

## Stock Buybacks Are Banned; Let It Be A Trend

*“The sooner we regain our sanity, kick our addiction to short-term shareholder primacy, the sooner we can start to invest in genuine economic growth where prosperity grows for everyone, through wages and compensation and the productive innovation it nourishes—rather than through a rigged boom on Wall Street.”*

- Peter Georgescu, Senior Contributor at Forbes

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### Introduction

One of Evergreen’s long-running themes for why US stocks have remained so elevated for so long is because America’s all-powerful central bank - the Fed - has continuously infused liquidity into the system. This fact was crystal-clear during the most recent market meltdown, when all major US indexes took a historic U-turn into bear territory. However, instead of continuing their precipitous slide, the Fed put on its cape and buoyed markets through its multi-trillion-dollar monetary maneuvers. These actions coincided with unprecedented fiscal stimulus from lawmakers and, as a result, the S&P has rebounded nearly 33% in less than two months (though it’s still down roughly 13% from its February high).

The quick snapback highlights a deepening divide between the economy (which now faces its biggest challenge since the Great Depression) and the stock market. The divide was on full display Tuesday as Fed-head Jerome Powell and Treasury Secretary Steven Mnuchin [addressed the future](#) of the US economy. For those who missed it, Mr. Powell’s tone was anything but upbeat and his outlook was anything but rosy. The hearing came at a pivotal moment, as US lawmakers weigh another round of fiscal stimulus to help soften the blow for consumers, businesses, and states that have been ravaged by the Covid-19 pandemic. (This additional spending may total as much as \$3 trillion, with California alone requesting \$1 trillion; to paraphrase the late Senator Everett Dirksen: “A trillion here, a trillion there, pretty soon you’re talking real money.”)

Despite our criticism of the Fed since we began our [Bubble 3.0](#) voyage in late-2017, we conceded in our [final Bubble 3.0 chapter](#) that the Fed is right to be infusing liquidity into the economy right now. (Don’t think we’ve gone completely soft on their reprehensible actions, though. We also emphasized that the Fed has been a deplorable protector of our nation’s currency over time as it has excelled at money creation during busts, but has neglected to correct course during booms.) Considering that the economy is now squarely in the midst of a bust, the question becomes how much is too much support for a bank that has shown little restraint even when times were good? If [MMTers](#) have their way (and that’s looking like a virtually forgone conclusion), then there could be no end in sight to all the monetary madness.

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While the Fed deserves a large portion of the credit for its role in levitating stocks over the last 11 years, the Central Bank has been far from the market's only bull catalyst. Equally deserving of credit are the many corporations that continued to elevate debt to dangerous levels to repurchase their own shares - a practice known as "corporate buybacks" - during the heat of Bubble 3.0.

In mid-February, right before the virus crisis exposed the imprudence of leveraged buybacks at higher and higher stock prices, [we wrote](#) that this game was likely nearing its end. As we noted at the time, both political parties were starting to take aim at what had devolved into a highly questionable - if not downright unethical - practice. One of the most alarming aspects of the entire buyback bonanza was that companies were repurchasing shares at a fever pitch at the same time insiders were dumping their shares with equivalent intensity.

Our timing for the article turned out to be fortuitous because in the month-and-a-half that followed, companies that tapped into federal stimulus funds were banned from buying back their own shares. It's not an exaggeration to say that buybacks have become politically incorrect—literally. Going forward, it's probable that only the most heavily cash-laden and profit-gushing companies—such as the one based in Redmond, Wa.— will feel the coast is clear to continue repurchasing their own shares.

In our view, and we think the logic is nearly unassailable, buybacks were the main driver of the last five years of the late and very great bull market. With those significantly reduced, the odds of another powerful and long-lasting bull market now look winning-the-lottery low to us. In the euphoria of the recent Fed-induced market rally, that reality seems lost on most investors...for the time being.

Last week, Peter Georgescu, a Senior Contributor at Forbes, [published an article](#) highlighting some of what Evergreen discussed in our [early-February missive](#) while expanding on the view that corporate buybacks should be a thing of the past long after the economy returns to normal. With Mr. Georgescu's permission, we are presenting his article, which extensively quoted our "[Bye-Bye Buybacks](#)" *EVA*, as this week's edition of the *Evergreen Virtual Advisor*. The original article can be found on [Forbes.com](#).

## **Stock Buybacks Are Banned; Let It Be A Trend by Peter Georgescu**

Many are celebrating America's bull market, now 11 years old and getting older—this coronavirus correction aside—the second-longest steady uptick in the nation's history. It's cited as one of the primary indicators of our economy's robust good health. Actually, it's closer to a fever, a sign that much in our economic metabolism is out of balance. The fact that the stock market has maintained much of its value even now, during the highest levels of unemployment since the Great Depression, indicates how disconnected Wall Street has become from the actual economy. We've become addicted to easy credit and the quick profit corporations can make by borrowing at low interest rates and manipulating their stock prices with it through buybacks.

David Hay, at [Evergreen Gavekal](#), a large private investment company, sees our current boom as the third great bubble of the past quarter century, leading us down the same path as the dot.com bubble of the 90s and the real estate bubble that burst in 2008. Recently, he pointed out how no burgeoning economy in the world is experiencing the rise in equity values we are seeing in the U.S. Around the world, in a vibrant economy, new growth tends to stagnate the stock markets. Again and again, stagnant or level stock markets are the earmark of a real growth spurt.

