

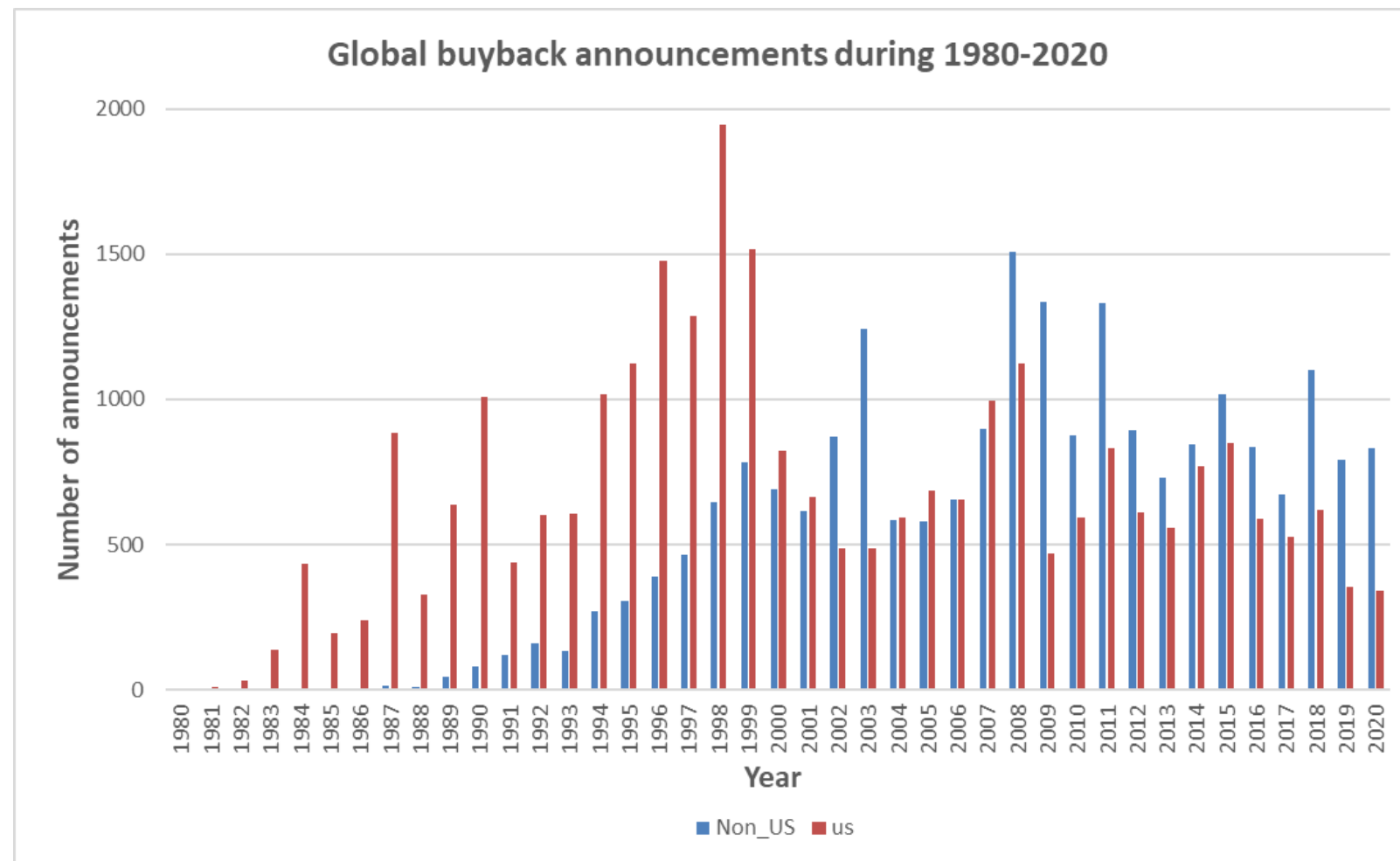
Shareholder Payouts and Short-Termism

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Source: M&A database in SDC Platinum

Some people hate share buybacks

Chuck Schumer (US Senator) :

- <https://www.youtube.com/watch?v=VphPChqusCY>

“I hate stock buybacks. Instead of investing in workers and in training and research and in equipment they don’t do a thing to make the company better and they artificially raise the stock price by just reducing the number of shares. They are despicable. I’d like to abolish them”.

