WOODSTOCK

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As they have been and as they will be into the near term, the investment world debates will be, to our minds, about 1. investing in US equities primarily versus an institutional-type diversified portfolio, 2. searching/stretching for yield and 3. choosing between active management and indexing.

A recent article comparing a "100% large cap US stock" portfolio to a "diversified 7 asset" portfolio calculated over a 46-year period that "in summary, the raw performance metrics reviewed here indicate that a one-asset portfolio was superior to a broadly diversified portfolio".[1] However, the article concluded that "if considering risk along with performance" the diversified performance was superior. What are the risk factors that turn raw performance upside down? The first is volatility as a measure of risk. Past articles from us have described why we think that is not a good measure of risk for high quality, US stocks and understates the risk for private equity or less liquid investments.[2] The other risk factor described is you or your advisor. "Clients who are honest about their tendencies to react poorly during periods of market volatility" should be in a 7 asset portfolio. We suppose that means the lack of liquidity with all those asset classes would force one to wait it out rather than act quickly. Not really reassuring or really much difference between portfolios if an investor or manager wants to panic and sell. On reflection, we believe the raw data wins.

Next, stretching for yield is dangerous. As one of our managers likes to paraphrase, more money has been lost reaching for yield than at the point of a gun. The current risky behavior was described in a recent article[3] as client psychology. When rates drop below 3% for "risk free" bonds, clients are more willing to invest in risky alternatives. This summer the yield on 10-year Treasuries was 1.6% and under 2% for an aggregate bond index. The advice? Don't stretch. Your principal would be at risk if economic difficulties engulf the issuer and cause defaults thereby negating the higher initial yield. The prescription? Look for stocks in your portfolio that are at a loss and sell them, as needed, for "homemade dividends".

And indexing. A recent article interviewing John Bogle, the founder of Vanguard and ardent proponent of indexing, highlighted some of his beliefs. He believes in investment companies owned by their clients, as both Vanguard and Woodstock are; stay invested, don't reach for yield, keep an eagle eye on cost, and it's unnecessary for US investors to invest outside the US. We agree. The success of indexing is from "teaching investors how to earn the market's long-run, average return without paying big fees to Wall Street". Woodstock's success is from picking high quality, US stocks for individually crafted portfolios at relatively lower fees, allowing individual tax and financial decisions to benefit those portfolios, while reaching for an equity-like return.

Mr. Bogle agrees that there will always be an active management business if only to set prices. However, the contrarian view is that as indexing crosses over from under 25%, meaning over 75% is actively managed, to something greater, the opportunity to beat the index with hard work at lower fees may increase. The passive, indexed portfolio carries much junk along with the good. Our recent performance has been good and we're dedicated to our individually crafted approach.

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[1] Financial Planning, October 2016

[2] Woodstock's Quarterly Market Perspective, Fall 2014, Summer 2016

[3] WSJ July 23-24, 2016

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Is Corporate America's Buyback Binge Coming to an End?

Maureen J. Murphy

Among the most prominent drivers of the 7-year bull market has been the power of a popular but controversial tool: the corporate share repurchase. Informally called buybacks, share repurchases--in which a company uses its own cash to buy its own stock--have been on a tear. "Since the start of the current bull market during Q1-2009, buybacks have totaled $3.1 trillion, well exceeding the $1.5 trillion during the previous bull market from Q3-2002 through Q3-2007."[1] However, there are some recent indications that the level of corporate discretionary buybacks may be receding. According to preliminary results recently reported by S&P Dow Jones Indices, S&P 500 companies spent $127.5 billion repurchasing shares in the second quarter of 2016, a 21% drop from the first quarter and a 3.1% decrease from the same period of 2015.[2] U.S. firms have been the biggest buyers of stocks in every year since 2009.[3] While share buybacks have both their fans and critics, the suggestion that a big component of the run-up in the stock market might be slowing down poses a potential headwind for equity markets and bears watching.

In this article we take a look at open-market buybacks--what they are, what some critics--positive and negative--have to say, the impact of corporate America's buyback binge in propping up stocks and what a slowdown may portend for equities.

