BUY BACKS

I have long since concluded that investing is far more about minimising losses than maximising gains. Much like sports such as Rugby or Cricket, if you defend well and limit the other team's ability to score points, winning is almost guaranteed. Not only does this strategy work in practice for me but it also reduces the rather unpleasant emotional reality that losing money is painful so while one must be able (and expect) to lose money some of the time, a defensive risk-averse strategy suits me.

One of the catalysts for both finding potential investments and for investing, that I am most attracted to is insider buying…not the illegal type of course but the decision by those closely associated with an organisation to allocate capital toward buying shares. As a fund manager sitting outside an organisation, there is only so much you can find out and learn about a company…there is a limit. So one of the things that gives me considerably more confidence when looking at a stock is the decision by senior management to either buy stocks for themselves or buyback stock for the existing shareholders. I must say I'm often suspicious when a CEO tells me how cheap their stock is and what great prospects it has and yet won't buy shares and neither will members of the board. Mmm

Anyway, while our experience tells us that buybacks are a great ingredient to a successful investment, I recently saw some research previously conducted into buybacks and their predictive capabilities (love that internet). Its findings were not surprising but reassuring all the same.

The research I'm going to make reference to is from the "Journal of Financial Economics 39 (1995) 181-208. It appears the research was conducted by David Ikenberry, Josef Lakonishok and Theo Vermaelen. These people came from four different universities spread across the USA and Europe.
They examined the long run share price performance following a period of on market share repurchase between 1980 and 1990. Their findings were summarised as follows:
"We find that the average abnormal four year buy and hold return measured after the initial announcement is 12.1%. For "value" stocks, companies more likely to be

repurchasing shares because of undervaluation, the average abnormal return is 45.3%. For repurchases announced by "glamour" stocks, where under valuation is less likely to be an important motive, no positive drift in abnormal returns is observed. Thus at least with respect to value stocks, the market errs in its initial response and appears to ignore much of the information conveyed through repurchase announcements"

So there are several findings made but one significant one, identified and alluded to above, is that an announcement of a buyback programme does not generally lead to an immediate market re-rating leading to a stock rebounding back to fair value. Indeed the average short-term share price response is 3.5%. The authors of the research called this modest response 'Underreaction Hypothesis' or UH, the authors quoted several other research papers identifying the same phenomenon.
The research observations were based on sample data of 1,239 stocks undergoing buybacks between 1980 and 1990 on the NYSE, NASDAQ or ASE. The following quote provides the summary that supports our views without providing you with extensive details of the research:
"*The most striking finding of this paper is that the information conveyed by open market share repurchase is largely ignored. Managers of firms that repurchase their own shares appear to be correct, on average, in assuming that they can buy shares at bargain prices to the benefit of their long-term shareholders. Beginning in the month following the repurchase announcement, the average buy and hold return over the next four years is more that 12% above that of a control portfolio. If undervaluation is an important motive overall, it should be particularly important for out-of-favour stocks, which tend to have high book-to-market ratios. Yet surprisingly, the market reaction to repurchase announcements is similar across all book-to-market firms. The average return over the next four years for a buy-and-hold portfolio of these stocks is 45% above that of a control portfolio of similar size and book to market firms. For low book-to-market firms, no abnormal performance is observed in long run returns"*

I don't know about you but it is exciting to read research that supports my investment strategy (with due respect to confirmation bias) yet also confirms that the market remains inefficient and therefore allows a disciplined value strategy to generate market alpha (out performance).

We continue to use smart money flows (insider buying/selling, substantial shareholder notices and buybacks) as a key consideration in our investment process. At the end of the day we believe in structural incentivisation as an incredibly powerful force and if insiders are putting their capital at risk via a buyback or direct buying…it's a strong statement.

For those interested in the whole article please see
http://faculty.insead.edu/vermaelen/_private/marketunderreaction.pdf

Good investing,
Nigel Littlewood