Two major criticisms

- Buybacks lead to underinvestment
- Buybacks are a stock price manipulation scheme benefitting insiders

Jesse's paper replies to the underinvestment criticism :

- Criticism ignores equity financing
- Criticism ignores that money received by shareholders get invested elsewhere
- Investment intensity has increased in spite of higher payouts
- Cash balances have been increasing-firms have not been “starved” by payouts

Comments (1)

- What about debt financing ?
 - Interest is tax deductible
 - Agency costs of free cash flow are lower (Jensen 1986)
 - Less adverse selection than equity (Myers and Majluf (1984))

Comments (2)

- Paper assumes investment is good
- But only positive NPV investments are good (sustainable)
- Even if you would find investment goes down it does not mean share buybacks are bad
- Buybacks reduce bad investments

Two major complaints

- Buybacks lead to underinvestment
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How do managers benefit from buybacks ?

- **EPS management** to increase compensation (Brav et al (2005))

=> Solution : Don't make bonuses contingent on EPS

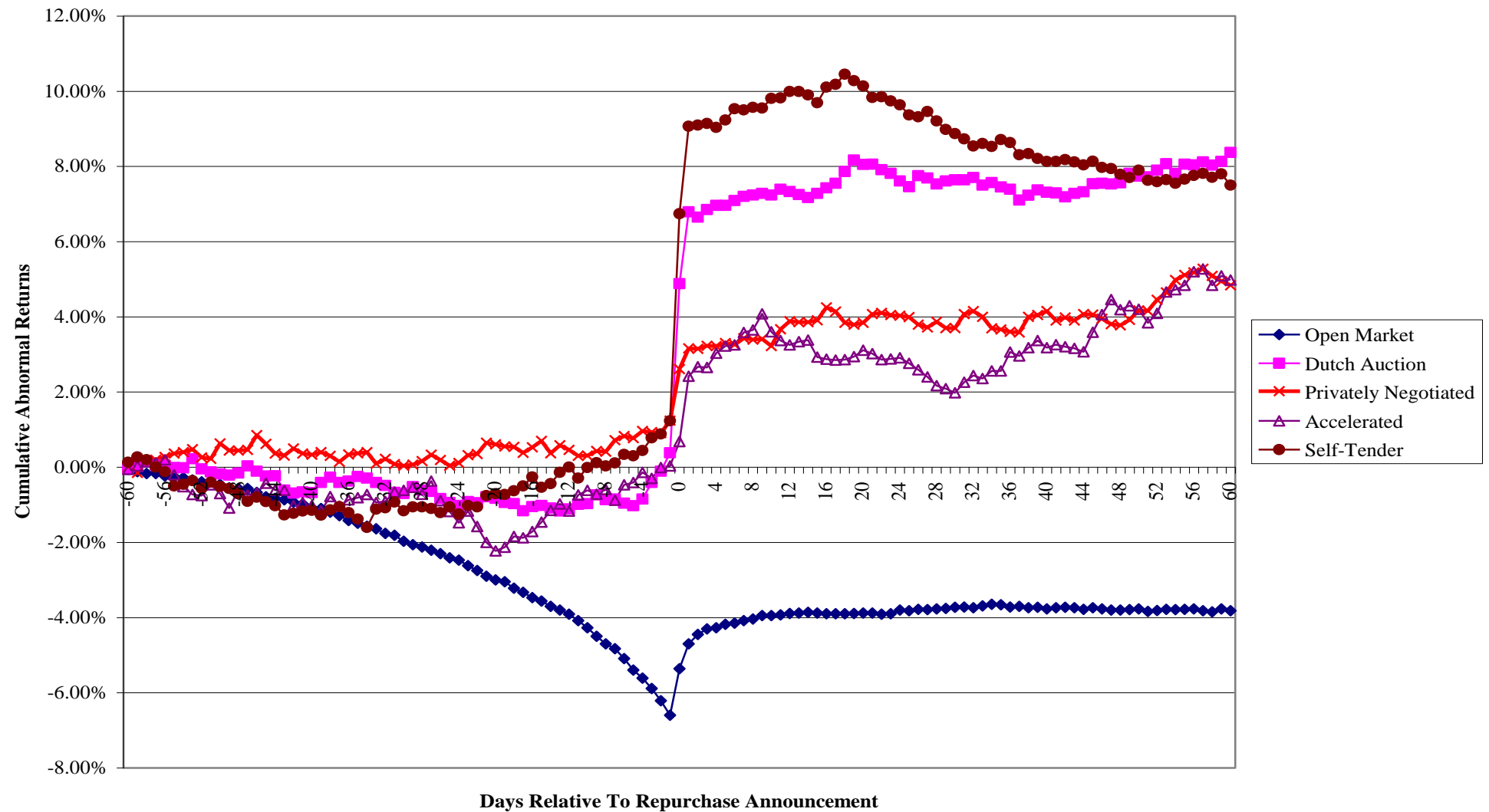
- **Increasing value of stock options** by lowering dividends (Kahle 2002)