We start with an analogy put forth by a business writer, and obvious critic of share buybacks, articulated in a recent article found in Business Insider:

"Imagine a restaurant that always has some empty tables. Sales are actually OK, and it's profitable, but the restaurateur's backers are obsessed with profits per table. They think raising that number would make the restaurant seem exclusive and attractive to new investors. But no matter how hard he tries, the restaurateur just can't get more people in the door. So he does something else: He takes away some tables. Its costs money to move and store the tables, but that very month, the same number of people visit the restaurant, and profits per table go up. Sales haven't changed, but now the investors are happy." "If this bothers you", the author writes, "consider that it's exactly like something public companies in America do every day".[4] (i.e. buybacks).

The aforementioned business writer has articulated one of the major arguments critics put forth against share buybacks--that the money spent on buybacks has no impact on a company's business and often comes at the expense of investment in productive capabilities, and consequently aren't great for long-term shareholders. Some argue that the only impact of buybacks--like the restaurant removing tables--is in making things look better than they are. Yes, earnings per share rise, but that's not because earnings are growing in response to fundamental improvements.

Companies have been allowed to repurchase their shares on the open-market with few regulatory limits since 1982, when the Securities and Exchange Commission instituted Rule 10b-18 of the Securities Exchange Act. Under the rule, a corporation's board of directors can authorize senior executives to repurchase up to a certain dollar amount over a specified or open-ended period of time, and the company must publicly announce the buyback program. After that, management can buy a large number of the company's shares on any given business day without fear that the SEC will charge it with stock-manipulation-provided, among other things that the amount does not exceed a "safe harbor" of the previous four weeks' average daily trading volume. The SEC requires companies to report total quarterly repurchases.[5]

Corporations generally give three main justifications for open-market repurchases[5]:

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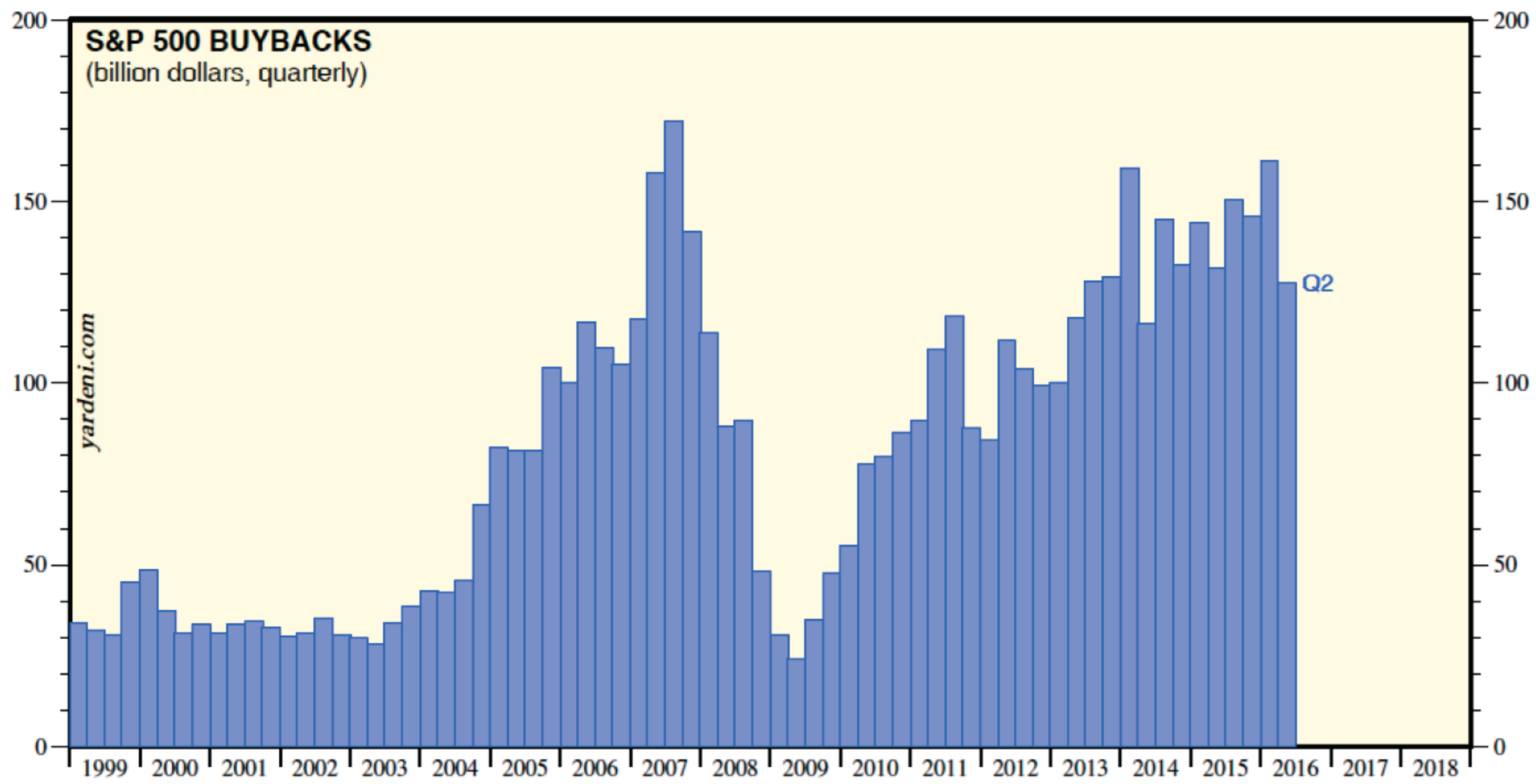
Figure 1



