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Are Your Investors in for the Long Haul?

Companies deploying higher percentages of their free cash flow into buybacks tend to deliver lower total shareholder return over time.

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In his February 1989 letter to shareholders, Warren Buffett wrote, "our favorite holding period is forever." Are your investors in for the long haul? If they aren't, how can you make investment decisions with long-term payoffs in the face of short-term pressures from constantly changing shareholders?

We all prefer to drive the share price higher now and over time, but would you be willing to suffer a 10% share price decline next week if in exchange you could be confident your share price would bounce back and then outpace the market by 20% over the next few years? Would your investors applaud such behavior? This is the conundrum many executives face when making important strategic decisions.

Margaret Mead said: "What people say, what people do, and what they say they do are entirely different things." What corporate executives often say is that they manage for the long term, and in many ways they do. Yet what they do in terms of capital deployment is often tilted toward boosting the share price even if the long-term upside is sacrificed.

Is that in response to investor pressure for short-term actions? Investors typically say they are interested in long-term value, yet their demands of management often indicate a short-term bias. Don't investors know what is best for them? Why do they often seem so short-term focused?

Perhaps the problem is that investors don't often hold their investments for very long. If an investor owns shares of a company for three months and then sells to buy another, she rightfully doesn't care what happens after she sells it -- she only cares about share-price performance while she holds it. Our very liquid capital markets provide immense societal benefits, but rapid shareholder turnover does have drawbacks.

How big is this problem? Consider Netflix. If we set aside short-term traders, quarterly shareholder filings show that the supposedly longer-term institutional investors buy and sell shares quite rapidly. On average since 2004 nearly 50% of the shares held by institutional investors are held for four quarters or less, and over 75% of the investor base turns over in less than four years.

Admittedly, Netflix has more shareholder turnover than many companies. But others face similar challenges. For Boeing, with its very long term product development cycle, 75% of shares are held for more than a year but only 40% for more than four years. At the other end of the spectrum is Wal-Mart, with 80% of its shareholder base holding for more than four years. Some companies really do have investors with extended time horizons like Warren Buffett.

Market Reactions Differ

There are countless studies of mergers and acquisitions showing that in the days surrounding acquisition announcements the share price of the buyer usually declines. One such study in the March 2005*Journal of Finance* found that "Acquiring-firm shareholders lost 12 cents around acquisition announcements per dollar spent on acquisitions for a total loss of $240 billion from 1998 through 2001."

Short-term "announcement studies" are often cited as evidence that acquisitions destroy value for the acquiring firm. But they typically examine shareholder reactions over a few days or weeks and assume the immediate reaction is correct over time, at least on average.

In contrast, our research shows that acquirers deliver higher total shareholder return (TSR) over time in the form of dividends and share-price appreciation. For example, my colleagues Steve Treadwell and Frank Hopson analyzed companies that made acquisitions of at least 20% of the acquirer's market capitalization each year during the decade of the 2000s. They found that for such acquisitive companies, TSR outperformed the S&P 500 index by 40% over the two-year period surrounding the deal.

Acquisitive companies tend to suffer declining share prices in the near term and rising prices over the longer term. Interestingly, share repurchases present the converse situation, in which share prices tend to rise when the repurchase is announced, yet companies executing heavy buybacks tend to underperform over the longer term.

Numerous researchers have identified a positive share-price reaction when companies announce share repurchases. One recent example from the Corporate Executive Board examined each quarter from 2008 through 2010 and found that share prices on the five days after a buyback announcement averaged 1.6% higher than over the five days before it.

Nearly two out of three companies had higher share prices after the announcement. Ironically, the only quarter when the reaction to buyback announcements was negative was when the market bottomed in the first quarter of 2009 and most shares could have been purchased at their lowest price.

Our research on the longer-term effects of share repurchases is counter to the short-term market reaction. We find that companies deploying higher percentages of the cash flow they generate into repurchasing shares tend to deliver lower TSR over time. This is so despite the accretion in earnings per share that comes from reducing the number of outstanding shares.

For example, we studied the 1,000 largest nonfinancial U.S. companies over the five years ending in 2009. We found the top quartile of buyback companies devoted over half their cash flow to buying back stock and that the median TSR of this group was 31% lower than the quartile that did not buy back any stock.

Some of this performance gap reflects a lack of desirable investment opportunities in some industries. But we replicated this analysis within many specific industries with consistent reinvestment opportunities and found that buybacks are a drag on TSR in most cases.

What Should Management Do?

Management actions often emphasize short-term share-price increases at the expense of the long term. Witness the current resurgence in buybacks: for the first half of 2011 the companies in the S&P 500 repurchased $193 billion worth of their own shares, nearly 3.5 times the rate in the first half of 2009.

With the stock market in suspended volatile neutrality, it seems that companies are trying to use buybacks to get some immediate positive share-price advantage. Will this serve their companies and their investors well over time?

A balanced approach is better. Executives cannot ignore the direct demands of their current shareholders even when those demands are very short-term in nature. But it also behooves them to consider the consequences for longer-term shareholders and the shareholders that will own the stock when the current short-term investors sell. The future shareholders will be no more or less important than the current shareholders.

For many companies, this longer-term perspective should lead them to deploy less capital toward buying back their stock and to be more open toward investing in the future growth of the business via acquisitions.

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