Research | August 2018

TRIMTABS ASSET MANAGEMENT

# Buybacks: Do All Roads Lead to Riches?

The cover story of the May 12, 2018 edition of Barron's was titled "Why the Buyback Boom is Bullish for Investors." This was one of dozens of articles reporting on the flood of buyback announcements. The dollar value of announced buybacks this year is at a record pace. Taking note that not all "announcements" result in a net reduction of a company's outstanding stock, it has been estimated by Standard & Poor's Howard Silverblatt that the first quarter of actual stock reductions did indeed set a record: approximately $190 billion among S&P 500 stocks.

In the ninth year of an economic expansion, many records are naturally being set. But the pace of the current set of buybacks is just in line with the rate of growth of profits: about 25% over last year. The other major direct return to shareholders, dividends, are also rising at about the same rate. In the last several quarters, the data has also begun to reveal that companies' investments in their business, in the form of capital spending, is accelerating and in the most recent quarter exceeded 20% growth.

The US economy has been in a steady, if modest, expansion this whole period. Obviously, however, not large enough growth to create 25% profit growth. The recent tax cuts are the added ingredient to the improved results.

So, in the light of an ongoing economic expansion and a massive tax cut, the kinds of corporate decisions we are seeing are not all that surprising. But it probably is a surprise that the market has not exactly followed the script that Barron's laid out for it. Indeed, many of the companies that have bought their stock back have underperformed the market. And that is not just in the recent six months or so – for more than the last three years, an index focused on companies with a strong history of buying back their own stock has underperformed.

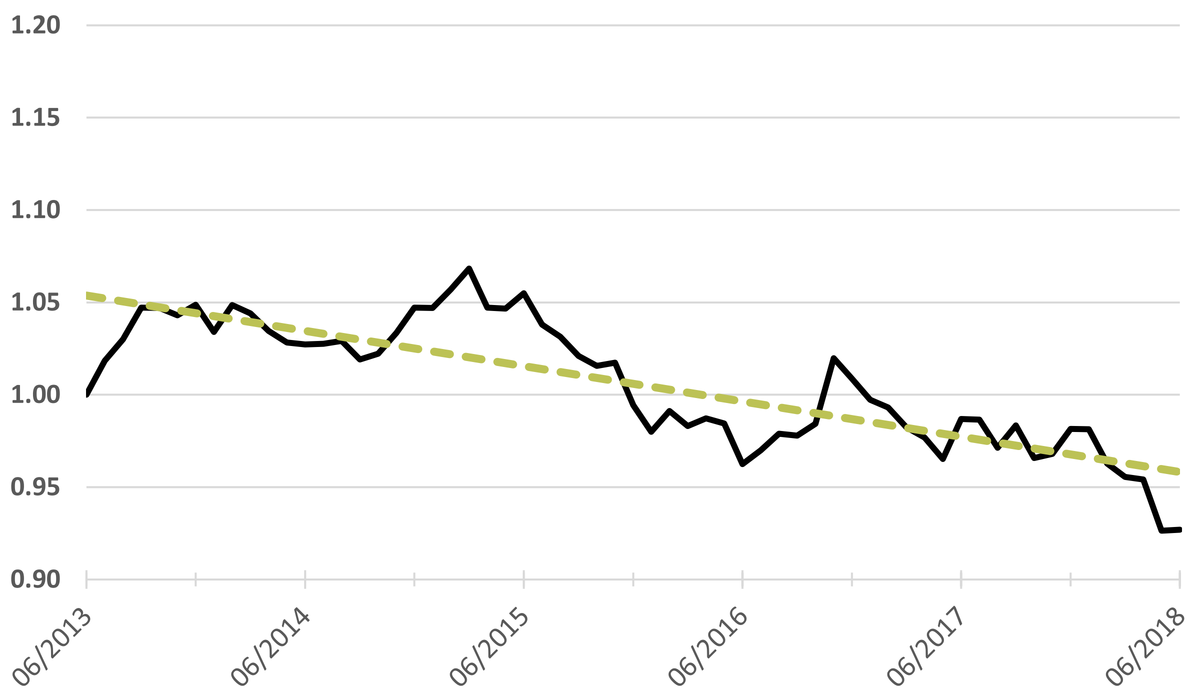
## Performance Issues

From a high-water relative mark at the end of June 2015, the NASDAQ US Buyback Achievers Index (which is comprised of US corporations that have effected a net reduction in shares outstanding of 5% or more in the prior trailing 12 months) appreciated, with dividends, by 26.8%

