Sankala Group

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Lemonade Stand Logic

Harold Hallstein

Value investing takes both quantitative and qualitative work. Out of respect for that balance, I try to alternate my focus in these letters to provide coverage of both approaches. Since the last letter on *bonsai* was qualitative, this letter will return to earnings, rates of change, and market mechanics.

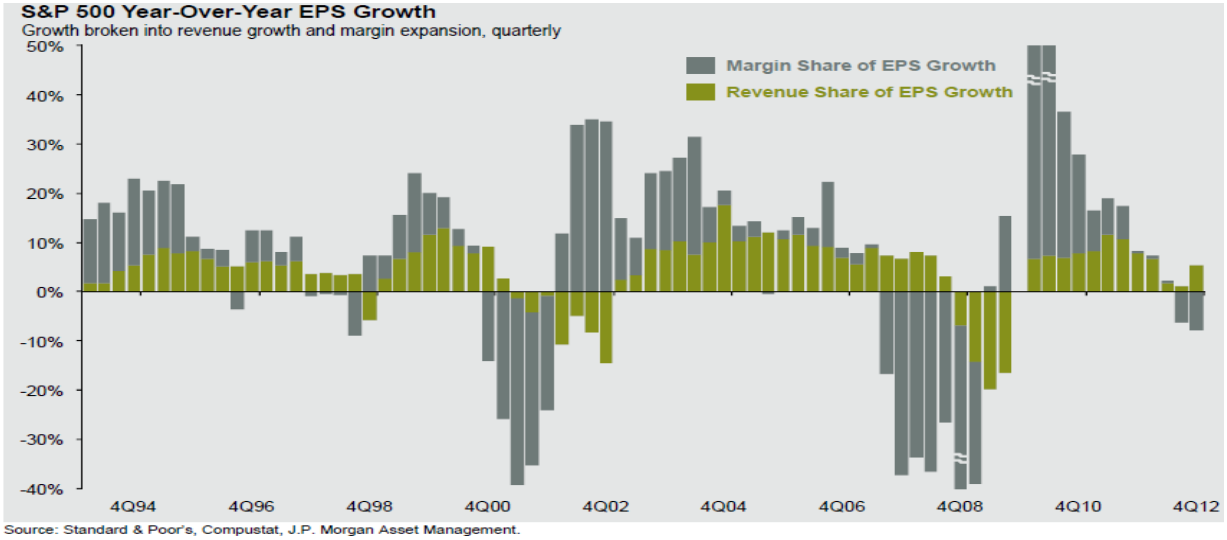
Let's start with a high-level look at the income statement of the S&P 500:

S&P 500 - Income Statement
Source: Standard & Poor's Financial Services LLC
USD, per share

	2012	2013 est.	% Change
Sales	$1,092	$1,131	3.6%
Operating Earnings	$97	$108	11.8%
As-Reported Earnings	$87	$97	12.5%
Operating Margin	8.9%	9.6%	7.9%

One sign of a robust economy is growing sales numbers. Unfortunately, it appears sales will remain slow in 2013. The S&P 500 will grow sales by ~3.6% in an economy that is experiencing 2.2% inflation, which means real sales growth is only ~1.4%. That is well below long-term averages. On the other hand, the S&P companies were able to ratchet up earnings by ~12.5%, which equates to ~10.3% after inflation — well above the norm. This letter will explore how U.S. companies pulled off this seemingly magical feat, which defies traditional lemonade stand logic.

When we were kids, we earned more money by selling more lemonade. How then does corporate America earn more without selling proportionately more lemonade? As the plot below illustrates, since 2009 companies have been relying on cutting costs (grey bars) to increase profits. This was highly effective in the aftermath of the crisis, but has become progressively less effective as time has passed. You can only decrease the quality of your lemonade and force overtime on your siblings for so long.



Now, in 2013, as sales growth remains stubbornly slow, corporate managers have moved on to a more opaque method of growing earnings per share. Rather than use their cash to invest in future productive capacity, they have been increasingly using it to buy back their own common stock on the open market. This activity, called share buybacks, is very interesting because it doesn't actually lift the current or future earnings capacity of the company a single dollar, but instead reduces the number of shares of stock outstanding which the companies' earnings are spread across.

The mechanics work as follows:

Earnings Per Share (EPS) = Net Income / Shares Outstanding

Share buybacks do nothing to increase the net income part of the equation. What they do is reduce the denominator (shares outstanding), so that the income is claimed by fewer shareholders. The result is an increase in earnings *per* share, despite the fact that no new profits have actually been made by the company. Management teams love this strategy because it allows them to create the appearance of earnings growth simply by moving cash around. If we don't watch the shop closely we might get taken in by this optical illusion.