Source: Standard & Poor's Corporation.

Figure 2

S&P Dow Jones Indices						
S&P 500 SECTOR BUYBACKS						
SECTOR $ MILLIONS	Q2,'16	Q1,'16	Q2,'15	12MoJun,'16	12MoJun,'15	5-YEARS
Consumer Discretionary	$20,283	$26,671	$22,568	$97,195	$85,966	$390,455
Consumer Staples	$11,720	$11,708	$7,739	$49,706	$40,399	$225,194
Energy	$1,386	$2,053	$3,547	$9,604	$28,205	$161,103
Financials	$25,666	$26,706	$21,276	$103,127	$83,614	$356,842
Health Care	$14,974	$30,626	$18,131	$76,892	$68,063	$337,890
Industrials	$21,897	$26,229	$17,172	$90,943	$69,328	$302,264
Information Technology	$30,066	$34,682	$36,674	$143,425	$146,602	$608,648
Materials	$1,269	$2,402	$2,395	$12,400	$22,666	$67,809
Telecommunication Services	$201	$12	$166	$1,084	$5,729	$36,562
Utilities	$38	$296	$1,894	$974	$2,949	$8,047
TOTAL	$127,501	$161,385	$131,562	$585,350	$553,522	$2,494,814

S&P Dow Jones Indices								
S&P 500 20 LARGEST Q2 2016 BUYBACKS, $ MILLIONS								
Company	Ticker	Sector	Q2,'16	12 Mo Jun,'16	12 Mo Jun,'15	5-Year	10-year	Indicated
			Buybacks	Buybacks	Buybacks	Buybacks	Buybacks	Dividend
			$ Million	$ Million	$ Million	$ Million	$ Million	$ Million
Apple	AAPL	Information Technology	$10,166	$36,949	$39,000	$126,809	$126,809	$12,489
General Electric	GE	Industrials	$7,966	$16,026	$0	$33,397	$57,737	$8,460
AbbVie	ABBV	Health Care	$3,803	$6,435	$5,644	$12,754	$12,754	$3,688
Microsoft	MSFT	Information Technology	$3,677	$15,969	$14,443	$48,117	$112,719	$11,319
McDonald's	MCD	Consumer Discretionary	$3,381	$11,630	$4,217	$22,628	$39,231	$3,125
JPMorgan Chase	JPM	Financials	$2,840	$7,003	$6,148	$26,642	$41,450	$7,021
American International Gr	AIG	Financials	$2,762	$13,196	$6,796	$35,508	$42,537	$1,432
Johnson & Johnson	JNJ	Health Care	$2,369	$6,954	$8,330	$35,303	$52,525	$8,802
Wells Fargo	WFC	Financials	$2,214	$8,354	$10,021	$32,972	$43,795	$7,717
Wal-Mart Stores	WMT	Consumer Staples	$2,117	$7,681	$1,365	$23,952	$57,129	$6,233
Monster Beverage	MNST	Consumer Staples	$2,000	$2,398	$420	$3,751	$4,003	$0
Boeing	BA	Industrials	$2,000	$7,751	$6,504	$20,054	$25,816	$2,777
Oracle	ORCL	Information Technology	$1,980	$10,529	$8,101	$45,320	$56,468	$2,490
CVS Health	CVS	Consumer Staples	$1,894	$6,027	$3,734	$21,650	$31,991	$1,826
Medtronic	MDT	Health Care	$1,763	$3,843	$1,605	$10,693	$16,087	$2,419
Goldman Sachs Gr	GS	Financials	$1,738	$5,934	$3,995	$26,781	$48,588	$1,080
American Express	AXP	Financials	$1,724	$5,361	$4,269	$21,206	$26,694	$1,103
American Airlines Gr	AAL	Industrials	$1,711	$6,151	$1,965	$8,200	$8,201	$212
Visa	V	Information Technology	$1,709	$5,562	$3,772	$19,344	$38,036	$1,067
Alphabet	GOOGL	Information Technology	$1,595	$5,473	$0	$5,561	$6,401	$0
Top 20			**$59,409**	**$189,226**	**$130,330**	**$580,642**	**$848,972**	**$83,260**
S&P 500			**$127,501**	**$585,351**	**$553,522**	**$2,494,814**	**$4,274,108**	**$412,920**
