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Agency Capitalism

8 The Rise of Agency Capitalism and the Role of Shareholder Activists in Making it Work
Ronald J. Gilson, Columbia and Stanford Law Schools, and Jeffrey N. Gordon, Columbia Law School

23 The Effect of Shareholder Approval of Equity Issuances Around the World
Clifford G. Holderness, Boston College

42 Does Mandatory Shareholder Voting Prevent Bad Acquisitions? The Case of the United Kingdom
Marco Becht, Université libre de Bruxelles, CEPR, and ECGI; Andrea Polo, Luiss University, Universitat Pompeu Fabra, EIEF, Barcelona GSE, CEPR and ECGI; and Stefano Rossi, Bocconi University, CEPR, and ECGI

62 The Early Returns to International Hedge Fund Activism: 2000-2010
Marco Becht, Université libre de Bruxelles, CEPR, and ECG; Julian Franks, London Business School, CEPR, and ECGI; Jeremy Grant, Berenberg Bank; and Hannes Wagner, Bocconi University, ECGI, and IGIER

81 How Has Takeover Competition Changed Over Time?
Tingting Liu, Iowa State College, and Harold Mulherin, Georgia State University

95 Do Large Blockholders Reduce Risk?
David Newton and Imants Paeglis, Concordia University

113 Estimating the Equity Risk Premium and Expected Equity Rates of Return: The Case of Canada
Laurence Booth, University of Toronto

126 Save the Buyback, Save Jobs
Greg Milano and Michael Chew, Fortuna Advisors

Columbia Business School

Save the Buyback, Save Jobs

by Greg Milano and Michael Chew, Fortuna Advisors

In a recent *New York Times* editorial, Senators Chuck Schumer and Bernie Sanders described stock buybacks—and dividends, too—as "corporate self-indulgence" and "an enormous problem for workers and for the long-term strength of the economy." It's true, of course, that the growth of jobs and median wages in recent decades has been disappointing, but the senators identify the wrong culprit. And in so doing, they perpetuate a misconception about the role of dividends and buybacks. Besides failing to note how such payouts increase capital productivity, the senators miss their critical economic function of recycling "excess capital" from large, mature companies with fewer investment or employment opportunities to the next generation of Apples and Amazons.

According to Schumer and Sanders, U.S. companies in thrall to shareholder value maximization are buying back their shares to boost earnings per share—and presumably their stock prices—while cutting back on long-term investment. To curb this behavior, the senators propose regulations that would require companies buying back shares to make simultaneous and comparable investments in projects that create jobs. And to make companies think twice about increasing dividends, they propose putting yet another tax on them—perhaps forgetting that the U.S., almost alone among nations, already taxes dividends twice, first as corporate income and then on investors' returns.

What the senators also fail to recognize is that, for companies that are truly intent on enriching their shareholders, the focus is much less on increasing next quarter's EPS than on earning competitive returns on capital and investing in their long-run "earnings power." The way to do that, as business schools and the likes of Warren Buffett have preached for decades, is to follow the Net Present Value rule: take all investments expected to earn at least their cost of capital, and walk away from the rest. The role of buybacks and dividends in this long-run value creation process, as suggested, is to pay out "excess capital" left over from earnings that cannot be reinvested in profitable growth opportunities. By returning capital to shareholders, companies convey their spending discipline and commitment to providing competitive returns on capital. Such distributions return cash to investors, who then reinvest it in growth companies that create jobs in more attractive industries.

Given that dividends and buybacks both allow companies to return excess capital to their shareholders, are there reasons for companies to prefer buybacks? Buybacks are more tax-efficient because they allow investors to self-select on the basis of their own tax positions—and then pay tax at the lower capital gains rates, and only on their gains above the purchase price, instead of on the full distribution. For companies, buybacks preserve flexibility by avoiding commitments to higher, and possibly unsustainable, dividend payouts, which tend to be viewed as "fixed costs."

One other common motive for buybacks is to recoup the value of "undervalued" shares—but this has proven to be a double-edged sword. As our own research shows, many companies have ended up overpaying by buying at the wrong time. To track buyback performance, we have developed a measure called "Buyback ROI," which can be compared to returns on capital spending, acquisitions, and other investments. It is calculated as an internal rate of return (IRR) that views the amount spent on buybacks as the "investment," and the dividends saved on the repurchased shares plus appreciation of (or loss on) the retired shares as the return. In a study

we published in 2018, three out of every four companies in our sample of S&P 500 companies (defined by minimum buyback thresholds) mistimed their repurchases over the prior five years to such an extent that their Buyback ROI was below their total shareholder return. Our finding reflects the well-known tendency of companies to buy back their shares closer to the peaks of business cycles than the troughs—with the result that such companies end up repurchasing far fewer shares than would be possible with better timing, and so shortchange their remaining shareholders. But this should not come as a surprise, since corporate cash generation tends to be at its highest, and investment opportunities most expensive, when nearing the tops of cycles.