To put this concept into stark perspective, between Q3 2011 and Q1 2013, the S&P 500 saw earnings per share rise by $3.70. Of that gain, fully 60% or $2.20 was attributable to share buybacks. Only $1.50 was due to organic growth in profitability.[1]

In the table below you will be surprised to learn exactly how much companies are spending on these buybacks:

S&P 500 Dividends & Buybacks

Source: Standard & Poor's Financial Services LLC

USD, billions

	Reported Earnings	Dividends	Buybacks
Q1 2013	$215	$71	$100
Q4 2012	$185	$80	$99
Q3 2012	$190	$69	$104
Q2 2012	$195	$67	$112
Q1 2012	$208	$64	$84

[1] J.P. Morgan Asset Management

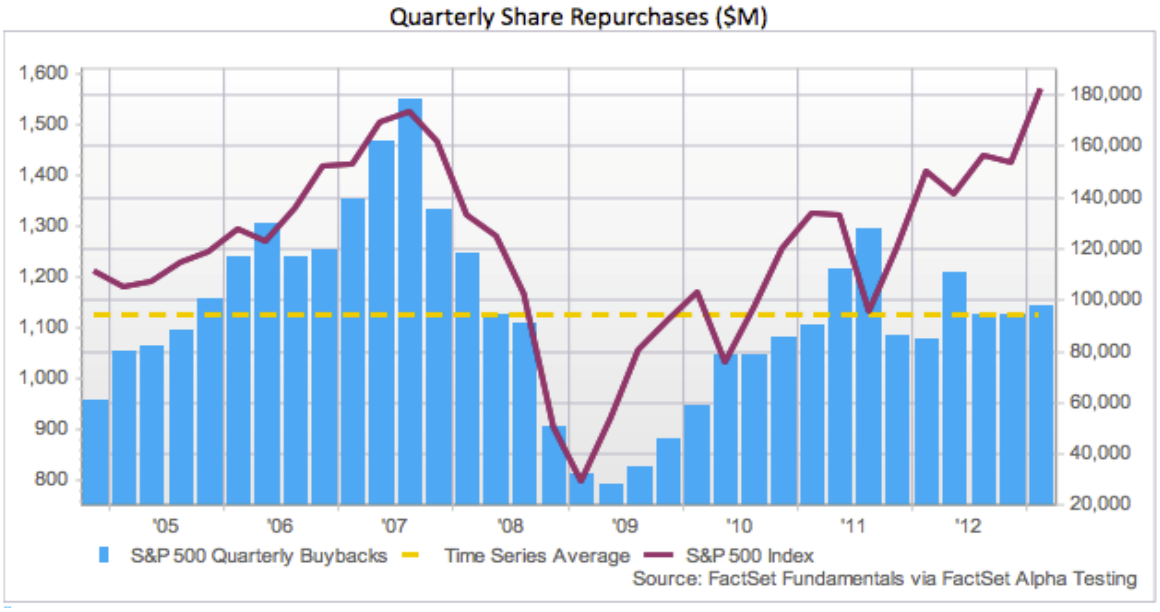
While I only show recent data to save space, it has been 14 quarters running that companies spent more on buybacks than dividends. Buybacks will likely reach past $420 billion dollars for FY 2013. That is an immense number, climbing steadily back towards the all-time high reached in 2007 of $590 billion.

To understand the execution of a buyback it will help to look specifically at Apple's program. Apple announced in Q2 that it will purchase $60 billion dollars' worth of its own shares, the single largest buyback in history. At the time, that equated to 12% of all shares outstanding. To make these purchases they raised money by selling $17 billion worth of bonds. You would rightly wonder why they sold bonds, since they are famous for having so much cash already. The reason is that selling bonds prevents them from having to repatriate cash held abroad and thus pay U.S. taxes. While this financial engineering has some questionable ethical overtones, it is legal under current law.

For ourselves, we need to recognize buybacks like these are *sometimes* good for us. Essentially, buybacks and dividends are both ways for companies to return part of our investment to us, but buybacks have the distinct advantage of returning our money in the form of capital gains. We control the timing of the tax realization on capital gains, and so can have more control over our tax bill. Dividends, on the other hand, get taxed each year mandatorily. In some cases, dividends are taxed at higher effective rates as well. Due to that, buybacks are a more tax efficient way for companies to return money to us.

We certainly need to be aware of the drawbacks of these buybacks as well. The glaring problem with buybacks is their inherent lack of sustainability as a driver of earnings growth. Unlike selling more lemonade, buybacks use the limited resource of cash to fund stock price gains at the potential expense of the company's liquidity and ability to reinvest in its underlying business. Taken to extremes, buybacks actually have ponzi qualities in the sense that they pay current investors at the expense the company's ability to succeed in the future.

If we dig deeper into the data we can also see that corporations' ability to time these stock repurchases has been abysmal. The chart below shows how companies made their largest buybacks in the *worst* quarter of the *worst* year to be buying stock in an entire generation:



The chart also shows how they compounded that error by buying essentially nothing during 2009, when prices were showing exceptional value. As a matter of fact, companies were issuing stock in aggregate in 2009, epitomizing buying high and selling low and destroying incredible amounts of shareholder value in the process.