Top 20 % of S&P 500			**46.59%**	**32.33%**	**23.55%**	**23.27%**	**19.86%**	**20.16%**
Gross values are not adjusted for float								

Source: S&P 500 Dow Jones Indices; September 28, 2016

1) Buybacks are investments in our undervalued shares that signal our confidence in the company's future.
2) Our company is mature and has run out of profitable investment opportunities; therefore, we should return its unneeded cash to shareholders.
3) Buybacks are necessary to offset the dilution of earnings per share when employees exercise stock options.

In most cases, the stock market reacts positively to repurchase activity by corporations, making such shareholder friendly actions a worthwhile alternative use of funds in the absence of favorable business opportunities. Since a repurchase lowers the number of outstanding shares, it increases the company's earnings per share even if profits remain the same and gives the remaining shareholders a larger stake in the company. In addition, the buyback usually gives the share price a boost resulting from changes to the company's capital structure and the signal the action sends to the market. One of the positive signals in this regard is directors' belief that the stock is a good investment. A buyback announcement indicates that a company doesn't have a cash flow problem and that it has sufficient cash on hand to meet interest payments and capital commitments. However, it also reveals a lack of organic growth opportunities.[6]

Even so, stock buybacks are not universally favored. While fans consider them to be a useful tool to return excess cash to shareholders, critics remain skeptical about their ability to create long-term value and consider the approach to be a poor substitute for proper business investment. Some believe that the buyback merely supports the company's stock price and enriches investors in the short term at the expense of long term strategic investment. Still others have suggested that the practice can boost executives' pay as stock-based instruments make up a large portion of executives' compensation.

One particularly vocal critic of buybacks has been Laurence Fink, Chief Executive of BlackRock, the largest asset manager in the world which oversees more than $4.8 trillion in investments. In April, 2015 Mr. Fink sent a letter to the chief executive officer of every company in the S&P 500 Index and urged other "C.E.O.s to stop being so nice to investors".[7] He argued for fewer share buybacks and dividends and more investments in long-term growth. He warned that CEOs should not give way to pressures of activist shareholders who often look for short-term gains and pressure companies to spend lots of cash on buybacks and increased dividends. Fink holds that some executives have under-invested in "Innovation, skilled workers or essential capital expenditures necessary to sustain long-term growth".[8]

