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The savvy executive's guide to buying back shares

Timing share repurchases is tricky. The most shareholder-friendly approach: don't try.

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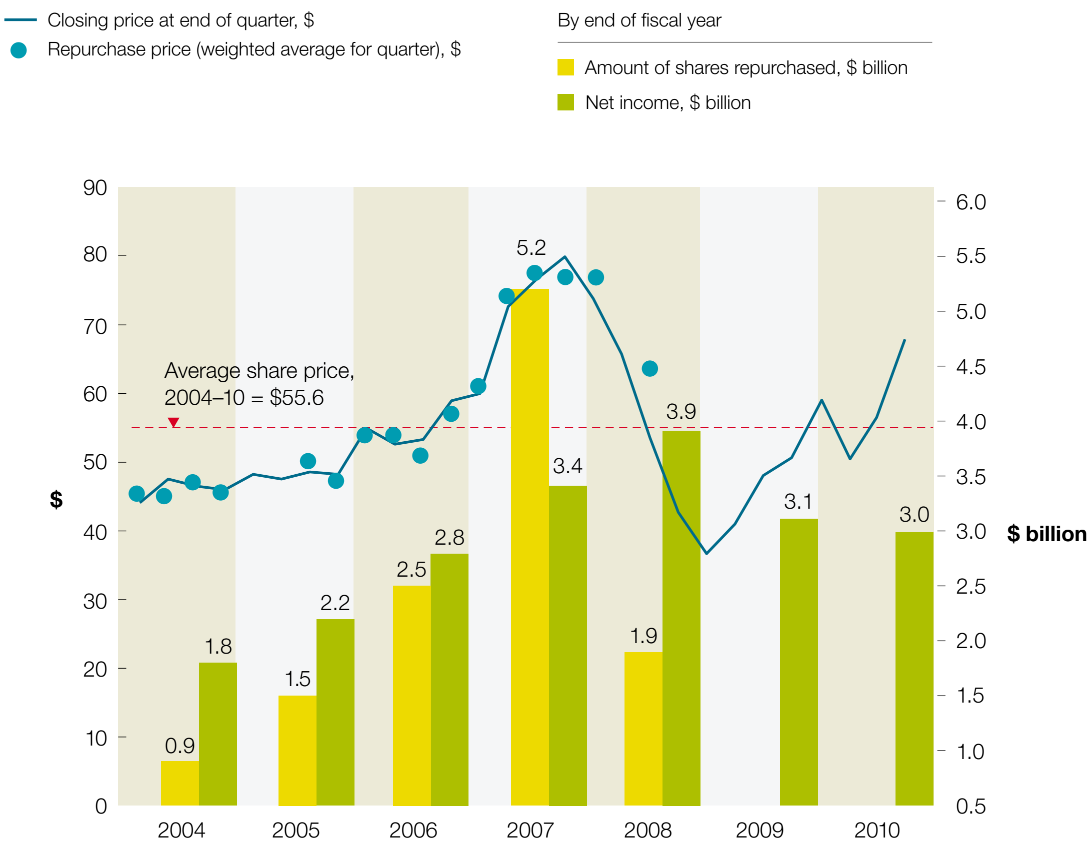
Managers, like investors, often gauge the performance of share repurchases against that old investment adage: buy low, sell high. If they could consistently time repurchases to periods when shares were undervalued, as some try to do, they could reward loyal shareholders at the expense of those who sell out.

Of course managers, like investors, can't always do what old adages suggest. Markets are volatile and unpredictable, and what seem to be longer-term trends can quickly reverse course. Overconfidence can lead executives to buy back shares even at the peak share price—and a bias for caution can restrain them from buying shares when prices are lowest. The result is that companies seldom consistently pick the right time to buy back their shares at advantageous prices.[1] Indeed, for the years 2004 through 2010, our analysis finds that a majority of companies repurchased shares when they and the market were both doing well—and were reluctant to repurchase shares when prices were low relative to their intrinsic valuations. Few stopped repurchases even as the market peaked in 2007. And when the market bottomed in 2009, few companies were buying back shares.

One global technology company is a typical case (Exhibit 1). After a large repurchase of shares in 2004, the company accelerated its purchases as profits and share prices increased. Just as prices

Exhibit 1

One global technology company repurchased more shares at their peak price than at any other time.



