Trend towards US buybacks debunks dividends myth

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US companies return a higher level of cash back to investors than Australian companies.

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One of the positive outcomes from the franking credit debate is the decision by some investors to establish more disciplined asset allocation in their investment decisions and, indeed, to look more closely at international equities.

As an adviser, I find there is a common perception that yields are lower offshore than those from the Australian market.

When you look at the broad measure of the US S&P 500 index at the end of December 2018, it is trading on a historical yield of 2.09 per cent against the domestic Australian ASX 200 at the same date trading on a gross yield before franking of 4.65 per cent. The ASX appears to be trading on a higher yield, but MSCI would argue differently.

The very nature of franking credits is one of the reasons Australian companies have maintained a high payout ratio regime. The policy is often criticised as domestic companies have underperformed when it comes to growth. One of the key reasons is that they do not retain capital and reinvest for growth.

While we have seen some share buybacks in Australia — and many such as the recent BHP buyback have been well received — buybacks in the US have become a favoured means of distributing cash to investors.

Much has been written about US buybacks, including in this newspaper, about how the rise of the buybacks has seen a distortion in earnings per share growth to meet short-term incentive targets. This occurs through a reduction in the overall capital base of a company. But in August 2018, the Morgan Stanley Capital Index group published a paper, "Taking Stock, Share Buybacks and Shareholder Value", which puts a different perspective on US share buybacks.

The paper points out that in 64 per cent of US large-cap companies, buybacks have exceeded dividends every year since 1997. In fact, buybacks have replaced and superseded dividends as the dominant way to return cash to investors.

Adding dividends on top of this — which exceeded 2.1 per cent of the same index at the end of 2016 — provides investors with total cash distributions of more than 6.4 per cent.

And so, turning to the negative view over the extent of US buybacks, the MSCI found no compelling evidence of a negative impact from buybacks on long-term value creation for investors.

MSCI looked at ESG ratings, capital expenditure, research and development and value creation. Interestingly, the strongest-performing companies were those most active in distributing cash back to investors via buybacks.

Their growth in popularity, MSCI argues, is that buybacks offer companies greater flexibility than dividends as they can more easily manage tax liabilities — and market expectations — on both timing and expectations of buybacks.

On the negative side, capital expenditure and research and development declined in nearly every year since 1997. In 2015, share buybacks exceeded capital expenditure for the first time.

Buybacks have become so entrenched on Wall Street that MSCI contends many firms that pay dividends wish they didn't (and if they could they would reduce dividends and increase buybacks).

Who is doing the buybacks? The higher sectors include IT and discretionary staples, with the lowest among telcos, real estate and utilities. This doesn't surprise me given the reliance on capital in these sectors. For the same reason, I am surprised IT is among the highest.

Companies with a large family shareholder with an element of control paid more in dividends than the average but were also large participators in buybacks. Founder-controlled companies such as Facebook or Alphabet are low on both dividends and buybacks.

US commentators like Yale professor Roger Ibbotsen now refer to “total payouts”. Ibbotsen argues dividends and buybacks are simply alternative means to the same end, which is about the distribution of corporate profits back to the investor.

When looking at buybacks and dividends in the US market as total payouts, the real situation debunks the common view that Australian companies have a high payout ratio relative to US equities. I would suggest US companies return a higher level of cash back to investors than Australian companies — and that is also after franking credits are taken into account.

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