While buybacks generally result in share price increases, some argue that not all buybacks are successful in providing value to shareholders. There is a difference between the simple short-term effects of a stock repurchase on the stock price and shareholder value creation. Share repurchases are known to benefit shareholders in the long-term only if the stock is materially undervalued. Poor timing in buying back stock often compounds the problem, as there is a risk that the company may be overpaying for its shares. "The continuing shareholder is penalized by repurchases above intrinsic value, Warren Buffet wrote in his 1999 letter to Berkshire Hathaway shareholders. "Buying dollar bills for $1.10 is not good business for those who stick around."[9] Notably, share buybacks peaked shortly before the financial crisis in 2007, suggesting directors aren't necessarily good at timing share repurchases. In the wake of the financial crisis, many companies reprioritized fortifying their balance sheets over returning cash to shareholders.

Currently, with balance sheet cash at record levels, corporations are faced with the challenge of how to deploy excess cash. They have the option to return excess cash to shareholders through buybacks and dividends, or invest in the company through business expansion and/or acquisitions. To be sure, over time, a company destroys value by continuing to keep hordes of cash on hand at a low rate of return. If a company is unable to invest at an attractive rate of return, and there is no better alternative use of cash through which the company can generate an attractive return, share repurchases remain a useful tool for

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returning capital to shareholders. Since dividend cuts can drive stock prices down, directors often prefer to maintain a low bar for dividend payments, returning additional cash via share buybacks which can be modulated as financial conditions necessitate. Share repurchases are furthermore a more tax-efficient way of returning cash to shareholders than dividend payments.

The Stock Buyback Conundrum—Will Corporate America Keep It Up?

As previously mentioned, in 2Q 2016 S&P 500 companies spent $127.5 billion on stock buybacks, a 21% decline from the $161.4 billion spent in 1Q 2016 (the second largest quarterly expenditure on record) and a 3.1% decrease from 2Q 2015 ($131.6 billion). The 2Q marked the smallest amount that the S&P 500 companies have spent on buybacks in two years. For the 12-month period ending 2Q 2016, S&P 500 companies increased their buyback expenditures by 5.8%, to $585.4 billion, up from $553.5 billion for the corresponding 2015 period. During 2Q 2016, for the tenth consecutive quarter, more than 20% of the S&P 500 constituents reduced their year-over-year diluted share count by at least 4%, therefore boosting their earnings-per-share (EPS) by at least 4%. S&P 500 companies reducing their share count during 2Q 2016 decreased to 275, from 324 in 1Q 2016 and 307 in 2Q 2015.[2]

As shown (see Figure 2), buybacks were concentrated, as the top 20 S&P 500 issues accounted for 46.6% of the total 2Q 2016 expenditures. During 2Q 2016, Technology stocks handily continued their buyback dominance, and accounted for 23.5% of all S&P 500 buybacks ($30.1 billion), up from 21.5% ($34.7 billion) in 1Q 2016. Health Care decreased its expenditures by 51.1% ($15.0 billion) after increasing by 86.1% ($30.6 billion) in 1Q 2016, representing 11.7% of all buybacks. Consumer Staples, which posted a modest 0.1% gain in expenditures, represented 15.9% of all buybacks.[2]

What do the recent declines in the level of corporate buybacks suggest about the equity market? Does this portend the start of a downward trend and removal of support that has been fueling the equity market gains?

Given that corporate repurchases have been the largest source of U.S. equity demand, a slower pace of buybacks is a headwind for higher share prices. That said, while fewer share repurchases may shift the balance between buyers and sellers in the short-term, stock price levels over the long term will be determined by earnings power. Earnings power increases with strategic investment spending, but having fewer shares outstanding is also a lasting benefit to earnings per share.