Source: Standard & Poor's; McKinsey analysis

peaked, in 2007, it bought back the most shares ever—more than five times as much as it had in 2004. As the financial crisis developed in 2008, managers reduced the level of the company's repurchases. It didn't buy back any shares in 2009 or 2010, despite continued strong profits and a bargain on share prices, which had dropped by around 50 percent. In hindsight, it's easy to understand why the company stopped the buybacks in 2009 and 2010, amid deep market uncertainty. Nonetheless, the best time to buy is generally when everyone is scared.

That buyback pattern is not unique. We looked at the S&P 500 companies between 2004 and 2011, a period for which we have quarterly share buyback data. It turns out that companies don't just tend to buy back more shares when the underlying earnings are strong—they also seem more willing to do so when their share prices

Exhibit 2

Companies would have earned more if they had purchased an equal dollar amount of shares each quarter.

We modeled total returns to shareholders (TRS) for a strategy of buying the same dollar amount of shares each quarter and compared this model with companies' actual TRS from share repurchases.

	TRS for actual shares repurchased[1] **relative to model,** %	**Number of companies,**[2] 2004–10
Only 23% of companies achieved TRS above that of the model.	12.5 and above	1
	10.0 to 12.4	0
	7.5 to 9.9	1
	5.0 to 7.4	2
	2.5 to 4.9	2
	0 to 2.4	25
77% of companies earned less.	0 to –2.4	29
	–2.5 to –4.9	26
	–5.0 to –7.4	9
	–7.5 to –9.9	12
Median TRS for actual share repurchases = –3.0%	–10.0 to –12.4	12
	–12.5 and below	16

[1] Where total shares were >25% of beginning shares outstanding. Based on S&P 500 members' quarterly repurchases from 2004–10. Sample size of 135 excludes 5 companies with unusual circumstances.
[2] Grouped in weighted 3-year-average TRS cohorts based on compound annual growth rate for TRS for up to 3 years immediately after purchase.

are high. The result is a cyclical pattern: companies pay out disproportionately large amounts at the top of a cycle and withhold repurchases at the bottom.

Over longer-term periods, such as the up-and-down market cycle from 1998 to 2005 or 2006 to 2010, share repurchases came at the expense of long-term loyal shareholders by delivering lower returns than they might otherwise have received. We compared the actual repurchases of S&P 500 companies from 2004 to 2010 with a modeled strategy of buying the same dollar amount of shares each quarter, much as an investor might regularly purchase shares as part of an income-averaging approach or as a company might think of a share repurchase as akin to a regular dividend. We found that the latter strategy significantly outperformed what actually happened.[2] For companies that repurchased 5 to

25 percent of their outstanding shares, the median return of actual buybacks lagged behind that of the modeled strategy by 4.5 percent. For companies that bought back more than 25 percent of their shares, the median return of actual buybacks lags behind that of the alternative approach by 3 percent. Only 31 percent of the companies earned a positive return from buying back shares—less than you would expect from a random throw of the dice (Exhibit 2).

These findings suggest an easy fix: companies should give up trying to time the market. Long-term shareholders will be better off if management would simply forecast total excess cash and evenly distribute it each calendar quarter as "dividends" in the form of share repurchases. CFOs can approach such regular buybacks in two ways. First, they can repurchase shares as excess cash becomes available. This is the easiest approach and the one least likely to send adverse signals to investors around the potential for excess cash or cash shortfalls. It is probably right for most companies, even if it generates lower returns.

Second, companies can evenly distribute similarly sized repurchases over time. For those willing to stand by their forecasts of future cash flows, this dividend-like approach will probably generate higher returns for shareholders. Investors will, however, inevitably try to determine exactly what management is thinking, given the level of repurchases it sets. And it's worth bearing in mind that as with dividends, investors may react negatively if repurchases eventually decline, viewing this as a signal of management's pessimism.

[1] Some academic studies have concluded that companies do, in fact, time their share repurchases well. Those findings, however, are driven primarily by smaller companies that make a one-time decision to repurchase shares. Once smaller companies are excluded, the smart-timing effect disappears. Furthermore, most of those studies were done before large companies began to repurchase shares regularly as a substitute for dividends.

[2] To test whether companies timed the repurchase of shares to the advantage of shareholders who didn't sell, we first calculated the three-year return after each repurchase date. We compared a weighted average of these returns, using the dollar amount of each repurchase as weights to a weighted average return, as if companies had repurchased the same dollar amount of shares each quarter. The results were similar no matter which measure of returns we used.

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