Lincoln Private Investment Office

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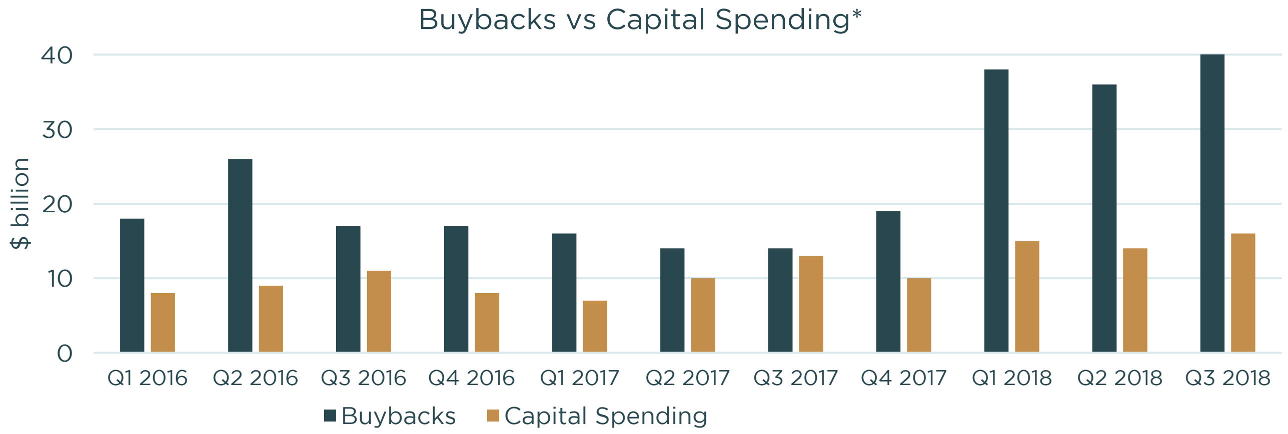
Corporate buybacks – is the party ending?

At the end of 2017, President Trump signed new regulations to cut the corporate tax rate from 35% to 21% and to introduce a one-time tax of between 8% and 15.5% on previously untaxed offshore corporate profits. This removed the incentive for companies to hold these monies overseas and resulted in a huge repatriation of cash into the US. The media reported that American companies were going to share these tax savings with employees and increase capital spending, thereby helping to boost the US economy. In fact, shareholders were the real winners from the tax cuts as corporate buybacks soared, whilst employee compensation and capital investment received less than expected.

In 2018 corporate buybacks have averaged $4.8 billion per day; this is double the pace of 2017 and has provided a strong tailwind for US equities. The 5 US technology companies with the largest amount of cash (Apple, Alphabet, Cisco, Microsoft and Oracle) have spent a combined $115 billion buying back their own stock in the first three quarters of 2018 alone, using cash that had previously been kept offshore. The chart below shows the discrepancy between buybacks and capital spending for those 5 US tech companies. A study from Bloomberg found that 60% of the gains from tax cuts will go to shareholders, compared with 15% for employees. This has further increased wealth inequality in the US, where the wealthiest 10% of Americans now own 80% of shares.

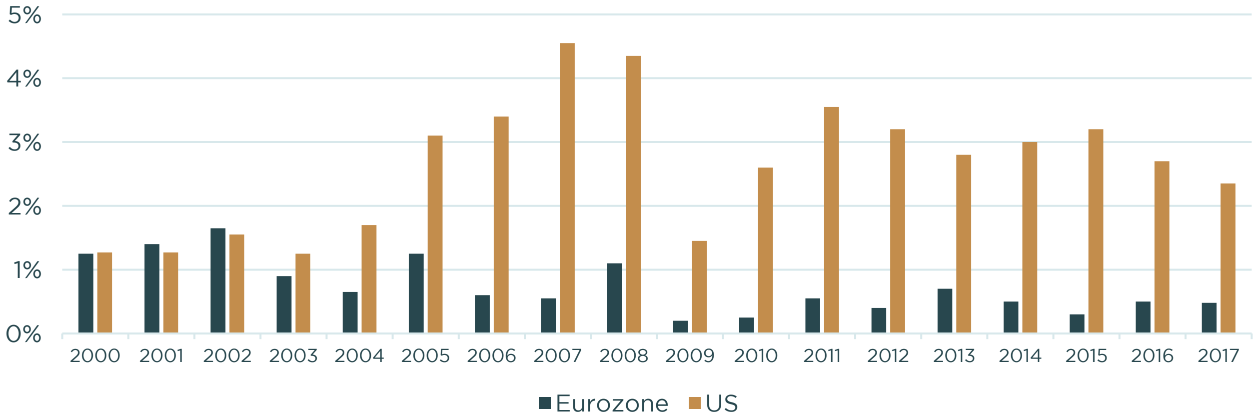


*for Apple, Alphabet, Cisco, Microsoft and Oracle
Source: The Financial Times, 2018

So, what exactly are buybacks? They are when companies purchase their own shares from the public, and then cancel them reducing the total number of shares in circulation. In a similar way to dividends, it is a method for companies to return cash to shareholders. Buybacks were illegal until 1982 because they were considered a form of market manipulation. Since then they have been widely used and can be viewed as either a positive or negative signal to the market. On the positive side, it may show that the companies believe their shares are undervalued, indicating optimism for the future and so increasing investor confidence. On the negative side, it can be a cause for concern as it may mean companies are seeing a lack of investment opportunities. Buybacks are a simple way to make a business look more attractive. By reducing the number of outstanding shares, a company's earnings per share will immediately increase, without any improvement in earnings growth.

Buybacks have become much more popular in the US than the rest of the world over the last 15 years. There is suspicion over the motivation for doing them, because US executive compensation is often linked to share price performance and improvements in the firm's earnings per share. The chart below shows the discrepancy in the size of corporate buybacks between the US and the Eurozone. In Q2 2018, the Federal Reserve's latest Flow of Funds report showed that buybacks accounted for a massive 83% of the total demand for US equities. Therefore, trying to forecast their pattern can be helpful in forecasting market returns. This was evidenced in October, when the S&P 500 fell 10%, peak to trough. This sell-off coincided with a "blackout" period for corporate buybacks. A blackout period refers to the month prior to companies releasing their quarterly results during which they are prohibited from repurchasing their own shares. With a large source of equity demand temporarily gone, the US market lost its support. Google Trends data recorded an all-time high in October for the number of times "buyout blackout" was searched, showing the increased focus that investors have on understanding this behaviour in order to monitor the market.

Corporate Buybacks as a % of Market Capitalisation:
Eurozone vs US



Source: Gavekal Data/Macrobond, 2018

We wrote in our Q3 Investment Letter about the disparity in performance between the US market and the rest of the world this year. One factor in this outperformance has been the tax changes and resulting repatriation of US Dollars. This has encouraged US companies to buyback more of their own stock, and with most of the offshore cash now repatriated, research indicates that we have probably seen the peak of buyback activity. Whilst we would anticipate levels to remain elevated versus the rest of the world, we should see US buybacks return to normal levels. With the artificial and short term sugar highs of corporate buyback activity slowing, we believe that the divergence in performance between the US and the rest of the world will close.

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