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# DIVIDENDS, BUYBACKS AND QUALITY VALUE

The Tax Cut and Jobs Act of 2017 had its intended effect of freeing up corporate cash. And similar to the Bush–era cash repatriation tax break, a preponderance of newly freed up cash was used by corporations for share buybacks. According to S&P Global, "[in Q4 2018] stock buybacks…set a fourth consecutive record of $223.0 billion. This [displaced] the previous record of $203.8 billion, set during Q3 2018 and is a 62.8% increase from the $137.0 billion reported for Q4 2017."

Senior Portfolio Manager, Scott Davis discusses buybacks, dividends and the ways in which corporations utilize cash to create long-term sustainable value for shareholders.

## The S&P 500 Index had its best first quarter in more than 20 years driven by the Federal Reserve's (Fed) dovish tilt and indications of an improving trade picture. Did dividend stocks keep up?

**Scott Davis**: The market has shown a tremendous bias towards growth and momentum, so dividend strategies lagged the overall S&P, but they still delivered very strong returns. Underperformance in a strongly positive quarter like we just had is not unexpected.

## Was there any one sector that was a driver in the first quarter? Or any particular detractors?

**Scott Davis**: Industrials did quite well, and so did Technology. In the case of tech, much of the strong performance was due to a recovery from the very depressed levels and negative sentiment we saw in the fourth quarter of 2018.

## Technology, on the surface anyway, would seem to be an area where there might be less opportunity for income investors. Is that perception wrong?

**Scott Davis**: Yes, in fact, we have had people question our exposure in the technology sector. There has been a shift in the mentality for cash deployment in lot of the technology companies. Semiconductor equipment companies, for example, have really changed their approach. Three years ago, a lot of these companies didn't pay dividends. Now, they are trying to broaden their shareholder base away from hedge funds and tech funds dictating the value of their stock.

We know that many hedge funds have a very short-term outlook, and a low tolerance for drawdowns. For instance, if a rumor comes out of Asia or the stock moves down unexpectedly, some tech investors will act on the share price action alone—momentum—versus staying the course and looking at the longer-term fundamentals. Not surprisingly, some companies want to get away from that dynamic, and by offering a dividend they can attract stickier money.

## What are the yields like on the tech dividend-paying stocks versus non-tech?

**Scott Davis**: It varies. Currently, they can yield anywhere from 1.5% to over 3%, and they will tend to have characteristics that allow for fairly high payout ratios—software services, for example, is not very capital intensive.

The thing that's fascinating is some of these companies are over $100 billion in market capitalization and are able to grow revenues and cash flows in the double-digits. It's very impressive, and in many cases we expect to see many years of growth at these levels.

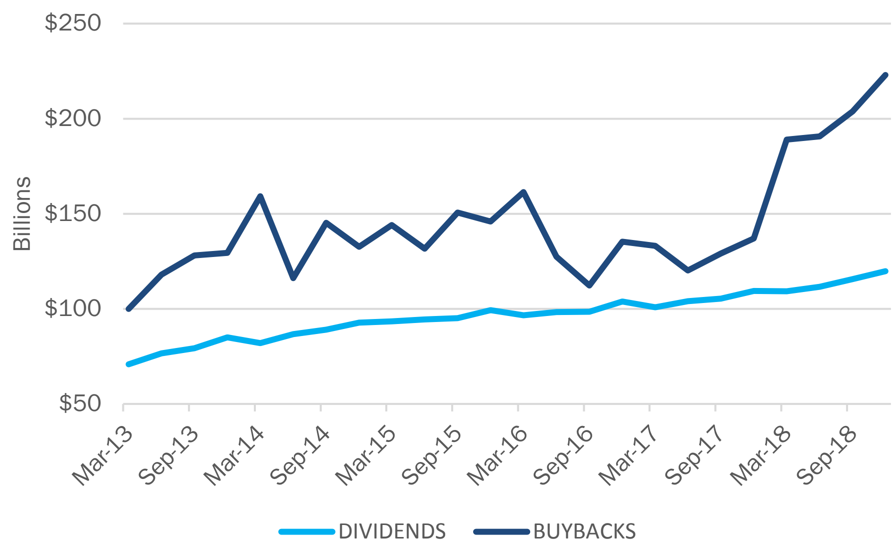
## We saw an extraordinary amount of share buybacks in 2018. How should investors think about buybacks?