=> Solution : Adjust strike price of options for dividend payments

- **Selling shares** after a buyback announcement (Jackson (2018))

Assumes stock price manipulation : false assumption (see infra)

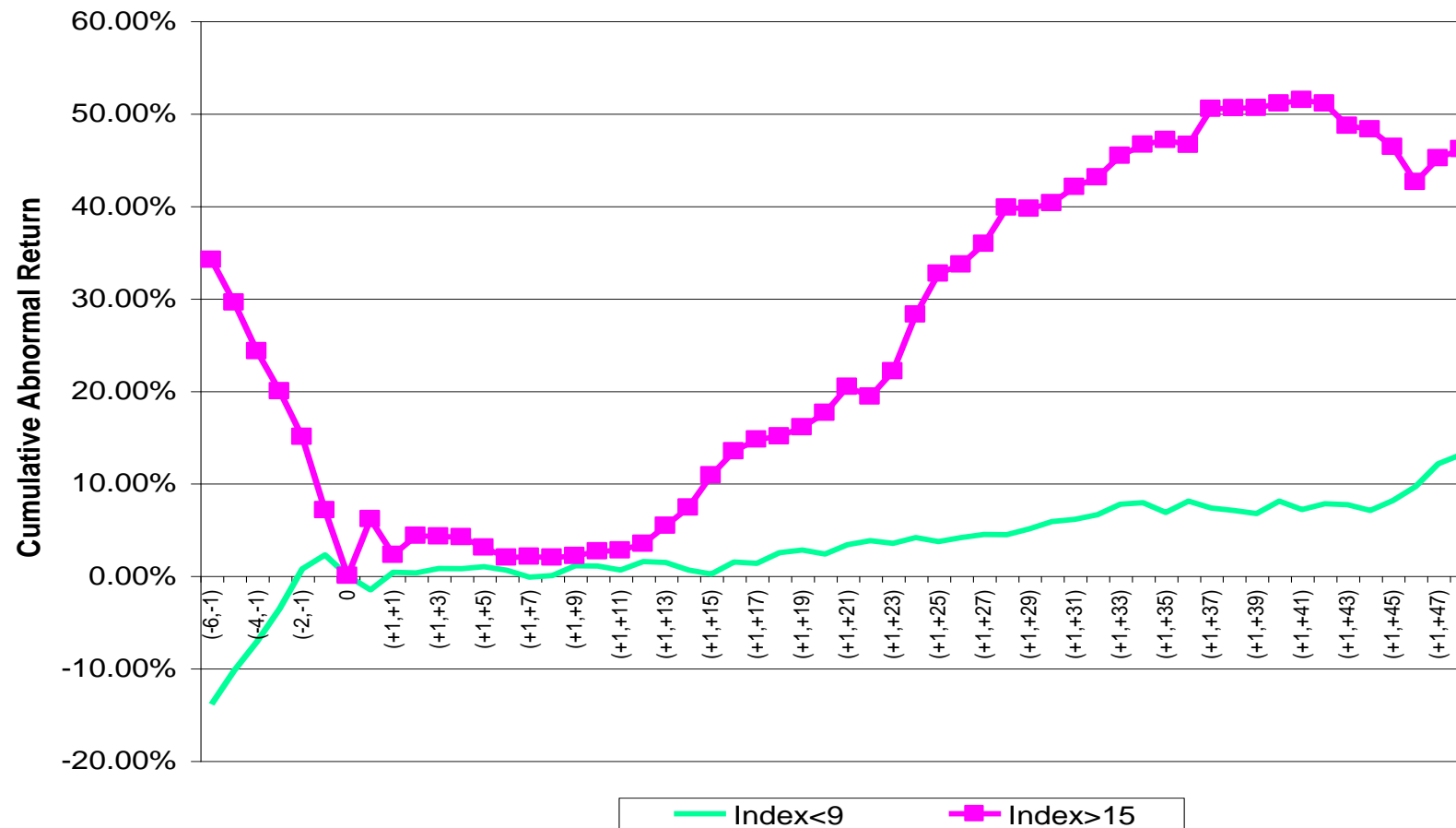
Shareholders love buybacks



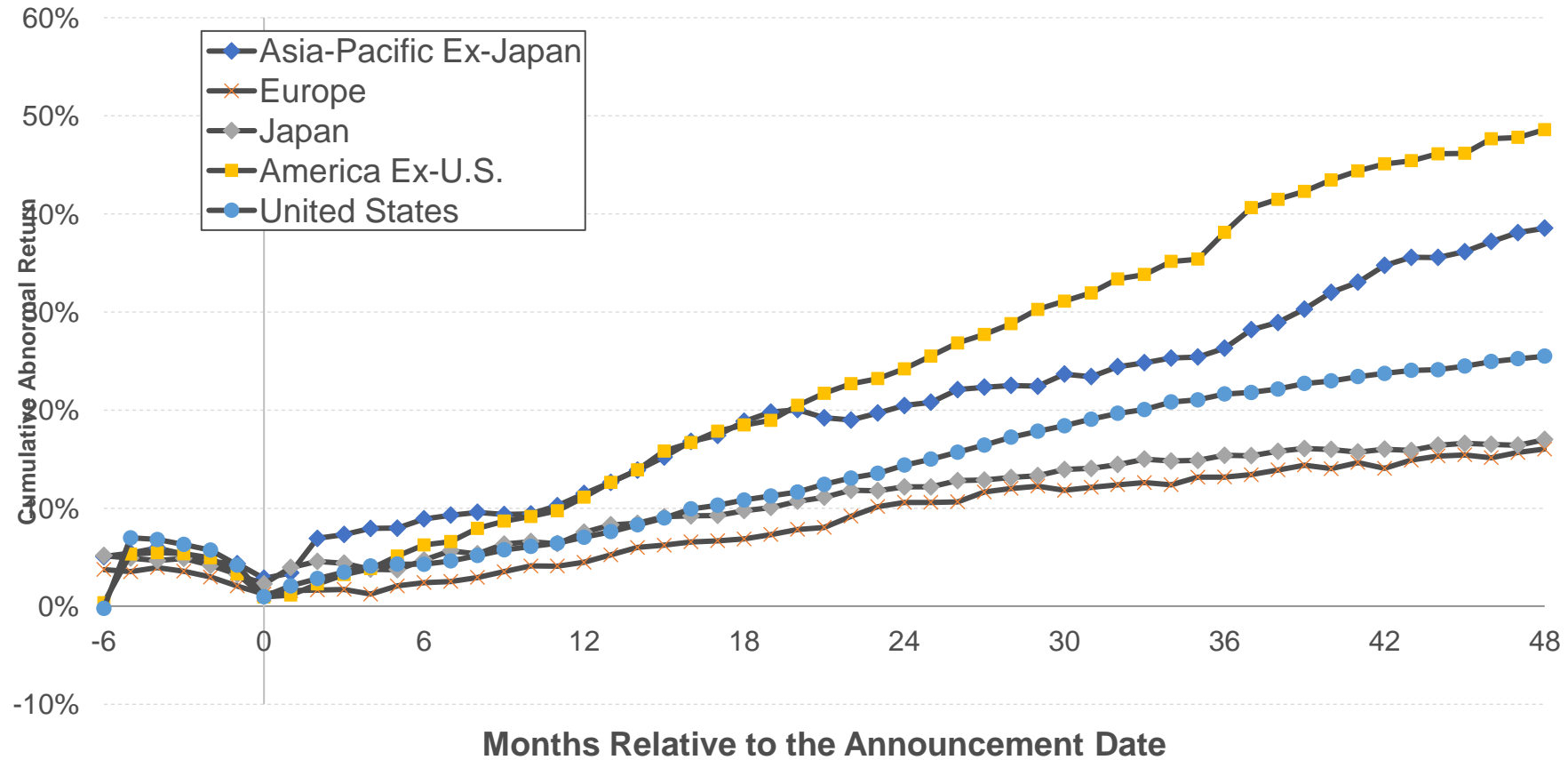
Why do shareholders love buybacks ?

- Happy that excess cash does not get wasted in negative NPV projects,
- Signal that stock is undervalued
- Tax benefits

No reversal in long run so no manipulation



No reversal in long run : global evidence



So why do insiders sell after buyback announcements ?

- Buybacks are announced after insider trading **black out periods** (before earnings announcements)
- Buyback creates **liquidity**
- No evidence insider selling is informative (Lakonishok and Lee (2011))

Criticism of TSR (Fried, Ma and Wang (2021))

“TSR don't measure actual returns to all shareholders : when a company buys back undervalued stock it's a wealth transfer from sellers to long-term investors”

- True, but which shareholders should managers care about ?

What does maximizing shareholder value mean?

- Maximize the wealth of the **current long-term** shareholders
- Investors who sell to the firm after a buyback in the open market would have sold anyway
- So **not** repurchasing undervalued shares will transfer wealth from current long-term shareholders to new shareholders.

The bottom line

- **Market** may have a **short term-view** : attach too much weight on bad short-term earnings
- **Managers with a long-term view** exploit this short-termism to benefit long-term shareholders by buying back undervalued shares

Thank you !