# Playing the Hand They Were Dealt

February 6, 2019

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Last Week's S&P 500 Index: +1.6%

**Key takeaways**

- *Under our equity analysis methodology, a higher forecast total yield is a desirable characteristic.*
- *Companies buying back shares do so for any number of reasons, but we generally see these purchases as positive.*

If the statistics being floated around the Street are accurate, share buybacks by companies in 2018 totaled right at or just above $1 trillion. You read that right—*trillion*. Large-capitalization companies, in general, have a greater ability to buy back shares than their small-capitalization cousins. And that is exactly what we have been seeing in recent years. Large caps, like those populating the S&P 500 Index, tend to have better balance sheets, easier access to credit, and bigger cash coffers from which to fund their purchases. Another source of funds, especially since the new tax code was enacted at the beginning of last year, has been money previously stashed overseas that has now been brought home (repatriated).

Many analysts consider share buybacks as a positive. After all, the number of shares outstanding is reduced, which, all else being equal, boosts the earnings per share of the company buying back its shares. Share repurchases have contributed to a meaningful amount of earnings growth in some quarters and years of this long economic expansion. Our analytical methodology uses *forecast total yield* as one of the value factors. This factor considers the expected dividend yield plus the percentage of total shares outstanding taken out of circulation in the buyback process. Companies might be buying back shares because they have confidence in the forward outlook or simply because they feel the market price is below what they consider fair value to be. Our methodology considers a higher forecast total yield to be a positive characteristic.

Other analysts consider stock buybacks to be a form of *financial engineering* that artificially inflates earnings and underscores a lack of opportunities for companies to invest in their businesses through expansion or capital expenditures. It is true that during the bulk of this long expansion, S&P 500 companies in general sat on a large amount of cash. Many were cautious and concerned that the U.S. and global economies were ready to roll over into another recession. Businesses have been more optimistic over the past couple of years, but that has not prompted the surge in capital spending that we had hoped for. Merger and acquisition (M&A) activity has climbed steadily during this cycle, with only 2018 showing a slight sequential decline over the 2009 through 2018 period. But cash balances at the large-cap index level (S&P 500 Index) also have risen in recent years, based on the latest Bloomberg balance sheet data, even as buybacks and M&A activity has been strong.

Based on our analysis, the sectors with the current highest forecast total yield are Financials, Consumer Staples, Information Technology (IT), and Industrials. We currently carry a most favorable rating on Financials and Industrials and are favorable on the IT sector. In addition to finding these sectors attractive based on our methodology, the macro environment that we foresee over the balance of this year also appears to favor sectors that are sensitive to a continuation of this economic expansion.

Companies choose to buy back shares in the open market for any number of reasons. Some want to boost earnings per share, while others simply do not see better opportunities to reinvest their cash in the business and earn an acceptable rate of return. Each company must examine their prospects and play the hand they were dealt.

## Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors.

Risks associated with the Technology sector include increased competition from domestic and international companies, unexpected changes in demand, regulatory actions, technical problems with key products, and the departure of key members of management. Technology and Internet-related stocks smaller, less-seasoned companies, tend to be more volatile than the overall market.

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