through July 31,2018. That is an annualized rate of total return of 7.4%. By comparison, however, the S&P 500 had a total return of 45.8% over the same time – an annualized return of 12.0%. The underperformance of the Buyback Index is even more pronounced this year.

The performance of this Index relative to the S&P 500 for the last five years is shown in **Chart 1**. (The source for all data is FactSet, Bloomberg and S&P.)

**Chart 1. Relative Total Return Growth of $1**
**Buyback Achievers Index vs. S&P 500 Index**




Only one of the concerns relating to this record involves the “demographics” of buybacks: the top 20 company buybacks equal all the others combined. Obviously, that makes the index sensitive to a handful of companies. But even measuring more broadly, according to S&P, 57% of the 350 of the S&P 500 companies that have bought back stock are lagging the market.

While Apple is the buyback champ (accounting for 10 of the 15 largest single quarter buybacks) it is not, however, the culprit in underperformance of buybacks. AAPL has easily outdistanced the broad market this year, as well as for the prior three plus years.

Taking the issue from the perspective of the buyback winners, our research suggests the clue to finding these gems revolves around the notion of “quality.” Unfortunately, while many investors and practitioners regularly talk about quality, this factor does not have an agreed-upon definition among analysts and academics. However, the weight of formal studies does center around balance sheet characteristics, profitability and the variability of each.

## Balance Sheets and Buybacks

So, is it possible to show the influence of, say, balance sheets on the performance of companies that are buying back their shares? We use a simple approach to begin to understand this kind of influence. We started with the non-financial members of the S&P 1500. Then each month, we separated the companies that increased their debt while reducing their share count from those which lowered their debt while lowering their shares. We equally weighted the companies in each group and calculated their market performance and repeated the process the next month.

**Chart 2** shows the performance of the buyback companies that reduced their debt relative to the performance of the S&P 500.

