. By design, the underlying securities in an index are weighted by market capitalization. Consequently, traditional passive investing is an implicit bet on market capitalization as an investment factor, which we believe is flawed.

MARKET CAPITALIZATION IS A POOR INVESTMENT FACTOR

In the chart below, we use S&P Compustat data to create example portfolios grouped by market cap. The selection universe in this paper, 'All Stocks', is equally-weighted, and serves as the benchmark for all factor excess returns.* For comparative purposes, the All Stocks universe is analogous to an equally-weighted Russell 3000® Index.



The chart clearly shows that larger stocks have historically underperformed over the long term, which is problematic, since most passive equity investments are concentrated in the two lowest performing deciles (9 and 10). Additionally, in rolling five-year observations, these groups of stocks tend to underperform our All Stocks Universe more than half of the time. There is clearly room for improvement in the 'efficient' large cap universe.

SHAREHOLDER YIELD: ALPHA GENERATION IN LARGE CAP STOCKS

In our view, management teams serve their shareholders in two capacities: (1) generate profits and (2) allocate those profits as efficiently as possible for shareholders' long-term benefit. In an analysis of corporate allocation over several decades, we find that the most rewarding way to allocate capital is to return it to shareholders. And while dividend income has its virtues, it's taxed twice—once at the corporate level and again at the individual level. A great advantage of buybacks is that continuing shareholders don't pay the second round of taxes.

At OSAM, our approach aims to capture the benefits of both dividends ***and*** buybacks. **Shareholder Yield is the sum of a stock's dividend yield (paid over previous twelve months minus special dividends) and the percentage of net share buybacks over the previous twelve months.** It is a powerful tool for identifying good management teams.

In fact, one of the most effective stock selection strategies in the U.S. over recent decades has been buying stocks in the midst of repurchasing significant quantities of their shares. Before diving into our analysis, though, we must understand ***why*** companies would repurchase their own shares:

- Companies like to repurchase shares when their stock is cheap, and a big buyback program often sends a message to investors that a company's management believes its stock is trading below intrinsic value.
- Shares are sometimes bought back to offset the dilution that happens when shares are granted to employees.
- Share repurchases can be used to "manage" or "boost" earnings per share (EPS).

Investors using buybacks as a factor to select stocks should ensure that companies are buying back stock for the first reason, and not for the second two.

IDENTIFYING THE BEST BUYBACK PROGRAMS

What has caused the recent boom in buyback programs, though? Regulation changes have contributed to this, as Safe Harbor legislation through SEC Rule 10b-18 in 1982 loosened the restrictions for when a company can repurchase stock. Do not underestimate the effect changes in regulation can have.

With this loosened regulation came opportunity. Repurchasing undervalued shares is one of the best ways to create value for shareholders, though not all share repurchases are created equal. Three qualifiers help identify the most attractive repurchasers:

- Focus on "net" buyback yield, which takes share issuance into account alongside *buybacks*, rather than "gross" yield, which does not.
- Avoid companies that have significant buyback programs but trade at expensive valuation multiples.
- Avoid the "EPS management" problem by insisting on strong quality of earnings alongside big buyback programs.

Factor Qualifiers

Factor Name	Calculation
"Gross" Buyback Yield	Total share repurchases ($) divided by market capitalization
"Net" Buyback Yield	Total share repurchases ($) minus total share issuance ($) divided by market capitalization
Value	Equally weighted rank of value using price/earnings, price/sales, EBITDA/EV, and free cash flow/EV
Earnings Quality	Year over year percentage change in total accruals

SHAREHOLDER YIELD: NET BUYBACKS

First, we compare the two different calculations for "buyback yield."[1] The table below breaks the universe of all U.S. stocks into deciles based on the two measures of buybacks, and shows the excess return of each decile since 1987.[2] **In each case, companies that have made the largest share repurchases over the prior year have gone on to significantly outperform the market in the following year and have done so with low volatility, while companies issuing large amounts of equity underperformed by a wide margin.**

[1] The period tested is 1987–2014 because the statement of cash flows is required to calculate gross and net buyback yield.

[2] Rebalanced on a rolling annual basis.