There's a reason.

A robust private sector borrows heavily to build, to invest in new creative capacity, not to repurchase its own stock. Either a company needs loans to invest in productive expansion, or it issues more stock for the same reason: to raise cash needed for that expansion. Hay claims, sensibly, that this is keeping stock prices level in those places where the system is working as it should, where stock is issued to help a company grow and compete in new or larger markets. In those cases, when you issue more stock, you dilute the share price: the value of the company gets spread, in smaller increments, over more and more shares. In developing countries this is what's been happening.

"The main international benchmark (for stock prices) excluding the US has essentially flat-lined for 14 years, while the S&P has continued to set new records since 2009," he [writes](#).

But in the United States, capital expenditures aren't accelerating. Instead, new cash is being used to reduce the number of equities available, thus artificially driving up their value. That practice has been exploding. It's an irresistible temptation, partly because everyone is doing it. Nobody wants to be left out. And the cash is just sitting there, idle, because it's a rare C-suite that has continued to invest in new, creative growth rather than pick the low-hanging fruit of easy money to be made through financial maneuvers. It was a good thing that companies receiving stimulus money to stay in operation during the Covid-19 shutdown have been [banned](#) from using it for stock buybacks. But it's too little too late.

"In 2018 alone companies paid out a combined \$1.25 trillion in dividends and buybacks," he writes.

Well, why not? If you're raking in profits, and you aren't bothering to ask the hard questions about how to use it for productive expansion—or to invigorate your work force with creative energy—then why not reduce the number of outstanding shares? But there's a catch. The fact that the Fed has been keeping interest rates remarkably low for a decade through quantitative easing means that the low-hanging fruit is more like that shiny apple that Eve picked in the garden. Worse yet, the higher profits are not used to drive organic growth by investing in R&D basic research. Nor incentivizing the workforce to increase productivity and drive innovation.

Executives are seeing an easy arbitrage: borrow a small fortune at 4 percent and spend it on their own company's stock, thus driving up its value by 10 or 15 percentage points. Why would anyone resist this overnight wealth? Get the loan, drive up the price of one's shares, sell enough to pay back the loan and pocket the rest. It is worth noting that until 1982, stock buybacks were illegal—deemed

as market manipulation. But since then, they have become the irresistible opioid of the financial world.

Here's the dark side: the ratio of debt to cash flow is at a 16-year high. Dividends and buybacks, Hay says, have been running above excess cash flow since 2013. It's boiler room ethics. Companies are in a fever of share repurchases while insiders—who are deciding those companies should buy their own shares—are selling in an equally destructive fever. It's incredibly duplicitous. And, as Hay says, it's destroying long-term shareholder value.

In the past decade, the Fed has generated \$4 trillion in BBs, as Hay puts it: Bogus Bucks. Those BBs have created \$4 trillion in another class of BBs: buybacks. Add to that Bogus Bonds issued by corporations and you have the greatest BB of all: our ready-to-Burst Bubble.

It can all be traced to short-term shareholder primacy governance. In fact, this buyback bubble is really the ultimate expression of that philosophy, which has turned the stock market into a casino and our corporate board rooms into parlors for rigged betting.

From a macro-economic viewpoint, this puts our entire economy at risk of another crash. Yet the risks, for individual companies, are dangerous enough. General Electric bought back shares worth tens of billions and then, because it backed itself into a financial corner, found itself in need of cash and having to issue new shares at a depressed stock value—despite all that financial manipulation. Boeing spent \$43 billion on repurchases, Hay writes, while spending only \$15.7 billion on R&D. The 737 Max debacle, a case study in how not to take shortcuts in aircraft redesign and pilot training, cost the aerospace giant \$9 billion and possibly ten times or more to come.

Meanwhile, Hay points out that in 2019 we witnessed the first signs of a genuine industrial recession as well as two quarters of falling profit across the economy. The sooner we regain our sanity, kick our addiction to short-term shareholder primacy, the sooner we can start to invest in genuine economic growth where prosperity grows for everyone, through wages and compensation and the productive innovation it nourishes—rather than through a rigged boom on Wall Street. Once the economy begins to ramp back up after the shut-down, it should become a widespread assumption that the time for stock buybacks has long passed—and what will be urgently needed more than ever is expanded production and better employee compensation.

## About [Peter Georgescu](#)

Peter Georgescu is the Chairman Emeritus of Young & Rubicam Inc., a network of preeminent commercial communications companies dedicated to helping clients build their businesses through the power of brands. Peter served as the company's Chairman and CEO from 1994 until January 2000. For his contributions to the marketing industry, he was inducted into the Advertising Hall of Fame. Peter immigrated to the United States from Romania in 1954 and graduated from Exeter Academy, receiving his B.A. with cum laude honors from Princeton and MBA from the Stanford Business School. In 2006, he published his first book *The Source of Success*, asserting that personal values and

creativity are the leading drivers of business success in the 21st Century. His second book, *The Constant Choice*, was published in January 2013. His latest book is *Capitalists Arise!* which deals with the consequences of income inequality and how business must begin to help solve the problem.

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