**Chart 2. Relative Total Return Growth of $1 Share Buyback with Strong Balance Sheet vs. S&P 500 Index**

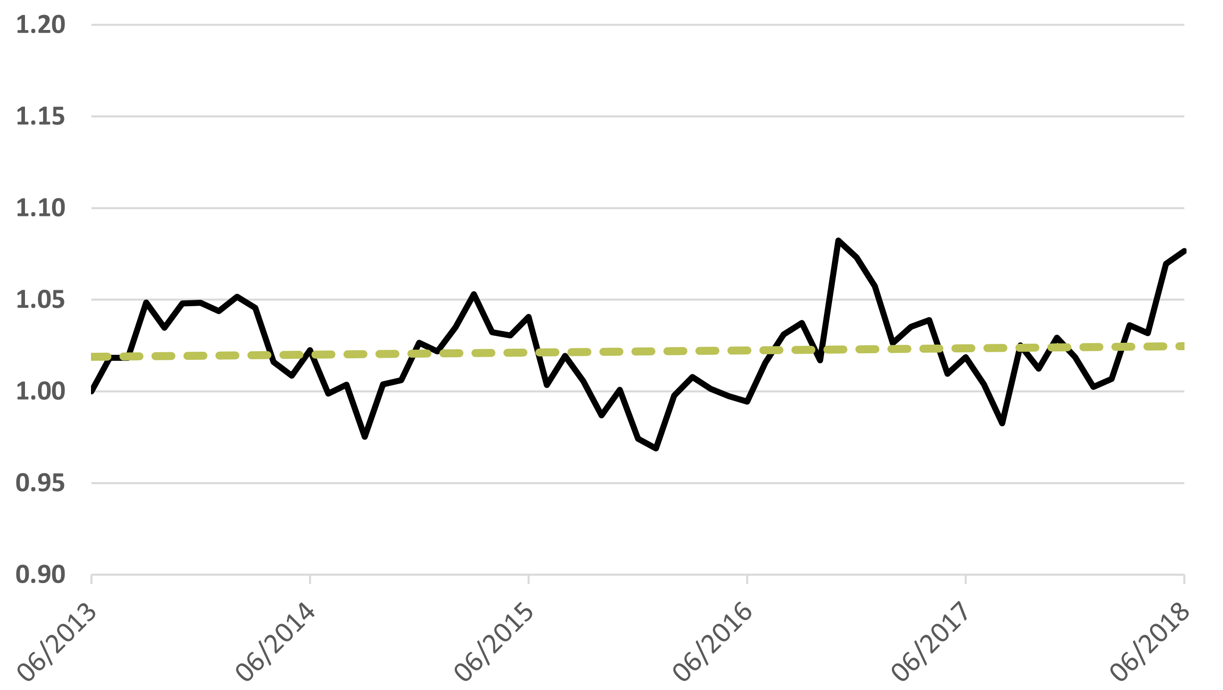
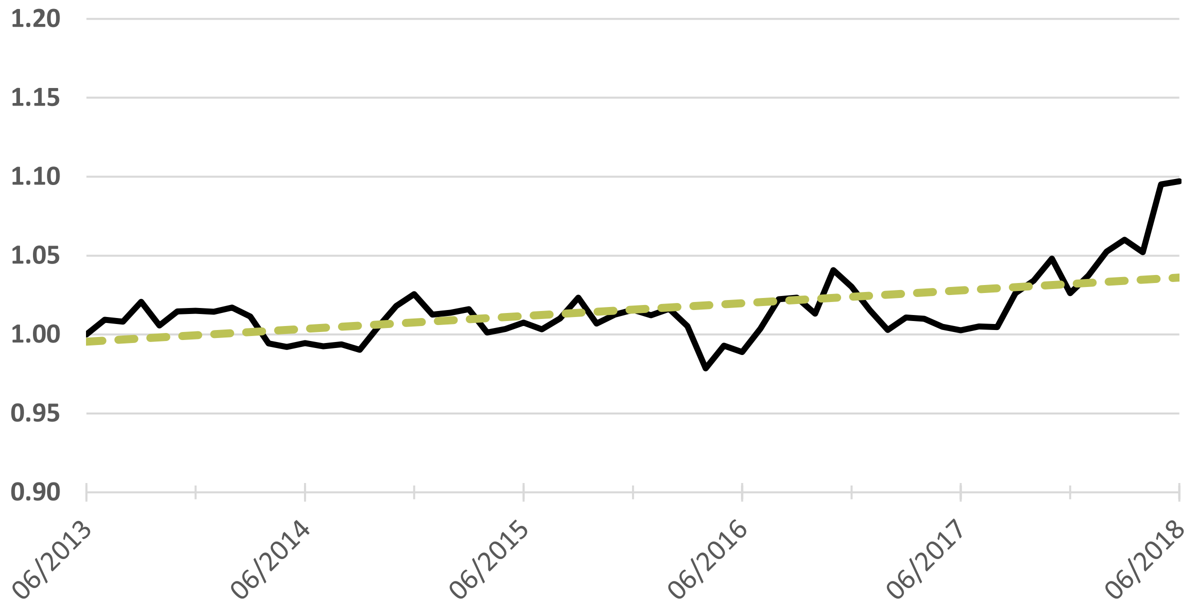


