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TRIVARIATE RESEARCH

INVESTOR COMMENTARY ON SHARE REPURCHASES, THE NIFTY NINETY, AND OUR VIEW OF THE FED

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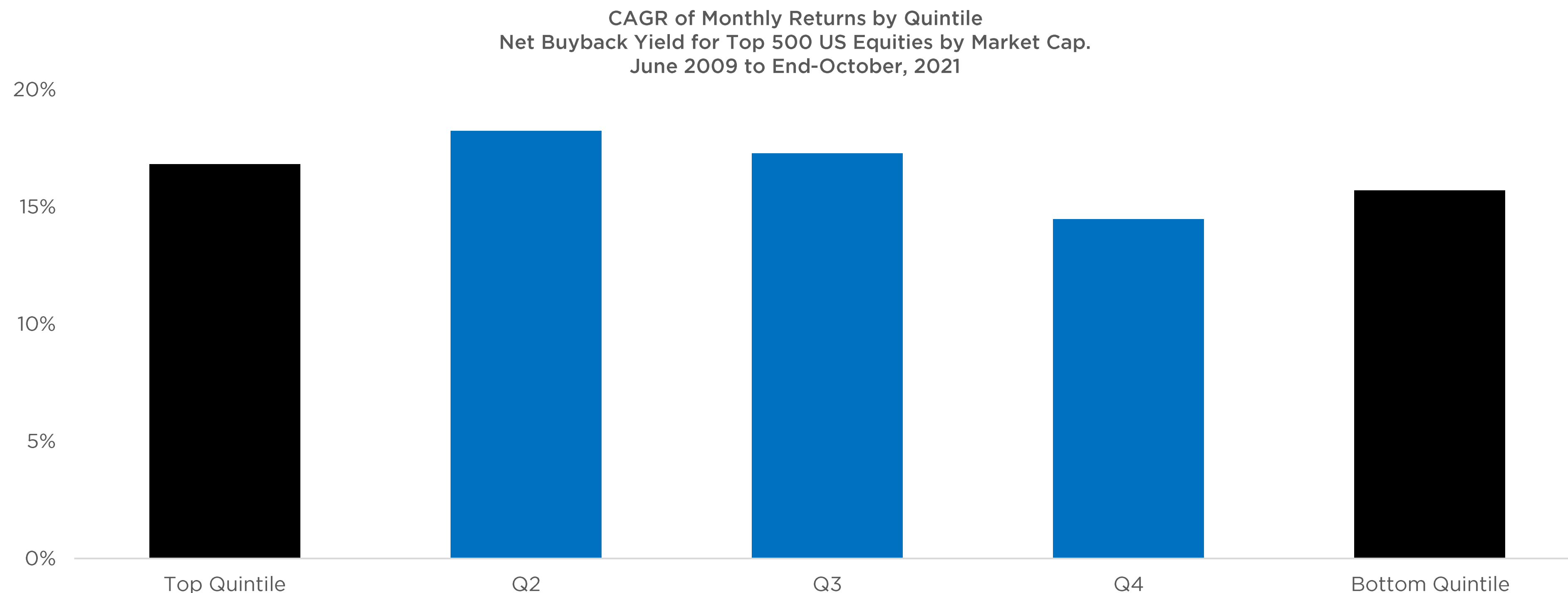
THOUGHTS ON THE FAILURE OF SHARE REPURCHASES

We recently published a note highlighting the lack of efficacy of share repurchases. Our analysis was based on a large basket of stocks looking back many years. The conclusion? Companies in the top quintile of buybacks do not subsequently beat stock doing no buybacks (the middle quintile), and companies that do the least buybacks / dilute their share bases do not lag the market.



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INVESTOR FEEDBACK ON SHARE REPURCHASES

This note generated a lot of feedback from investors and corporates themselves:

1. A number of investors broadly agreed, with responses like "Amen" and "Dividends would be better." We are not sure if this is just their required investment mandate, but clearly there are a group of investors who have been critical of management teams for buybacks. They view this capital use as excessive, or question the fact that as stocks rise, management teams dedicate the same amount of capital to buybacks every quarter. It is worth noting that few companies executed large buybacks at the bottom in Q2 2020.
2. We also received contrary feedback from investors that expressed the sentiment that they wished companies did buybacks before catalysts played out, if the company did not want to do large M&A. We plan on addressing other uses of capital and the markets rewards and penalties for this in the coming weeks.
3. One mega cap company's investor relations team argued that they carefully assess the free cash flow per share and compare it to all alternatives for deployment. My pushback to this company was that their massive multi-year share repurchase might have been successful in their ex-post analysis, but this occurred at the same time their profit margins expanded by 1000bps, so isolating the efficacy of the buyback is challenging. Moreover, we are NOT saying that buybacks don't work for some companies or are not a great use of capital in many cases. Our simply put thesis is that since the financial crisis, in aggregate, for a large group of stocks, buybacks have not been a good use of capital. Prior to that period, from 1970 through 2006, it was.

