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Stock buybacks: Buy high and sell low

By Scott Cendrowski, reporter July 11, 2011: 5:00 AM ET

That's what most companies do when they buy their own shares. But you can avoid the trap.

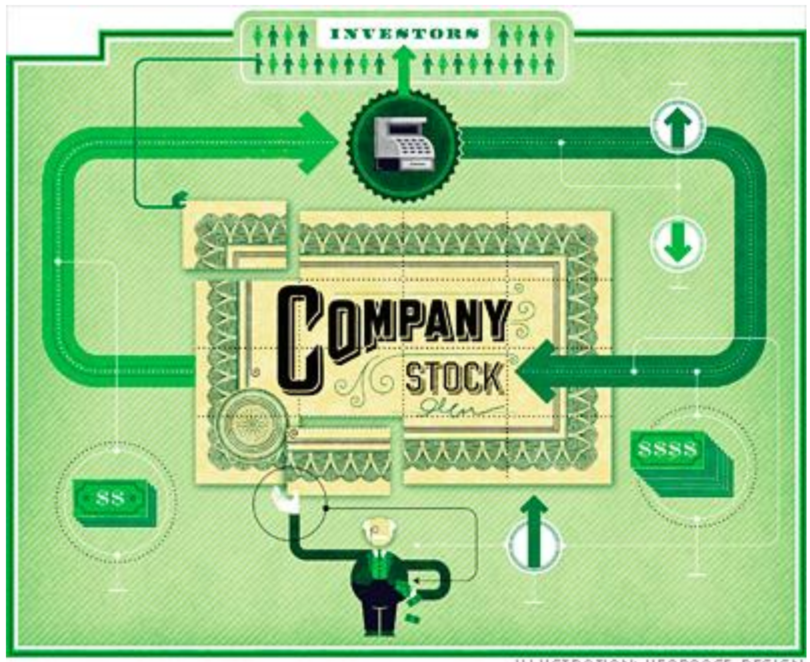

ILLUSTRATION: HEADCASE DESIGN

FORTUNE -- In 2006 and 2007 timber giant Weyerhaeuser (WY) conducted one of the biggest share buybacks in its history. It unleashed $800 million to purchase its shares, which were dancing near an all-time high of $80. In 2009, with the stock at $30, the company spent a mere $2 million on its own stock. Similarly, semiconductor equipment maker MEMC Electronic Materials (WFR) purchased $100 million of its shares near their peak of $90 in 2007. Today the shares are trading at $8, and MEMC shows no signs that it's buying. Then there's the ultimate horror story: Citigroup (C) spent $31 billion last decade on its own stock, only to see it crash 97%. Citi then needed $45 billion in infusions from the government.

Call it the other bubble: From 2004 to 2008 companies flush with cash and confidence spent $1.8 trillion on their own soaring shares. When the market collapsed, what did they do? Rather than take advantage of discount share prices, as wise investors are supposed to do, they stopped buying. Indeed, the chart below illustrates just how closely share buybacks track the markets, when they should be doing the opposite.

That's newly relevant because buybacks are again reaching record levels. U.S. companies have announced $273 billion in stock repurchases through mid-June, says Birinyi Associates, on pace for the third-largest year ever.

In theory, investors should benefit when companies acquire their own stock. Fewer shares outstanding means larger profits per share and thus a higher stock price. And if the company, which knows its prospects better than anyone, is buying, that's a good sign, right? Alas, in recent years it often hasn't worked out that way.

Indeed, investors shouldn't treat a repurchase on its own as a signal to buy. Companies announce buybacks for many reasons -- among others, to mop up the extra shares issued to executives or because management thinks shares are undervalued -- and only some have positive implications.

Today's buybacks could very well bite investors, argues Charles Biderman, CEO of TrimTabs Investment Research. "We have an anomaly right now," he says. Even as buybacks proliferate, executives aren't spending their own money on their company's shares. Insider purchases through mid-June were on track to trail even 2009's total, which itself was just a quarter of the purchases made in 2007. "That indicates to me that companies are flush with cash, and don't feel they have anything to do with the cash in terms of their business," Biderman says. "So they are supporting their stock price, doing what the Street wants them to do, which is buying back shares."

Companies, it turns out, are prone to the same mistake individual investors make. Says Greg Milano of Fortuna Advisors: "The real problem is not the act of buying back stock. It's the timing." Companies have the most money at the top of the business cycle, when their share price is peaking, and they wind up buying high. "Companies spend first on making good investments," he says, "then acquisitions, then they pay down debt. Only after all that do they buy back stock."

That said, some companies are clearly better than others at this particular game. Fortuna Advisors has tallied buybacks at S&P 500 companies over the past 10 years, comparing the price at the time of repurchase with today's stock price to calculate a theoretical "return on buyback" figure.

The biggest winner: travel website Priceline.com. (PCLN) In 2006 it spent $130 million on its own shares before its booming European business caught analysts by surprise and the stock tripled; a second repurchase also paid off. Overall Priceline's buybacks have generated an estimated 1,013% gain. By comparison, the average S&P 500 company's annualized return on buybacks over the past decade was 6.3%, according to Fortuna -- not even enough to cover the cost of capital needed to pay for the shares.

So how should investors play the new buyback boom? It may seem obvious, but repurchases are best viewed as one useful item of information to be weighed along with traditional metrics, such as price/earnings ratios or indications that company executives are buying the stock for their own portfolios. By that standard, shares of J.P. Morgan Chase (JPM) and Wells Fargo (WFC) look appealing. Repurchase plans at the two banks rank among the 10 largest of 2011, and insider buying exceeds selling at both banks. With JPM, new regulations have scared investors, but its conservative capital levels and solid return on equity make it attractive, especially at its anemic 7 forward P/E. For its part, Wells faces none of the proprietary-trading regulations that could hamper other banks, and its percentage of mortgages in delinquency or foreclosure is about half that at Bank of America (BAC).

Two companies with strong buyback records have also announced repurchases this year. Express Scripts (ESRX), the pharmacy benefit manager, ranked 15th in Fortuna's study and expects to spend $1.7 billion on purchases. Railroad operator Union Pacific (UNP), whose sales rose 13% in the last quarter because it was able to raise freight prices, plans to acquire 40 million shares by 2014. It's that sort of buyback -- one accompanied by rising sales and strong fundamentals -- that can put a stock on track for a good return.