

REGULATORY UPDATE



Senator Elizabeth Warren's recent attack on corporate buybacks jeopardizes the fortunes of both the 1% and the 99% alike, says Michael Kastner, principal at Halyard Asset Management

Earlier this month, Massachusetts-based senior US senator and Democratic Party member Elizabeth Warren, called for the Securities and Exchange Commission (SEC) to take action by curbing publically traded corporations from buying their own equity shares in the secondary market. While the practice has been under debate lately, it's difficult to make the case that the SEC has jurisdiction to stop the practice, or even that it's desirable to do so.

Arguably, the stock market has benefitted meaningfully from the zero interest rate policy the Federal Reserve (Fed) has had in place since 2008. With overnight interest rates at zero and longer maturities yielding less than 3%, corporations have been borrowing in the corporate bond market and using the proceeds to buy back stock. While the practice increases total debt and eats away at the creditworthiness of the corporation, management has been rewarded for eroding their balance sheet.

The action directly drives the price of their stock higher, as the number of shares available for trading, also known as the "float," is reduced. Moreover, by shrinking the float, the company boosts the earnings per share (EPS) reported, as earnings per share is simply total net income divided by the number of shares outstanding. In essence a company can have no growth in net income, but by buying back stock, can claim to be increasing EPS profitability. As the earnings per share rises, the CEO and senior management can justify paying themselves a handsome compensation package of cash and stock, which is likely to be at the root of Senator Warren's objection.

This virtuous circle has lifted the valuation of many companies, pushing stock indices ever higher. The paradox is that while senior management authorizes stock buybacks, they routinely sell their personally owned shares. Again, we suspect that those sales, despite being legal and acceptable, are objectionable to Senator Warren. While it may sound like a Ponzi scheme, it's important that Senator Warren understands that it's not. Certainly, senior management is benefitting directly and in some cases in an outsized way; but it's also important to remember the adage "a rising tide lifts all boats".

The wealth effect of a rising stock market benefits shareholders, pension funds, endowments and investment boards. While Senator Warren may object to corporate management compensation, taking action to restrict it by curbing corporate buybacks is wrong minded, in our opinion, and would likely result in a sharply lower stock price.

With that, the question is: should we expect corporate buybacks to propel stock markets to higher prices, especially with the Fed poised to raise interest rates? Our expectation is



'yes' in the near term, but probably not in the longer term. The consensus expectation is that if the perpetually dovish Fed raises interest rates, stock prices will fall.

Historically, that would be the logical outcome, but that view ignores corporate buybacks. Corporate management has viewed each of the market corrections suffered in recent years as an opportunity to buy stock at a discount. We suspect that when the Fed raises rates and stock prices fall, corporate treasurers will again step in and buy. However, as earnings growth slows and price-to-earnings multiples continue to creep higher, corporations will be getting less value out of their purchases.

At some point the rating agencies will take note of their capital structure as being too debt-heavy and at risk of a credit downgrade. In that scenario, the company would likely be forced to stop or scale back the purchases, and risk losing support for the stock price. Moreover, with that demand absent, the stock price would fall, causing further balance sheet deterioration. However, that scenario would likely transpire over a period of time.

To have the SEC implement regulation banning the practice of buying back stock would be a hard brake to the stock market and could very well result in a sharp and meaningful drop in stock prices. I don't think anyone wants to see that. ■

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