**How investors may be getting fooled by buybacks**

* The Associated Press
* Posted March 11, 2014 at 12:15 p.m., updated March 11, 2014 at 3:17 p.m.  
  Read more: <http://www.vcstar.com/news/2014/mar/11/how-investors-may-be-getting-fooled-by-buybacks/#ixzz2vxjznwkk>   
  - vcstar.com

NEW YORK — NEW YORK (AP) - If you're puzzled why the U.S. stock market has risen so fast in a slow-growing economy, consider one of its star performers: DirecTV.

The satellite TV provider has done a great job slashing expenses and expanding abroad, and that has helped lift its earnings per share dramatically in five years. But don't be fooled. The main reason for the EPS gain has nothing to do with how well it runs its business. It's because it has engaged in a massive stock buyback program, halving the number of its shares in circulation by purchasing them from investors.

Spreading earnings over fewer shares translates into higher EPS - a lot higher in DirecTV's case. Instead of an 88 percent rise to $2.58, EPS nearly quadrupled to $5.22.

Companies have been spending big on buybacks since the 1990s. What's new is the way buybacks have exaggerated the health of many companies, suggesting through EPS that they are much better at generating profits than they actually are. The distortion is ironic. Critics say the obsessive focus on buybacks has led companies to put off replacing plant and equipment, funding research and development, and generally doing the kind of spending needed to produce rising EPS for the long run.

"It's boosted the stock market and flattered earnings, but it's very short term," says David Rosenberg, former chief economist at Merrill Lynch, now at money manager Gluskin Sheff. He calls buybacks a "sugar high."

Over the past five years, 216 companies in the S&P 500 are just like DirecTV: They are getting more of a boost in EPS from slashing share count than from running their underlying business, according to a study by consultancy Fortuna Advisors at the request of The Associated Press. The list of companies cuts across industries, and includes retailer Gap, supermarket chain Kohl's, railroad operator Norfolk Southern and drug distributor AmerisourceBergen.

The stocks of those four have more than tripled, on average, in the past five years.

Companies insist that their buybacks must be judged case by case.

"The vast majority of our shareholders are sophisticated investors who not only use EPS growth but other important measures to determine the success of our company," says Darris Gringeri, a spokesman for DirecTV.

But Fortuna CEO Gregory Milano says buybacks are a waste of money for most companies.

"It's game playing - a legitimate, legal form of manufacturing earnings growth," says Milano, author of several studies on the impact of buybacks. "A lot of people (focus on) earnings per share growth, but they don't adequately distinguish the quality of the earnings."

So powerful is the impact, it has turned what would have been basically flat or falling EPS into a gain at some companies over five years. That list includes Lockheed Martin, the military contractor, Cintas, the country's largest supplier of work uniforms, WellPoint, an insurer, and Dun and Bradstreet, a credit-rating firm.

It's not clear investors are worried, or even aware, how much buybacks are exaggerating the underlying strength of companies. On Friday, they pushed the Standard and Poor's 500 stock index to a record close, up 178 percent from a 12-year low in 2009.

"How much credit should a company get earning from share buybacks rather than organic growth?" asks Brian Rauscher, chief portfolio strategist at Robert W. Baird & Co, an investment company. "I think the quality of earnings has been much lower than what the headlines suggest."

And it could get worse.

Companies in the S&P 500 have earmarked $1 trillion for buybacks over the next several years. That's on top of $1.7 trillion they spent on them in the previous five years. The figure is staggering. It is enough money to cut a check worth $5,345 for every man, women and child in the country.

There is nothing necessarily nefarious or wrong about buybacks per se. It doesn't seem that managements are trying to cover up a poor job of running their businesses. Even without factoring in a drop in share counts, earnings in the S&P 500 would have risen 80 percent since 2009.

The problem is that many investors are pouring money willy-nilly into companies doing buybacks as if they are always a good thing, and at every company.

A fund that tracks companies cutting shares the most, the PowerShares Buyback Achievers Portfolio, attracted $2.2 billion in new investments in the last 12 months. That is nine times what had been invested at the start of that period, according Lipper, which provides data on funds.

For their part, the companies note there are all sorts of reasons to like them besides EPS.

WellPoint points out that it has increased its cash dividend three times since 2011, a big draw for people looking for income. Cintas says that it's timed its buybacks well, buying at a deep discount to stock price today. And DirecTV says investors judge it also by revenue and cash flow, both of which are up strongly.

What's more, companies seem to genuinely believe their shares are a bargain and they'd be remiss for not buying, though their record of choosing the right time is poor.

The last time buybacks were running so high was 2007, right before stocks fell by more than half.

There are signs the next $1 trillion in buybacks for S&P 500 companies could also prove ill-timed. Stocks aren't looking so cheap anymore. After a surge of nearly 30 percent last year, the S&P 500 is trading at 25 times its 10-year average earnings, as calculated by Nobel Prize winning economist Robert Shiller of Yale. That is much more expensive than the long-term average of 16.5.

Many investors assume shrinking shares automatically make remaining shares more valuable. The math is seductive. A company that has $100 in earnings and 100 shares will report $1 in earnings per share. But eliminate half the shares and the same $100 is spread over 50 shares, and EPS doubles to $2.

But that doesn't make the shares more valuable.

Shares aren't just a claim on short-term earnings. They are an ownership stake in an entire company, including R&D programs and its capital stock - the plants, equipment and other assets needed to boost productivity long into the future. Critics say the lavish spending on buybacks has "crowded out" spending on such things, which is at its weakest in decades.

"It's just like your car depreciating or your home depreciating - you have to invest," says Gluskin Sheff's Rosenberg, "The corporate sector has barely preventing the capital stock from becoming obsolete."

One result: U.S. productivity, or output per hour, increased just 0.5 percent last year, a pitiful performance. It has grown by an average 2 percent a year since 1947.

If not reversed, history suggests stocks will suffer. In a 2010 study, Fortuna's Milano found that stocks of companies that spent the most on buybacks vastly underperformed stocks of those that spent the least on them - at least over five years.

It's unclear whether the kind of investor who dominates stock trading now cares about the long-term, though. Buybacks are one of the few sure-fire ways to push a stock higher in the short term, and investors these days are very short term.

They "don't care what happens in three or five years," laments Rauscher, the Baird strategist. "The market has become less of an investor culture, more of a trading one."

Read more: <http://www.vcstar.com/news/2014/mar/11/how-investors-may-be-getting-fooled-by-buybacks/#ixzz2vxjt01aN>   
- vcstar.com