**Scott Davis**: I'm largely agnostic to buybacks—a company should do them when they make sense. I don't think that every buyback is a good buyback. The downside comes when some investors begin to think that a buyback is associated with generating improved fundamentals. There is a diminishing return with a buyback, especially as a company's share price goes up.

If a company starts to buy its stock back at well above the company's worth, it can destroy value. General Electric spent more than $30 billion buying back its stock at over $30 per share—not a very good use of capital. Buybacks can be a great tool, but you have to think about how best to use them. As with dividends, you need to understand how a company is sourcing the cash.

The perception of buybacks has changed. Dividends were the accepted way of returning cash for a long time because companies ran the risk of being accused of manipulating their stock price if they bought back their own shares. In the 1980s, the SEC ruled favorably on the practice of buybacks, which allowed it to flourish. They are not equivalent, though.

**Exhibit 1: S&P 500 dividends and buybacks**




Source: S&P Dow Jones Indices

The dividend is a tangible return: once a company declares one, it's difficult to stop. If a company decides to cut or discontinue a dividend, there's a financial repercussion. In contrast, we often see buybacks announced, and unless you're carefully keeping track, you don't know if companies have actually gone through with them.

## Has tax legislation impacted the buyback versus dividend calculus?

**Scott Davis**: In an attempt to stimulate the economy, former President George W. Bush gave a cash repatriation tax break in 2004-05 and the administration thought that a lot of it would drive capital expenditures. It didn't; it drove buybacks instead. The same thing seems to have happened now with the Tax Cuts and Jobs Act of 2017. There has been a lot of money used from the most recent tax cut to increase buybacks. As an investor, you want to understand how excess cash is being used. Not growing a business over time or reinvesting in the plant equipment of the business—that's never a good situation. If buybacks are simply being used to engineer earnings or to enrich the management team, the market will normally figure that out and revalue the stock price accordingly.

## It sounds as if buybacks can be an indicator of company management.

**Scott Davis**: We look at buybacks, dividends and management of cash overall. There are many instances of mismanagement of capital—sometimes when a company is holding too much cash, it can be a wasted asset. Similarly, there can be a lot of ill-conceived projects—a company building a new plant right at the top of the market, for instance. Building excess capacity can be just as bad as buying back stock at the top of the market. A return on an investment like that can be low-single digits, and that isn't a good use of capital. We're constantly looking at and analyzing the return on that investment capital. With both buybacks and dividends, we want to understand how a company is sourcing the cash. Taking on leverage for either a buyback or dividend is unappealing.

We want to see that management is keeping its approach to cash in balance—reinvesting in the business in ways that will drive shareholder value. What drives company value over time is the growth of earnings and cash flow. Our internal research in Exhibit 2 shows that value factors that focus on operating cash-flow (OCF) and free cash-flow (FCF) have had a meaningful performance advantage versus other value metrics over the last ten years.