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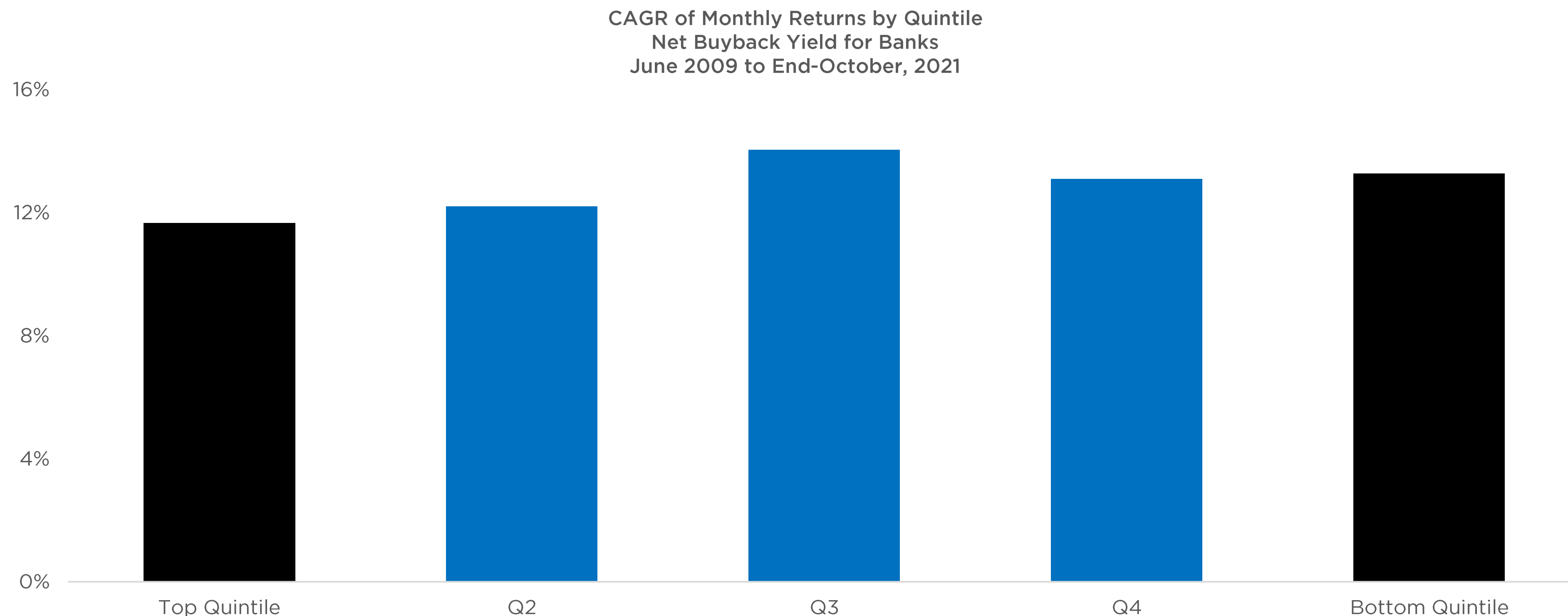
BUYBACK FAILURE FOR BANKS

Given the fast improvement in bank balance sheets since the financial crisis and the establishment of a comprehensive capital analysis and review (CCAR) for the large banks, we thought buybacks would have been in aggregate an efficacious use of capital for banks since the financial crisis. However, banks buying back more than 2.5% of the shares in a 9-month period did not subsequently outperform banks diluting their share base by 2.5% or more over the same time frame.