What can companies do to avoid falling into this trap? How can managements commit to paying out their excess capital, while avoiding the temptation to buy back shares at overly high prices?

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Companies should use dividends as their primary way of paying out their "normal" levels of free cash flow—that is, the difference between their recurring cash flows and their normal reinvestment in the business. There is no timing or "wealth transfer" risk with dividends since all shareholders are treated the same. Unexpectedly high cash flows can be used to fund stock buybacks, but only if management is convinced that the company is overcapitalized and not overvalued. And to guide the timing of their stock repurchases, companies should consider establishing objective signals based on performance and valuation metrics that indicate a reasonably high probability of an acceptable Buyback ROI. Given the sheer size of many buyback programs, the gains for the long-term shareholders of companies achieving even minor improvements in buyback timing could be very large. And in cases where the risk of overvaluation is substantial, management should either be patient or consider the use of special dividends to avoid both the wealth transfers associated with buybacks and the increase in fixed payments that comes with regular dividends.

But how, then, should companies address the senators' problem—how can they avoid underinvestment and encourage their managers to take on all projects expected to produce value-adding growth?

In my forthcoming book, *A Cure for Corporate Short-Termism*, I argue that companies should reexamine their performance-measurement, decision-making, and reward systems to make sure they are not discouraging managers from taking positive-NPV projects. As one simple example, bonuses tied to year-to-year increases in returns on capital may well be encouraging the managers of a company's most profitable business segments to limit their growth investments. If your business is already earning 40% on capital, why take on a project earning 30% and drag down the average? Companies can correct this problem by realigning their business management processes around a measure of *economic profit*—one that charges business units for their use of capital, but without penalizing new investments that could reduce their average return.

Finally, what should regulators do to address this underinvestment problem? The short answer is nothing. Buybacks are not a cause, but rather a symptom, of the problem. In response to technological change and obsolescence, capital spending on manufacturing and traditional plant and equipment has been falling for decades in all of the world's developed economies. But U.S. corporate investment in R&D has continued to be strong, reflecting the global shift from tangible to intangible assets.

And buybacks and dividends, far from contributing to an underinvestment problem, are playing an important role in bringing about this shift. What the senators fail to recognize is that the capital paid out by U.S. companies to their shareholders does not disappear from the economy. As Harvard law and economics scholar Mark Roe pointed out in a recent study, in each year during the past decade, some $250 billion of net new capital has flowed into smaller (non-S&P 500) U.S. companies. And this figure would be much larger if it included the venture capital, angel investing, and private equity that is effectively funded in part by the distributions of public companies. In other words, the buybacks and dividends of more mature companies are being recycled by investors into those companies that have been responsible for most of the job creation in recent years. Why would we want to stop this virtuous cycle?

The main effect of the senators' proposals would be to trap more capital inside companies that don't have productive uses for it. Those companies facing the greatest pressure to pay out their excess capital are the ones with the fewest promising investments—and requiring *such* companies to invest in

low-return activities would only weaken their financial condition, leading eventually to further job erosion, not growth. To see a case where companies were long discouraged from paying out shareholder capital, consider the performance of the Japanese corporate sector and economy during much of the past 30 years. The Nikkei 225, which is now trading at around 21,300, has yet to come anywhere near the peak of almost 39,000 that it reached in 1989. Thus it's no shock that U.S. GDP growth has been more than double Japan's since then.

So let's give market-based solutions a chance to lead the way. Although we'll continue to see downsizings and layoffs, we'll also end up with more net new jobs and growth in new and exciting industries and companies. That's how healthy economies are supposed to work. And to the extent we can judge from recent job and wage growth, ours seems to be doing just that.

GREG MILANO is founder and chief executive officer of Fortuna Advisors, an innovative strategy consulting firm that helps clients deliver superior Total Shareholder Returns (TSR) through better strategic resource allocation and by creating an ownership culture. He is the author of the forthcoming book, *A Cure for Corporate Short-Termism*.

MICHAEL CHEW is an editorial consultant for Fortuna Advisors, and an editor of the *Journal of Applied Corporate Finance*. He recently edited Greg's forthcoming book, *A Cure for Corporate Short-Termism.*

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