**Exhibit 2: Cash-flow (OCF and FCF) performance versus other value metrics**

| | Reported | | | | | | Forecasted | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Calendar Year | Book/Price | Sales/Price | Earnings Yield | EBITDA/EV | OCF/Price | FCF/EV | Book/Price | Sales/Price | Earnings Yield | EBITDA/EV |
| 2010 | 2.0 | 1.0 | (6.9) | (3.6) | 2.1 | (1.3) | (0.0) | 2.4 | (4.9) | 2.1 |
| 2011 | (1.7) | (6.1) | 7.1 | 4.4 | 5.2 | 13.7 | (1.8) | (5.8) | 4.2 | (6.2) |
| 2012 | 2.0 | 4.8 | (3.0) | 0.5 | 1.9 | (1.6) | (0.1) | 3.7 | (2.2) | (0.6) |
| 2013 | 4.2 | 8.1 | (1.7) | 7.2 | 5.0 | 1.2 | 3.3 | 6.9 | 5.6 | 7.5 |
| 2014 | (0.0) | 4.9 | 9.1 | 6.9 | 10.9 | 8.3 | 0.3 | 4.4 | 7.1 | 2.3 |
| 2015 | (10.4) | (9.9) | (7.9) | (10.1) | (8.0) | 0.3 | (15.4) | (10.7) | (5.3) | (6.7) |
| 2016 | 8.0 | 10.1 | 10.5 | 13.1 | 14.5 | 4.8 | 6.7 | 11.7 | 5.1 | 11.7 |
| 2017 | (9.0) | (8.6) | 4.0 | (1.2) | (1.4) | 4.2 | (8.6) | (9.0) | (4.7) | (5.0) |
| 2018 | (16.9) | (9.3) | (13.3) | (12.9) | (5.0) | 1.6 | (18.0) | (8.6) | (15.9) | (4.8) |
| 2019 | (3.3) | (5.4) | (5.6) | (5.7) | (3.3) | (3.9) | (2.1) | (7.2) | (4.4) | (7.9) |
| | | | | | | | | | | |
| **TOTAL** | **(25.2)** | **(10.6)** | **(7.7)** | **(1.5)** | **21.9** | **27.4** | **(35.8)** | **(12.2)** | **(15.5)** | **(7.5)** |

Source: Columbia Threadneedle Investments; as of March 31, 2019

Yearly Factor Quantile Spreads (Top 20% minus Bottom 20%); Russell 1000 total returns, excluding stocks in the financials and real estate sectors; monthly rebalancing sector relative; square root of market value weighted. See factor descriptions below.

## Does a dividend-driven strategy force you to look at interest rates differently than a growth manager that might have a lot fewer dividend-paying stocks?

**Scott Davis**: While it doesn't appear to be a current concern, the reality is that rising rates can hurt a growth stock just as much as a dividend stock. The long-term interest rate is important to us as it sets the discount rate. When the Fed put the discount rate to zero during the financial crisis, stocks went through the roof.

There's one number every long-term investor would like to know: what's the long-term Treasury bond going to trade at? Because that's the discount rate.

Do I think there are areas in dividend investing that can be highly impacted by interest rate movements? Yes, those tend to be bond proxies. For example, REITs (real estate investment trusts) and utilities are highly correlated with the movement of Treasuries.

It concerns me when people assume that all dividend stocks are simply subject to interest rate movements. For example, one large pharmaceutical company had a high dividend yield but also had a drug that could be worth in excess of $10 billion. In that case, investors are not just owning it for the dividend yield, they're owning it because of the growth characteristics around this new drug. But again, we're trying to understand what's contributing to dividend growth. Dividend growth in our mind, if it's done correctly, i.e., coupled with growing earnings, growing cash flow, is what should drive stock values higher over a three– to five–year period.

**Factor Descriptions**

| Name | Description |
|---|---|
| **Book to Price** | Book Equity / Market Value |
| **Earnings Quality** | Cash flow conversion of corporate earnings |
| **Earnings to Price (Earnings Yield)** | Trailing 1-year Earnings / Price |
| **EBITDA to EV** | Trailing 1-year Operating Income / Enterprise Value |
| **FCF to EV** | Trailing 1-year Free Cash Flow / Enterprise Value |
| **OCF to Price** | Trailing 1-year Operating Cash Flow / Market Value |
| **Sales to Price** | Trailing 1-year Revenue / Market Value |

**Past performance does not guarantee future results.**



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