Weekly Trends

PRIVATE CLIENT SOLUTIONS

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Share Buybacks: Trick or Treat

Global equity markets had a solid week as a slew of positive events pushed stocks higher in all major global indices. Canada was the weakest of the bunch barely squeaking out a positive return, with the resource-based S&P/TSX Composite Index under pressure from significant price drops in oil and gold. Both commodities are either at or have broken through key technical support levels (WTI = US$80, Gold (US$1,180) due to a surge in the US dollar. The US dollar-weighted index (DXY) is now at a 4½ year high.

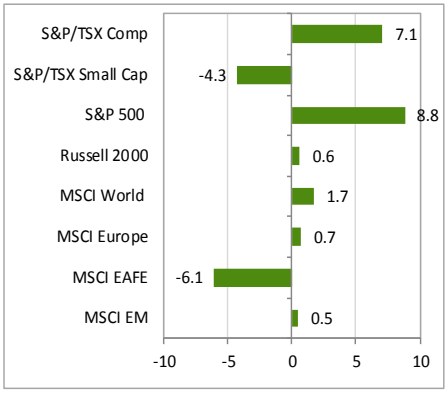
As expected, the Fed officially ended its bond purchase program on Wednesday and left their key interest rate unchanged. The Fed's commentary had a more balanced assessment of economic conditions and expectations, and the statement kept the "considerable time" language. A slightly hawkish tone was implied with an upgraded assessment of the US labour market, and the dismissal of the possibility that energy price declines will have a sustained effect on inflation. The Fed stated that the next interest rate move will be data dependent and consensus has pushed the next potential rate hike up a month to September 2015. Fueling the optimistic outlook for the US was the third quarter annualized GDP (q/q) print which topped estimates at 3.5% vs 3.0%.

Corporate earnings in the US continue to be very positive with 362 companies in the S&P 500 Index now having reported. Over three quarter of the earnings reports were positive surprises with only 16% missing expectations. This is comparatively better than the third quarter results seen last year which had 67% beating consensus, and 20% of the companies with negative results.

The Bank of Japan topped off the week on Friday as it unexpectedly increased monetary stimulus. The BOJ reported it will increase holdings of government bonds to 80 tln yen and boost exchange traded fund purchases to 3 tln yen. The Nikkei surged nearly 5% on the news, and the Yen dropped to its lowest level in 7 years.

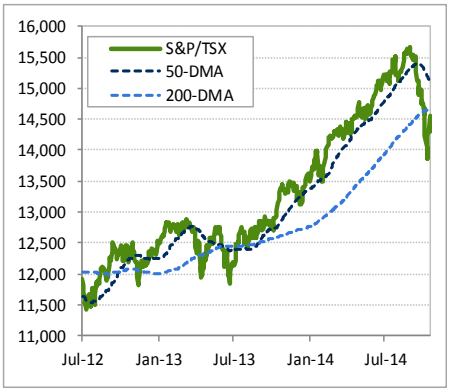
IBM (IBM-US) announced this week that its board has approved a US$5 bln share buyback in addition to the US$1.4 bln remaining from its existing program. There has been much criticism on IBM pursuing share repurchases as opposed to investing in new technology. With the popularity of stock buybacks exploding in the past 10 years, we take a closer look at this management strategy in the latter part of this commentary.

Equity Market YTD Returns (%)



Canadian Sector	Curr. Wt	Recommendation
Consumer Discretionary	6.0	Market weight
Consumer Staples	3.2	Market weight
Energy	23.9	Overweight
Financials	35.8	Overweight
Health Care	3.2	Underweight
Industrials	8.9	Overweight
Information Technology	2.0	Overweight
Materials	10.1	Market weight
Telecom	4.7	Underweight
Utilities	2.0	Underweight

Technical Considerations	Level	Reading
S&P/TSX Composite	14,583.5	
50-DMA	15,012.1	Downtrend
200-DMA	14,695.3	Downtrend
RSI (14-day)	44.9	Neutral



Source: Bloomberg, Raymond James Ltd.

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Stock Buybacks

The Numbers

As of third quarter, there have been over 200 stock buyback announcements from S&P 500 companies this year. This equates to approximately US$300 bln of stock repurchases. For 2013, the total value of stock buybacks was a whopping US$500 bln, which was up 250% from 10 years ago.

So who are utilizing this strategy? Companies in the information technology space have done the most in the past five years by far, with consumer discretionary and health care companies rounding out the top three. As expected, telecom services and utilities are at the bottom of the list, since these companies tend to turn cash flow into dividends for the shareholder.