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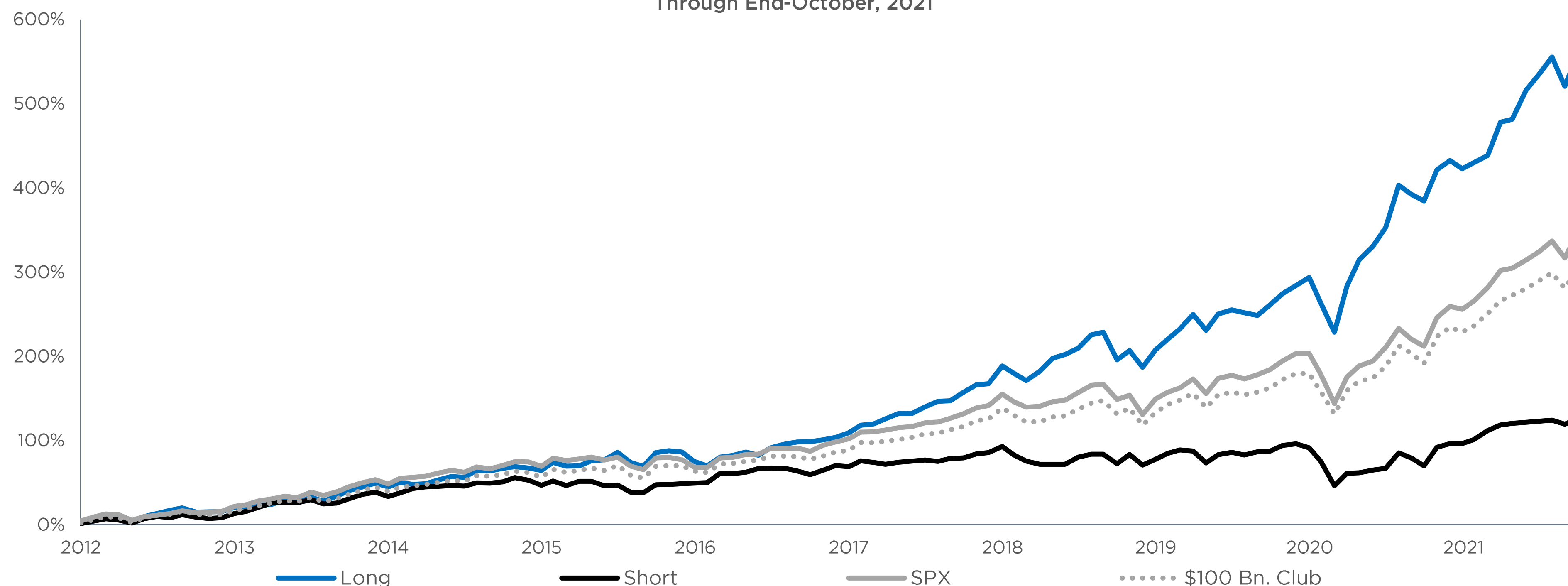
THE NIFTY NINETY – SURPRISING THAT SELL-SIDE ANALYSTS MATTER

Last week we published a note analyzing the 93 US companies that are currently $100 billion market capitalization or larger and established a framework for picking winners from losers among this group. One of the five signals we used was sell-side analyst recommendations – we were surprised that the evidence showed that these added value. Some of our work on sell-side estimates in certain parts of the market had shown the sell-side analysts were a counter indicator, fueling our prior thought process that this might serve as an efficacious counter indicator. We analyzed the average rating of the analysts and looked at the subsequent average monthly returns. The data are compelling- the most loved stocks beat the market, and the least loved lag. Our explanation ex-post is that only companies bereft of M&A options and with clear negative catalysts would fall in the bottom-quintile of the analyst recommendations, while the most-loved have obvious high growth and potential for lots of M&A.



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OUR VIEW OF THE FED

While marketing in Boston last week we met with one investor that agrees with our view that the Fed will not act for a long time. Mostly, we have received pushback or indifference to our view. We established in a note last week that our best guess for when the Fed raises the front end is the second half of 2024, vs. the consensus that we will see at least two hikes in 2022. The part of the argument we did not make in our piece is "what the market is telling you."

While investors (both equity and fixed income) seem very concerned about the Fed raising the front-end and causing a large rotation or sell off, the market itself does not seem to be. The 10-year yield has remained relatively stable at 1.5% for the last couple of months.   After a back-up a couple of months ago, the 2-year yield appears to have plateaued at 0.5%.   The five-year / five-year breakeven rate has remained relatively steady around 2.25%. The market is telling you not to worry about long-term inflation.   Those who think there will be structural and strong inflation will argue the market is wrong and that is the opportunity, but one of the main points in our note was that we think the Fed is smart.   This investor agreed and added that part of their intelligence is to look at the market, which is a discounting mechanism, to inform their view.   That is less worrisome than the banter today.

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