Excess Return vs. All Stocks (%)

Worst ← → Best

Buyback Decile:	1	2	3	4	5	6	7	8	9	10	Spread Best-Worst Decile
"Net" Buyback Yield	-7.42	-4.33	-1.00	0.41	-0.10	-0.77	0.97	1.70	2.35	3.87	11.29
"Gross" Buyback Yield	-2.10	-1.78	-2.22	-1.69	-2.16	-1.77	0.38	1.82	2.32	3.54	5.64

Volatility (%)

Worst ← → Best

Buyback Decile:	1	2	3	4	5	6	7	8	9	10
"Net" Buyback Yield	23.99	22.90	20.89	20.14	19.48	18.39	17.39	16.29	15.91	17.00
"Gross" Buyback Yield	20.43	20.68	20.74	20.65	20.94	19.33	17.48	16.39	16.11	17.38

Using net buybacks instead of gross protects investors against firms that are repurchasing shares just to offset shares issued to employees, or other non-value creating reasons.

SHAREHOLDER YIELD: VALUE

The large cap space is supposedly the most "efficient" and difficult to outperform, but most large buyback programs are conducted by large, established firms. By narrowing our analysis to just large stocks, however, we demonstrate that two additional refinements significantly improve the raw buyback signal.

After controlling for the first pitfall of buybacks (repurchases to offset share issuance), the second pitfall is buying companies with large buyback programs that repurchase shares at exactly the wrong time: when their stock price is very expensive. The table to the right breaks all large stocks into 25 groups according to two factors: their net buyback yield, and their valuations.

Annual Returns — Buybacks & Value

Buyback Yield Quintile	Value Quintiles: 1	2	3	4	5
1	11.7%	10.9%	8.0%	6.9%	3.5%
2	12.6%	10.6%	9.8%	9.3%	7.7%
3	13.6%	10.4%	9.2%	9.0%	7.6%
4	13.2%	10.5%	9.3%	9.4%	6.6%
5	15.3%	13.4%	11.4%	9.2%	5.1%

Repurchasing Shares & Cheap

$\underbrace{\hspace{8cm}}_{\text{10.2% annualized return gap among large share repurchasers (based on current valuation)}}$

Repurchasing Shares & Expensive

Stocks in the upper right are both expensive and issuing shares; **a brutal combination**. Stocks in the lower left, with a return of 15.3 percent, are buying back lots of shares, but when the stock is also cheap; **a historically powerful combination**. Finally, stocks in the lower right are also buying back lots of shares but at expensive valuation multiples. This final group has a return of just 5.1 percent, **confirming that Value is a crucial component to any strategy favoring large buybacks.**

SHAREHOLDER YIELD: EARNINGS QUALITY

The final qualification is avoiding companies that seem to be manipulating or smoothing their earnings. The below table shows the same 25 groups among large cap stocks, but instead of combining buybacks with value, it combines buybacks with earnings quality. A similar story emerges. The bottom row illustrates that strong buybacks and strong earnings quality produce a much better annual result (14.5 percent) than strong buybacks and poor earnings quality (9.0 percent).

Annual Returns — Buybacks & Earnings Quality

		Earnings Quality				
		1	**2**	**3**	**4**	**5**
Buyback Yield Quintile	**1**	10.3%	9.5%	9.8%	7.4%	4.2%
	2	12.2%	10.6%	10.4%	8.9%	6.6%
	3	12.1%	10.6%	9.6%	9.9%	8.2%
	4	12.4%	11.1%	9.6%	10.1%	10.3%
	5	14.5%	14.0%	13.2%	10.7%	9.0%

Repurchasing Shares & High Quality

Repurchasing Shares & Low Quality

5.5% annualized return gap among large share repurchasers (based on current valuation)