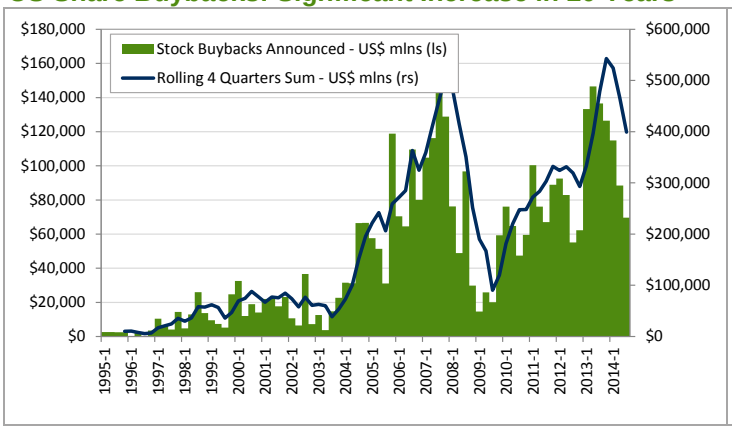
Buyback 101

Management of companies who have large cash balances should have an obligation to shareholders to utilize the cash in an efficient manner. Remember, cash belongs to shareholders and they expect a decent return on equity. With excess cash, a company can: reinvest in the business (e.g. build up operations, improve technology); look for M&A opportunities to increase or diversify business lines; and/or redistribute cash back to shareholders, either by stock buybacks or dividends. In the 1980s and into the early part of the 1990s, dividends were the primary method in which shareholders were compensated. However in the past 20 years, stock buybacks have become the more popular form for companies looking to reward investors. Buybacks help to boost share prices by reducing the number of shares outstanding and therefore increasing shareholders claim to earnings. Open-market share repurchases are the most commonly used mechanism in which stock buybacks are completed. Other methods include: private negotiations; repurchase of 'put' rights; a fixed price tender offer; and a Dutch auction. Below are some of the main reasons of why companies do share buybacks:

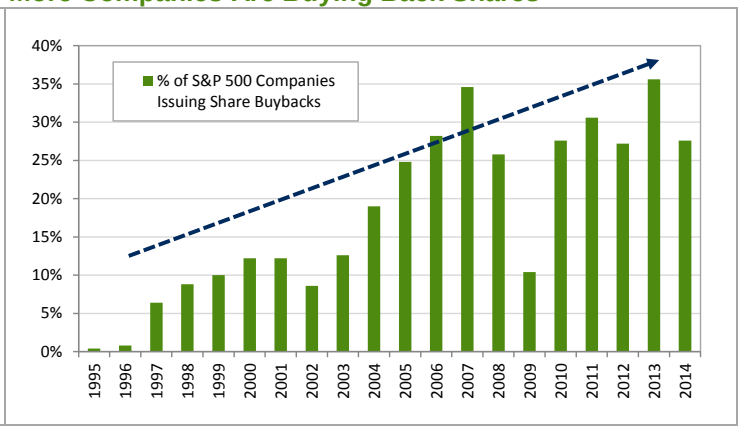
Why Do Companies Use Share Buybacks?

- ***Increase the Share Price:*** This is purely a supply and demand issue. If there are fewer shares outstanding there is less supply. Each share has theoretically more "value" because of scarcity.

US Share Buybacks: Significant Increase in 20 Years



More Companies Are Buying Back Shares



Source: Bloomberg, Raymond James Ltd.

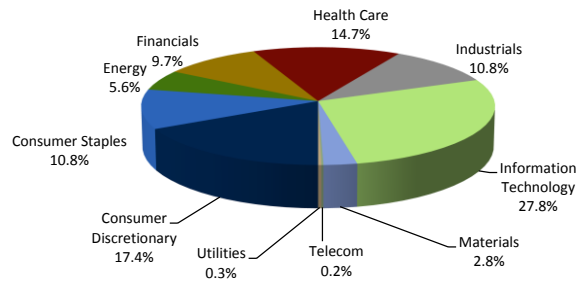
- ***Improve Key Financial Ratios:*** Any key fundamental company ratio that has shares outstanding in the divisor/denominator will be increased with a buyback. If the number of shares decreases, the overall ratio will increase. Some notable examples are: Earnings Per Share (EPS), Return on Assets (ROA), and Return on Equity (ROE).
- ***Undervaluation:*** If management believes that the stock is undervalued – the stock price is lower than its intrinsic value - why not invest in yourself at a cheap price.
- ***Undilute Shares Outstanding:*** Whether it's from an acquisition using shares, or employee stock options used as compensation, the amount of shares outstanding can increase. Companies can buy back shares to decrease the dilution of shares and readjust the capital structure.
- ***Better Taxes:*** For most investors in Canada and the US, capital gains are taxed more efficiently than dividends. On the corporate side, a company that spends the cash to repurchase stock will save on taxes paid on the interest income with that money sitting in an account.
- ***Prevent "Deworsification":*** Peter Lynch defined "deworsification" as companies who attempted to diversify their business, but in doing so dragged down their overall returns.
- ***Fend Against Future Downside:*** Whether it be an M&A gone wrong or a dividend cut, the future is unpredictable. An announcement on a cut in stock buyback has less detrimental effect on the stock price than the other two scenarios.
- ***Defend Against Takeovers:*** Stock buybacks can be used as a preventative measure against takeovers by boosting share price, enabling control of voting rights and changing ownership structures. These can increase the difficulty and cost of buying company shares.