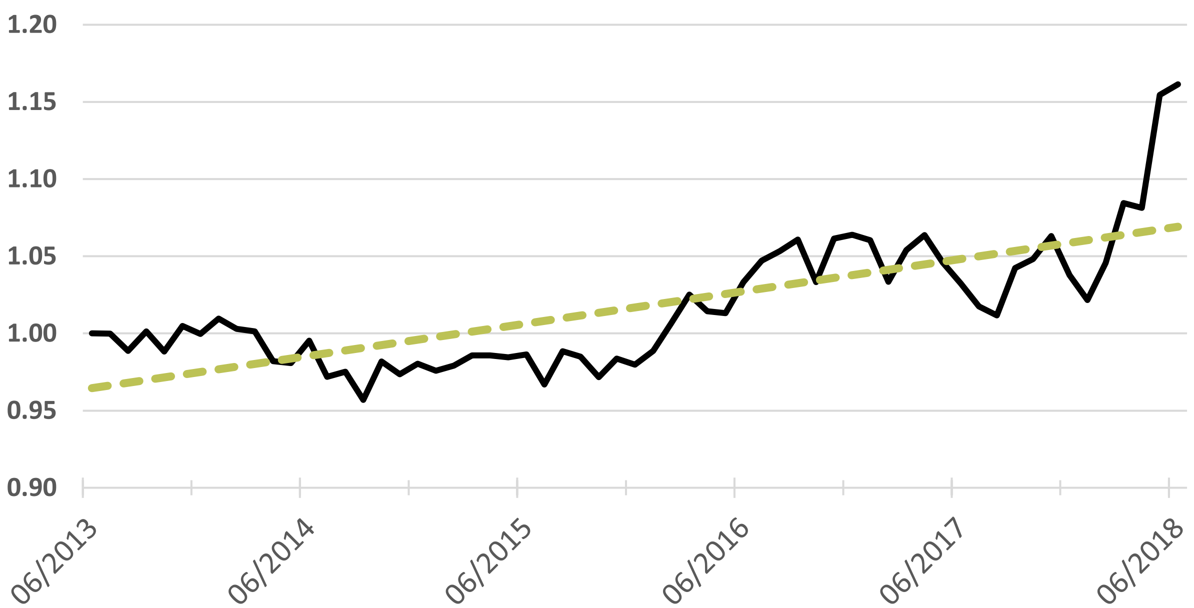

**Chart 3** gives the record of the “strong” balance sheet companies to the weak.

**Chart 3.** Relative Total Return Growth of $1 Share Buyback with: Strong Balance Sheet vs. Weak Balance Sheet




Finally **Chart 4** is the relative performance of the buyback companies that reduced their debt compared to the Buyback Achievers Index.

**Chart 4.** Relative Total Return Growth of $1 Share Buyback with Strong Balance Sheet vs. Buyback Achievers Index



In general, the evidence suggests that investors should check the balance sheets of the buyback companies to gain a little additional edge.

## Free Cash Flow and Buybacks

Our experience in searching for high quality companies also extends to the profitability question. Specifically, we focus on companies with either strong or weak free cash flow. Our previous White Paper[1] on free cash flow established the notion that free cash flow is a major enhancement to analyzing corporate performance – largely because management reports using Generally Accepted Accounting Principles leave much to be desired. Using a similar technique to the one used for balance sheets, we separated buyback companies into those which had positive prior 12 months free cash flow and those with negative free cash flow.

