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When companies buy their own shares, should you?

By Andrew Leckey

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Companies that find themselves flush with cash have been buying back their shares in 2011.

Not the least of this group is Warren Buffett's Berkshire Hathaway. Technology, drug and railroad companies are also repurchasing in large quantities because they feel their stock is underappreciated.

If they're so convinced that they're getting a bargain, perhaps investors should take a closer look as well.

"There really aren't too many choices that companies have to use their cash," explained Hugh Johnson, chairman and chief investment officer with Hugh Johnson Advisors in Albany, N.Y. "They can pay dividends, buy other companies, reinvest in their own businesses or buy their shares back."

A share repurchase program reduces the number of shares outstanding, increases earnings per share and can also raise the market value of the remaining shares. The fact that a company is buying its shares back implies it has a lot of cash, which by that measure is success, said Johnson.

Yet a share buyback alone, either directly in the market or by offering shareholders the opportunity to tender their shares to the company at a fixed price, isn't reason alone to buy a company's stock.

"We are actually more pleased when we see the companies do something else with the money, such as buy other companies or expand current businesses," said Johnson, whose views are shared by some other experts who suspect CEOs and boards may sometimes use buybacks to make things look better than they actually are.

However, if a company's management and board are capable, you can be sure they've already asked themselves what move would have the most positive effect on the stock price, he acknowledged.

Typically, a company takes more than a year to complete a share repurchase, with its first major buy taking place in the first month of the program. Sometimes buyback programs are extended or cancelled

based on company and market conditions.

"We avoid companies with share buybacks that look good but must borrow in order to buy those shares because the company isn't generating cash flow," said Charles Biderman, CEO of TrimTabs Investment Research in Sausalito, Calif. "I want to make sure companies are growing their cash and giving it out through dividends and share buybacks."

A share buyback and a dividend payout each represent return of capital to investors, Biderman said, but a share buyback is tax-free to the shareholder while a dividend requires that you "must pay Uncle Sam and the state."

"Whenever companies feel good about the future, they shrink the float of their shares," he added. "When they feel bad about the future, they sell shares for cash."

Basing its portfolio on the liquidity a company has for share repurchases and dividends, the actively managed **AdvisorShares** **TrimTabs Float Shrink** (TTFS) exchange-traded fund was introduced in October. It is sub-advised by TrimTabs Asset Manager.

The average company in its portfolio has considerable cash and is reducing its number of shares by 6.5 percent a year, said Biderman. About half of the portfolio is in small-capitalization stocks.

Consumer staples represent 30 percent of the fund and information technology 20 percent. The top five holdings are **Digimarc Corp.** (DMRC), **Teekay Tankers Ltd.** (TNK), **LTX Credence Corp.** (LTXC), **Herman Miller Inc.** (MLHR) and **Xyratex Ltd.** (XRTX).

Between 2004 and 2006, homebuilding companies were loaded with cash and aggressively bought back their shares at the peak of the market, noted Eric Landry, director of industrials research for Morningstar Inc. in Chicago. That strategy turned disastrous when the financial crisis hit the industry and its stocks.

"For an investor to know whether a share buyback is prudent or not, you must have an idea of whether you believe the stock is undervalued," Landry explained. "In the same way that a company analyzes a decision on whether to buy a factory, it must decide whether the share buyback is the best current use of capital."

A dividend that locks a company in over a longer term may not be a smart decision for a company that operates in a volatile business, he said.

NVR Inc. (NVR), a giant homebuilder operating across 14 states, has never paid a dividend but has consistently outperformed the market because management buys its stock back when it is cheap, said Landry.

Other companies that he considers to be savvy at buying their shares back at the right time and price are **3M** (MMM), the vast industrial company whose Scotch Tape and Post-It Notes products are especially well-known, and **Illinois Tool Works Inc.** (ITW), a diversified global industrial company that is adept at using its ample cash to make acquisitions as well.

Morningstar identified a list of quality companies that have reduced their shares outstanding over the past five years and still been able to pay out dividends. Among the stocks on its list are **BHP Billiton** (BHP), **Becton, Dickinson & Co.** (BDX), **Medtronic Inc.** (MDT), **Parker Hannifin Corp.** (PH) and **The Western Union Co.** (WU).

The fundamental business, prospects and debt of a company must also be weighed carefully.

"Share buybacks should be only one of many things that an investor looks at when deciding whether to invest in a company," concluded Johnson. "You should always ask yourself exactly why a stock is cheap."

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