The Downside

The important question is not why a company does the buyback, but the reason behind the why. This is where the downside of share buybacks can end up really hurting the company, and in turn the shareholder in the long run. Below is a list of reasons of why stock buybacks may not be a good idea:

- ***To Compensate For Personal Gains:*** This would typically only affect the management team of the company. Sometimes, stock options can be granted to management teams and CEOs based on performance metrics which can

Which Sectors Are Doing It: Past 5 Years



Companies With Most Share Buybacks Since 2010

Company	Symbol	Sector	Value (US$ mlns)
APPLE INC	AAPL	Information Technology	$90,000
INTL BUSINESS MACHINES CORP	IBM	Information Technology	$65,000
PFIZER INC	PFE	Health Care	$46,000
WAL-MART STORES INC	WMT	Consumer Staples	$45,000
MICROSOFT CORP	MSFT	Information Technology	$40,000
JPMORGAN CHASE & CO	JPM	Financials	$36,500
ORACLE CORP	ORCL	Information Technology	$30,010
PHILIP MORRIS INTERNATIONAL	PM	Consumer Staples	$30,000
3M CO	MMM	Industrials	$26,500
CISCO SYSTEMS INC	CSCO	Information Technology	$25,000

Source: Bloomberg, Raymond James Ltd. As at Q3-2014.

range from stock price appreciation and improved fundamental data points and ratios. Buybacks can be used to hide these compensation packages. Stock options should not be granted at the expense of shareholders.

- ***Using Debt to Fund Buybacks:*** From a taxation perspective this seems like a positive reason, however, we believe this has potentially more downside risk. Interest expenses paid on debt are tax deductible and the tax savings could translate into share price appreciation. However, cash reserves would be drained which could hurt credit ratings. It is usually a lack of cash that gets a company into financial trouble.
- ***Nothing Else to Do:*** Is this a signal that company management has admitted that they do not have ideas on how to use the excess cash efficiently? Is the company giving up on growth?

Investing in Share Buybacks

Below are a list of ETFs that utilize share buybacks. These are by no means recommendations but a way to play a buyback strategy through a diversified vehicle.

- ***PowerShares Buyback Achievers Portfolio (PKW-US)***: This cap-weighted ETF holds stocks that have reduced net shares outstanding by at least 5% in the past 12 months. It is reconstituted once a year.
- ***AdvisorShares TrimTabs Float Shrink ETF (TTFS-US)***: Starting with the Russell 3000, the top 100 stocks are screened out eliminating the ones that buyback shares using debt. The companies are then equal-weighted and holdings are re-adjusted every month.
- ***Cambria Shareholder Yield (SYLD-US)***: This is the most stringent of the three ETFs, due to its active management. SYLD invests in 100 stocks with market caps greater than US$200 mln that rank among the highest in: paying cash dividends; engaging in net share repurchases; and paying down debt on their balance sheets.

ETF	Symbol	1 Yr	3 yr	5 Yr
PowerShares Buyback Achievers	PKW	15.75	25.09	19.19
AdvisorShares TrimTabs Float Shrink	TTFS	18.09		
Cambria Shareholder Yield	SYLD	14.13		
S&P 500 TR USD		19.73	22.99	15.70

Source: Morningstar. Performance as at September 30, 2014. Annualized

Bottom Line

Shareholders can be rewarded in two ways, through capital appreciation and with dividends. Stock buybacks is one of the ways to increase stock price. They can both be positive and negative for a company, but the important issue is the rationale behind repurchases. Investors need to decide if management is making the right decision under their company's circumstances or if it is a short-term way to appease shareholders. Though share buyback announcements historically has been seen as positive, with the extent that buybacks have skyrocketed in the past 10 years, many are worried that things may have gone too far. Each share buyback should be analyzed on a company by company basis, and looking at a metric like shareholder yield (which includes stock buybacks, dividends, and debt reduction) is advisable. Like most things in life, having too much of one thing is usually not a good thing.

Shareholder Yield

Dividends, share buybacks and debt reduction have been factors that many active managers have sought out historically including Warren Buffet. To engage in these types of activities sustainably, it is generally preferred that companies utilize free cash flow rather than using debt. William (Bill) Priest of Epoch Investment Partners focuses their investment process on the generation and optimal allocation of free cash flow. He coined the three activities mentioned above as Shareholder Yield in a 2005 white paper titled *Shareholder Yield as a Dominant Driver of Future Equity Returns*. This is not to say the focus of the investment process falls on companies that exclusively engage in paying dividends, share buybacks and debt reduction as in the ETFs on the left, but rather companies that optimally allocate their free cash flow. This can come in the form of capital return to shareholders in dividends, share repurchases, or debt reduction (shareholder yield), or in the form of capital growth such as internal projects or acquisitions. The management team is indifferent between the two, as long as it is beneficial to shareholders. Improving free cash flow is one of several factors used in the initial quantitative screen to narrow the investment universe for candidates to include in the portfolio after performing the appropriate fundamental analysis on each name. Member of the Raymond James Focus List, **CI American Value** is sub-advised by Epoch and managed by William Priest and David Pearl. The fund provides investors with active management and exposure to companies that are growing free cash flow and allocating it in an optimal manner to benefit shareholders.

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