SCOPE OF THE HIGH CONVICTION MARKET

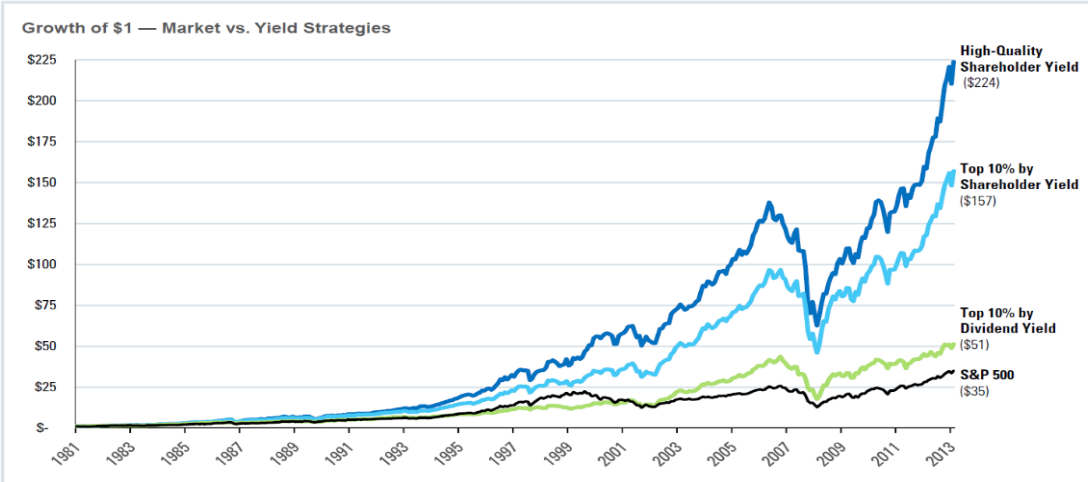
Only some thirty percent of all buybacks come from 'high conviction' firms repurchasing between five and ten percent of their shares. The 'very high conviction' firms, repurchasing more than ten percent is a smaller segment.

THE RESULTS: A COMPLETE APPROACH TO YIELD

Buyback programs are a strong proxy for management discipline. If managers recognize value in their own share price, *then foregoing misguided investments and opting instead for large share repurchases can create huge value for shareholders*.

Bringing these concepts together, consider the growth of $1 invested in 1982 in four different large cap strategies:

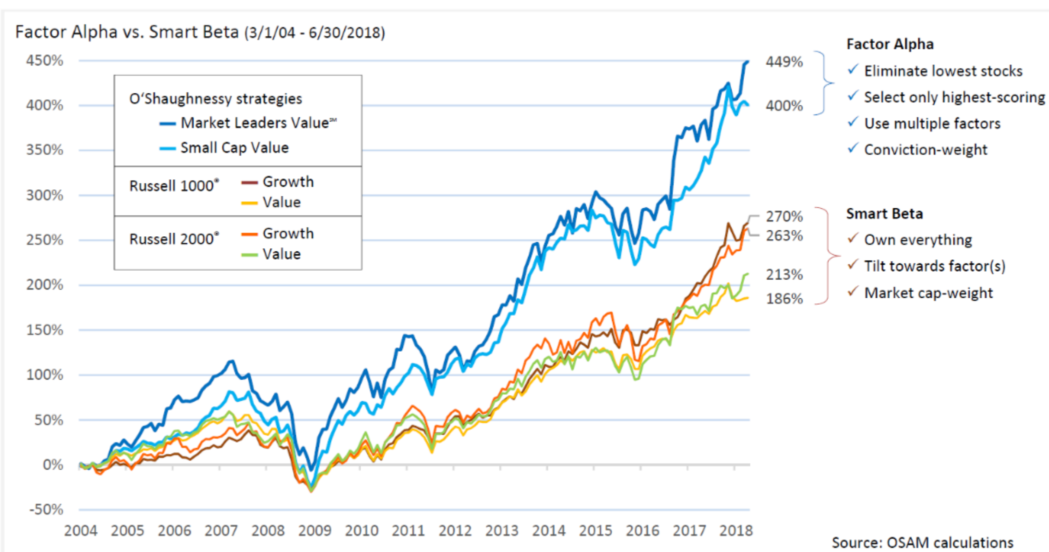
1. ***S&P 500***
2. **Top 10 percent of large stocks by *Dividend Yield****
3. **Top 10 percent of large stocks by *Shareholder Yield*** *(dividends + buybacks)**
4. **Top Large Stocks by *Shareholder Yield*** *after eliminating the half of the stock universe with the lowest valuation and poorest quality**



CONCLUSION: SHAREHOLDER YIELD GENERATES ALPHA IN LARGE CAP STOCKS

When utilizing buybacks as an investment signal, apply the President Reagan maxim of "Trust, but verify." Buybacks should be used in combination with value to confirm management's motives for repurchasing shares and to ensure that they are buying at a discount. Use accruals to make sure that management isn't manipulating earnings, and "net" buyback yield to adjust for share issuance. Used collectively, this approach can provide a comprehensive look into a company and allow investors to use stock buybacks as a signal for wise investments.

The strong outperformance of OSAM's Market Leaders Value strategy is a testament to the power of Shareholder Yield in the 'efficient' large cap space.



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