**Chart 5** shows the performance of the positive free cash flow buyback companies to the S&P 500.

**Chart 5.** **Relative Total Return Growth of $1 Share Buyback with Strong Free Cash Flow vs. S&P 500 Index**

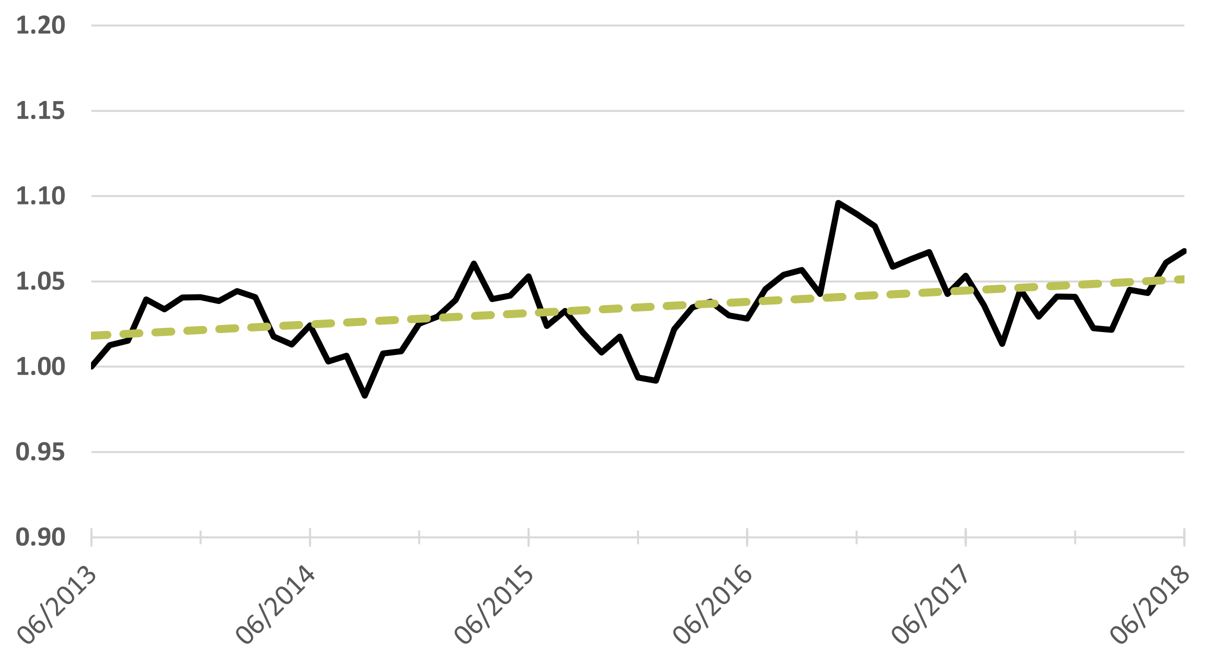
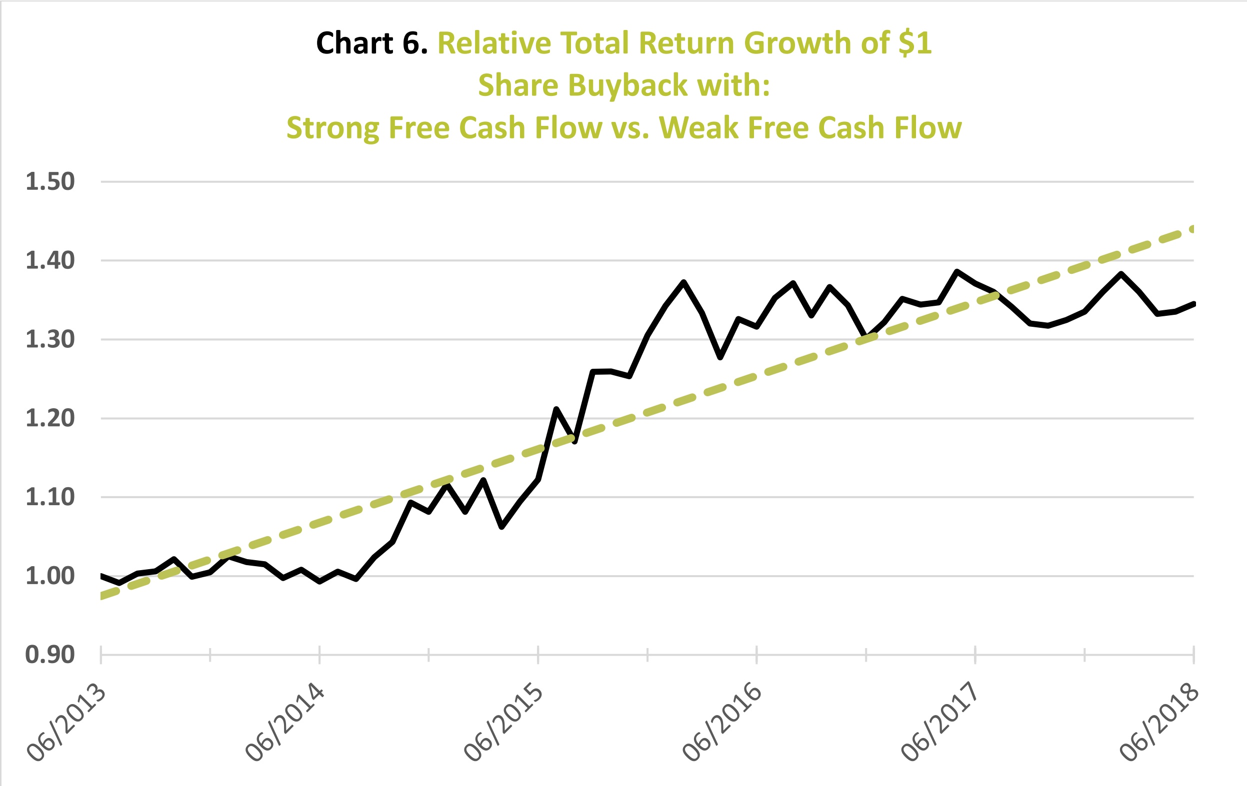
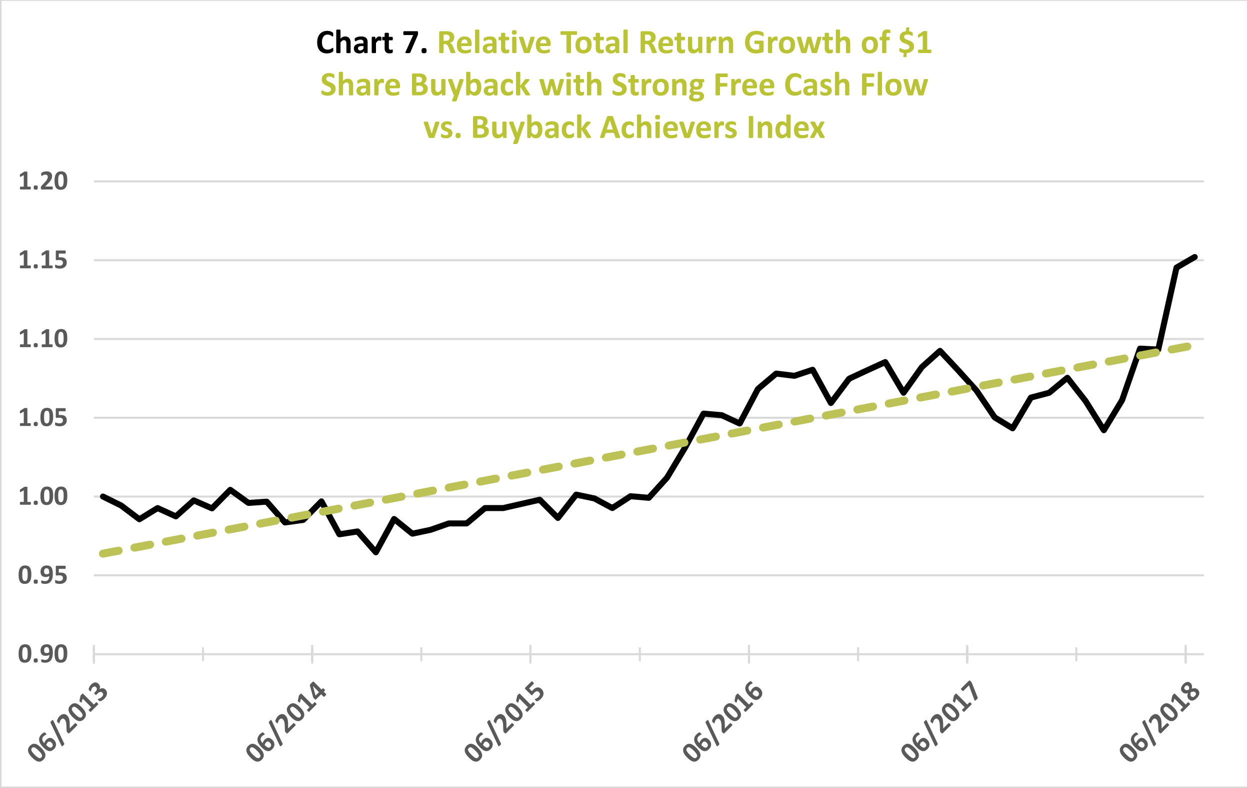