Despite the decrease in share buyback expenditures by S&P 500 companies in 2Q 2016, the ability of companies to increase buybacks remains high, as cash is at a record level and the cost of debt low.[10] However, the 2Q 2016 decline in buybacks may raise concerns that corporate managements don't believe the economy will be strong enough to support these programs. Economic growth is still sluggish to non-existent around the globe. U.S. Gross Domestic Product (GDP) growth in 2016 is expected to be less than 2%, which will be an unprecedented 11th year in a row of less than 3% growth. The "slower for longer" economic cycle, now more than seven years old, should continue to the end of the decade as the Federal Reserve nurtures what is still an economy that cannot reach "cruising altitude" because of various headwinds. According to Baseline, analysts expect earnings for the S&P 500 companies to decline for the sixth consecutive quarter during the 3Q 2016.[11] Above-average valuations are also perhaps making it less attractive for companies to buy back their stock. With the S&P 500 Index now within 2% of its all-time high of 2190 reached on August 15, 2016, stocks are not cheap and are selling above their historic median Price/Earnings ratio based on estimated 2017 consensus earnings.

The U.S. presidential election has added additional uncertainty and may have caused companies to be less confident.

We continue to believe that U.S. equities appear more attractive than other asset classes. The fixed income markets appear to offer little in the way of prospective returns and returns on cash remain close to zero.

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Many stocks continue to pay dividends in the 2%-4% range, while buying back shares and growing earnings. At Woodstock we plan to stay the course with our equity focus on well-managed companies with strong financial characteristics and sustainable competitive advantages; investing in these have historically produced attractive long-term returns while offering liquidity and we anticipate that will continue. ◆

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Article Sources:
[1]Yardeni Research, Inc., October 4, 2016; [2]S&P Dow Jones Indices, September 28, 2016; [3]HSBC, Tonev, Anton and Jose, Davey, The Nomadic Investor, "Beware a slowdown in US share buybacks", March, 2016; [4]Business Insider, Bryan, Bob, "U.S. companies have spent $2 trillion doing something that has absolutely no impact on their business", June 15, 2016; [5]Harvard Business Review, September, 2014, Lazonick, William, "Profits Without Prosperity"; [6]Valueline, Ajila, Saumya, "Share Repurchases Are On the Rise", July 7, 2015; [7]Wall Street Journal, Sorkin, Andrew, "BlackRock's Chief, Laurence Fink, Urges Other C.E.O.s to Stop Being So Nice to Investors", April 13, 2015; [8]Reuters, Hunnicutt, Trevor, "BlackRock stock buybacks continue. . .", July 14, 2016; [9]Berkshire Hathaway Inc. company website; Warren E. Buffet's 1999 Letter to Shareholders; [10]S&P Dow Jones Indices, Silverblatt, Howard, "S&P 500 Buybacks . . .", September 28, 2016; [11]Baseline

Tax Update

What should a tax department provide to its clients? Government requires a complete and accurate tax return. Jointly a client and tax preparer work to accomplish that. Additionally, a preparer should look over a client's return and try to find one good idea a year. That's the effort that should be given, it doesn't always develop an idea. The odds of it happening increase if the preparer sends out a tax preparation guide every fall with ideas for the coming tax year. Laws change and there are always changes in a client's situation. A review of the guide may generate some questions which may develop into a good idea. It's a collaborative process and there are no stupid client questions. The topic is very complex.

The future is where we are going either with good ideas or without them. Significant future benefits can occur with a financial review. A good understanding of a client's tax and, then, financial situation coupled with a forecast utilizing a Monte Carlo method can provide valuable insights. Basically, the Monte Carlo method was developed as a way of addressing "complex problems that can't easily be solved with an equation".[1] A computer can run many simulations with random selections of range-bound variables to "see what happens". Of course, the assumptions may be wrong. In practice, a recent article about spending practices by retirees wondered "why the well rarely runs dry".[2] The Monte Carlo method described above calculates, for a given level of spending, when will the money run out. People react to the knowledge of "how long" by under spending in the early years of retirement with the result being, the well rarely runs dry. The rule of thumb 4% initial withdrawal rate, the article says, was built for environments that have horrible returns in the first part of retirement. The long term effect of a 4% spending rate in normal environments is likely to be compound growth and getting even farther ahead. These tools are here at Woodstock and the individual circumstances are yours, so please let us know if we can help you prepare and plan. ◆

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[1] WSJ August 13-14, 2016
[2] Financial Planning, October 2016

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