Companies' failure to take advantage of good deals in 2009 was only natural. They had little cash left to buy stock after overpaying so badly at the top. Banks, of course, had also lost appetite for lending to finance buybacks by that time, further reducing funds available for repurchases. It's a great lesson for us about liquidity, and the immense value in having cash available when it becomes scarce.

General Electric (GE) is perhaps one of the most egregious examples of a company that has destroyed tens of billions of dollars of shareholder value with terrible buyback and issuance decisions. From 2005—2007, GE bought back $25.7 billion worth of shares when the market was peaking. Then GE went into a liquidity spiral in 2008, forcing management to get most of that very same cash back by selling $12 billion worth of new common stock at extremely low prices. They also sold $3 billion of preferred stock (and more warrants for common stock) to yield an outrageous 10% to Warren Buffett. The value GE lost overpaying at the top and then redoubled by selling shares at the bottom explains a significant amount of the empty space above the current stock price. That missing value is now seen as an increase in the book value of Berkshire Hathaway and other institutions that saved GE from the brink of bankruptcy.

So, how do management teams get things so badly wrong? Aren't insiders supposed to know more about the state of their business than outsiders? To answer that question, I searched far and wide before eventually discovering a relatively unknown paper by Alice A. Bonaimé and Michael D. Ryngaert, professor's of Finance at University of Kentucky and University of Florida. The paper is titled *"Insider trading and share repurchases: Do insiders and firms trade in the same direction?"*

Since my job is to distill information for clients, I will get right to the conclusions of the study. They found that insiders often trade their personal shares *against* their own companies repurchase programs, and further, when this happens the performance of the stock afterwards is significantly worse than when they trade in the same direction as the company.

That blew my mind for a moment as I grasped the conflict of interest inherent in an executive authorizing stock repurchases with shareholder money, while simultaneous planning to sell their own personal stock into that self-created buying pressure. I turned to Skadden, the well-know securities law firm, for more insight. Based on their *Share Repurchase Corporate Finance Alert* dated February 2013, it appears there are, in fact, ways to cover your ass legally when selling personal stock back to your company at inflated prices you caused by authorizing share buybacks! You just need to be ready to pay $1200 an hour to know exactly how it works.

Looking at all this from a wide angle, it is clear **the traditional view that corporate buybacks are a signal of value in the market is simply corporate spin**. While some companies are using the buyback tool wisely, others are using it as a last ditch effort to lift earnings per share figures when the normal methods stop working. Further, they may also be doing this in preparation to sell their own personal stock, so they can then buy it back at lower prices when investors finally realize there aren't many new lemonade customers around. This, clients and friends, is corporate finance *samsara,* the perpetually undulating playing field we must navigate as investors.

A short anonymous comment I found after an article used in my research sums it up nicely:

"go public - *take bonus*
leveraged share buyback - *take bonus*
roll over debt - *take bonus*
go bankrupt - *take bonus*
go private - *take bonus*
emerge from bankruptcy - *take bonus*"

Of course, not knowing whether to laugh or cry, we must continue to invest our savings. Despite all, the ownership of high-quality corporations remains our best long-term option to preserve and grow the delayed gratification we have accumulated. We just need to bring

disciplined analysis to the playing field in order to avoid getting whipsawed by these corporate machinations.

One key element of that analysis is the understanding that earnings growth has both quantity and quality. We know the quantity of EPS growth will be about 10.3% in 2013. Yet, I also hope you are now convinced the quality of this year's earnings growth is a little suspect. A huge portion of it was created through buybacks versus new lemonade sales.

As shareholders, the part of the economy we want to own is good product and good service being sold into an expanding marketplace. In order to make sure we don't stray too far from this vision, it's critical we look past outward appearances and explore the content behind the rates of change we observe.

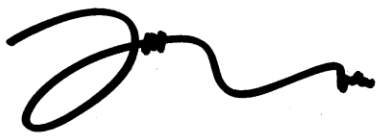
All this argues for increasing caution in our U.S. stock allocations. Since late 2009, when I started this business, the S&P has rallied strongly relative to most all other markets. As a result, our total dollar exposure to U.S. stocks has climbed dramatically, and increased significantly relative to the other assets we own like international and emerging market stocks, global bonds and real estate. Fortunately, many client portfolios are in need of global diversification, and we have continuing opportunities to make these adjustments on very favorable terms.

We need to keep doing what we have been doing for the last year, and trim back growth in our U.S. positions, while adding to other markets that are likely to see stronger sales growth and thus more organic earnings. In the final reckoning, I'm confident good fresh lemonade will outlast all the tricks and shortcuts.

Some other ideas I have been exploring with clients:

- Municipal Bond Closed-End Funds
- Long-term earnings power of the IBOVESPA (Brazil)
- UTMA & UGMAs as vehicles for college savings
- The impact of rate hikes on Real Estate Investment Trusts (REITs)

Best,



Harold A. Hallstein IV
Sankala Group LLC
T: (720) 310-0605
F: (866) 892-0819

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