**Chart 6** gives the record of positive to negative free cash flow buyback companies.

[1] Free Cash Flow: An Upgrade to Management Reporting, February 2017




Finally, **Chart 7** is the relative performance of the buyback companies with positive free cash flow compared to the Buyback Achievers Index.



In general, the evidence suggests that investors, in addition to checking balance sheets, should also scrutinize a company's free cash flow.

**Table 1** summarizes the annualized total return results for the 5 years ending 6/30/2018.

**Table 1. Annualized Total Return, 6/30/2013 to 6/30/2018**

| Portfolio | Annualized 5 Year Total Return |
|---|---|
| S&P 500 | 13.42% |
| Buyback Achievers Index | 11.71% |
| Reduced Debt Buyback Group | 15.11% |
| Positive Free Cash Buyback Group | 14.92% |

## Even Better

Our own experience with portfolios has demonstrated that, first, a more sophisticated and deeper exploration of both balance sheets and free cash flow than the simple approaches presented here bears fruit. Second, the combination of balance sheets, free cash flow and share count in one process can create attractive return streams.

**Ted Theodore, CFA**
Vice Chairman
Chief Investment Officer

**Vince (Qijun) Chen**
Quantitative Analyst

*The fund's investment objectives, risks, charges and expenses must be considered carefully before investing. The prospectus contains this and other important information about the investment company, and it may be obtained by calling 1800-617-0004 . Read it carefully before investing.*

**Investing involves risk. Principal loss is possible. There is no guarantee that TTAC will achieve its investment objective. Investing involves risk, including the possible loss of principal. Because the Fund is an ETF (rather than a mutual fund), shares are bought and sold at market price (not NAV), may trade at a discount or premium to NAV, and are not individually redeemable. Owners of the shares may acquire those shares from the Fund and tender those shares for redemption to the Fund in Creation Unit aggregations only, consisting of 25,000 shares. Brokerage commissions will reduce returns. Investments in the Fund include risks associated with small and midcap securities, which involve limited liquidity and greater volatility than large cap securities.**

**Past performance does not guarantee future results. Index performance is not indicative of fund performance.**

Fund holdings and/or sector allocations are subject to change at any time and are not recommendations to buy or sell any security. One cannot invest directly in an index.

Trim Tabs asset management is the advisers to the TrimTabs All Cap US Free-Cash-Flow ETF. The TrimTabs All Cap International Free-Cash-Flow ETF is distributed by Quasar Distributors, LLC.

The Standard & Poor's 500 Index (S&P 500) is an index of 505 stocks issued by 500 large companies with market capitalizations of at least $6.1 billion.

The S&P 1500, or S&P Composite 1500 Index, is a stock market index of US stocks made by Standard & Poor's. It includes all stocks in the S&P 500, S&P 400, and S&P 600. This index covers 90% of the market capitalization of U.S. stocks.

Free Cash Flow (FCF) represents the cash that a company can generate after accounting for capital expenditures.

Top Holdings as of 6/30/2018:

| | Portfolio Weighting % | Ticker |
|---|---|---|
| Valero Energy Corp | 1.31 | VLO |
| Inogen Inc | 1.27 | INGN |
| Domino's Pizza Inc | 1.27 | DPZ |
| Broadridge Financial Solutions Inc | 1.24 | BR |
| Aspen Technology Inc | 1.24 | AZPN |
| Fortinet Inc | 1.24 | FTNT |
| ConocoPhillips | 1.23 | COP |
| Burlington Stores Inc | 1.22 | BURL |
| VeriSign Inc | 1.21 | VRSN |
| Robert Half International Inc | 1.21 | RHI |