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Buybacks Expected to Increase

By Nathaniel Popper

Investors are bracing for companies to ramp up purchases of their own shares in response to expected tax changes in the new year, despite growing criticism of buybacks.

Companies have two main ways to return cash to investors: paying money in quarterly dividends or repurchasing shares on the open market. A number of academics and investors, and a new industry survey, suggest that companies are likely to shift more money to buybacks after this year because taxes on those gains are expected to grow less than a proposed tax increase on dividends.

Peter C. Andersen, a portfolio manager at Congress Asset Management, expects share repurchases to increase and has added them to his list of the 10 most important things to consider when analyzing a stock. Last week, Mr. Andersen added News Corporation to the 23 other stocks in a mutual fund he runs because of, in part, the company's growing buyback program over the last two years.

"Dividends were the big thing," said Mr. Andersen, who manages the All Cap Opportunity mutual fund. "I think we'll stop seeing that popularity, and the new focus will be on stock buyback programs."

Wall Street and corporate America have been taking steps to prepare for the broad array of tax increases and spending cuts set to fall into place at the end of the year. While the White House and Congress are negotiating a compromise that could avert some of these changes, most executives and investors expect at least some tax rates to grow even if a deal is struck.

The Obama administration is pushing to sharply increase the rate at which dividends are taxed, to 39.6 percent from 15 percent. At the same time, the White House has proposed that the benefits derived from share repurchases, capital gains, be subject to a smaller tax increase: to 20 percent from 15 percent. Both types of investment income would also be hit by a 3.8 percent surcharge tied to the administration's health care legislation.

Companies including Wal-Mart and Las Vegas Sands recently decided to pay out their fourth-quarter dividend this year instead of early in 2013 to take advantage of the current tax rate on dividends. Some investors have sold off winning stock positions to lock in the current rate on capital gains. But while these are one-time changes aimed at capitalizing on existing rates, any moves to increase share buybacks could continue in the long run.

Mr. Andersen likes the prospect of more buybacks because he thinks they lift the price of a stock. Share repurchases are popular with executives because they lower the number of outstanding shares and increase the amount of profit per share, a popular measure used to evaluate companies and determine executive pay.

But some academics and investors believe the growth of the practice could lead to more misuse of corporate funds.

Gregory V. Milano, chief executive of Fortuna Advisors, said that companies frequently buy back their stock when it is at a peak; then the price drops, erasing any potential benefit to shareholders.

The number of share buybacks hit a low in 2009 when companies would have had the greatest advantage from buying their own shares. More important, he said, companies generally get lower returns from buying back stock than they do from investing in their businesses and staff.

Mr. Milano is expecting the number of buybacks to tick up with the coming changes, but he is not happy about it.

"When you buy back stock with money you could have reinvested, you not only deliver worse returns, you wind up employing less people," he said.

A surge in stock repurchases is still far from a sure thing. Taxes on dividends could rise less than is currently projected, allowing dividends to maintain their appeal to corporate executives. Even if those rates do rise, executives could choose to use their cash for other purposes, such as acquiring other companies or investing in new facilities and employees.

But in recent years, buying back stock has become one of the most popular ways for executives to use their excess cash.

In recent days, Chipotle, Starbucks and Bebe Stores all announced plans to ramp up their buyback programs.

Procter & Gamble executives announced this month that they were increasing the amount of money available for stock buybacks to $6 billion from $4 billion at the same time that they were preparing to lay off over 5,000 employees.

None of these companies has mentioned the prospect of tax increases as a motivating factor. But in a recent survey of 100 American companies, conducted by the financial data firm Markit, half of the companies willing to talk about their dividend policies said that if the tax rate on dividends increased, they were likely to shift money to share buybacks.

"You will see companies essentially scaling back their tendency to do dividends and moving into repurchases," said Douglas J. Skinner, an accounting professor at the University of Chicago's Booth School of Business. "They won't do this radically, but the rate will increase from what it otherwise would have been."

The surge in the popularity of both dividends and buybacks is attributed to, at least partly, the Bush administration's 2003 move to lower the tax rate on most investment income to 15 percent.

In the two years after those cuts, 145 new companies began paying out dividends, and 222 companies initiated buyback programs, according to a study led by Jennifer Blouin, an accounting professor at the University of Pennsylvania, and two economists at the University of North Carolina.

Companies in the Standard & Poor's 500 spent $2.7 trillion on buybacks from 2004 to 2011, and paid $1.8 trillion in dividends in the same time, according to a Credit Suisse research paper released in June. So far this year, companies have announced share buybacks worth over $220 billion, more than were announced in all of 2011, Markit found.

The 2003 tax cuts made dividends a more attractive option than they had been in the past, as compared with share repurchases, while the coming changes are set to work the other way, making buybacks more attractive than they currently are.

The study led by Ms. Blouin found that some companies showed a preference for dividends over buybacks after the 2003 changes particularly when the companies had board members who would benefit from the policies.

This time around, Ms. Blouin is expecting to see those same sorts of companies shifting their money to buybacks, which could make these companies more attractive to investors than dividend-paying companies.

“If you are looking to move out of a dividend-paying company, now you are going to look more favorably on a company that has a repurchase regime,” Ms. Blouin said.

In the long run, though, investors who opt for buybacks may not benefit. By one recent estimate from Credit Suisse, most of the buybacks done by companies in the Standard & Poor’s 500 index from 2004 to 2011 have not yet added much value for remaining shareholders.