Social Capital Makes the Difference Between ‘Good’ and ‘Bad’ Buybacks

Executives who respect both the letter and the spirit of ethical norms aren’t born – they’re shaped by their home communities.

The **controversy around share buybacks** may say as much about declining public trust in business as it does about the practice itself. Detractors attempt to discredit buybacks entirely by citing ethically questionable uses, such as artificially inflating share price, manipulating earnings-per-share (EPS) and valuing shareholder wealth above value-creating investments. Yet the official purpose of buybacks is far more benign. They’re designed to allow genuinely undervalued companies to bet on themselves, converting informational inefficiencies in the market into sustainable shareholder returns. After all, if one defines business ethics as respecting implicit contracts, companies have an ethical obligation to increase long-term shareholder value – emphasis on “long-term”, at least in the United States where the implicit contract is the fiduciary responsibility to maximise shareholder value. Duration is key; time is the proving ground of ethical sincerity.

Broadly speaking, then, the ethical beauty or ugliness of buybacks is in the eye of the beholder. However, our **recent research**, forthcoming in the *Journal of Financial and Quantitative Analysis*, finds that the virtues of specific buyback programmes are linked to the trustworthiness of individual CEOs. Trustworthiness may seem subjective, but it doesn’t come from nowhere. It resides, quite literally, close to home – in companies’ home communities.

Buybacks and trust

Our dataset comprised 7,649 buyback events carried out by US firms between 1992 and 2016. We split the data according to the associated companies’ stated motivations (gleaned from media statements) for undertaking buybacks: undervaluation, sloughing off excess cash to shareholders, EPS management, expanding an existing buyback programme, or no reason explicitly mentioned. Finally, we factored in long-run (48 months) shareholder returns, and the level of public trust in the counties in which each firm was headquartered.

We measured public trust using information from the **General Social Survey**, specifically the averaged answers to the question, “Generally speaking, would you say that most people can be trusted or that you can’t be too careful in dealing with people?” Certain geographic and demographic factors were correlated with public trust. For example, states near the Canadian border had higher trust averages, as did counties with more wealthy, highly educated inhabitants. Southern states, especially those along the Mexican border, scored lower for public trust.

If we assume that individual behaviour is influenced by the local environment, we can further posit that levels of public trust in a firm's surrounding community would tell us something about the values practised at HQ.

Indeed, greater-than-average trust in the HQ county was associated with as much as 2.4 percent higher returns per year. Apparently, CEOs from high-trust counties were more literal about their ethical mandate to provide long-term shareholder value. Our study focused on buybacks, but we see no reason why this wouldn't apply to business decisions in general. Moreover, our results held up when we reran our analysis with two alternative trust proxies: an intra-organisational measure derived from employee satisfaction surveys, and an index of CEO integrity generated through machine learning analysis of earnings conference call transcripts.

To further verify our findings, we compared the trust bump in shareholder returns to the "U-index" – a measure developed by **Peyer and Vermaelen**, which compiles classic signals of undervaluation such as small market cap and a recent dip in share price – for each firm. Trust, when decoupled from likely undervaluation, retained its salutary effect on shareholder value. The biggest increases in long-term returns consistently came from companies with both high trust and high U-index; the least monthly excess returns were produced by low-trust, low-U-index firms. This implies that undervaluation and trust are not proxies but mutual complementors.

We also found that in the absence of trustworthiness, companies that self-reported undervaluation in press releases did not see a boost in long-term returns. In other words, firms' declarations that they were doing the right thing by shareholders were not credible without trust to back them up.

Social capital

In his landmark research, Robert Putnam (***Bowling Alone***) coined the term "social capital" to describe the advantages accruing to cohesive, trusting communities and societies. Social capital is associated with better health outcomes, higher academic performance and more responsive government institutions. Human collectives simply fare better on the whole when members can rely on one another.

At the same time, recent research finds that community-level conditions are more influential in shaping our lives than previous generations of scholars thought. Our study adds to these streams of insight, directly connecting a community's social capital to the outlook and behaviour of its resident managers. Given the complexities of global business in which many of the firms we studied are enmeshed, it's both significant and surprising that hyper-local characteristics would appear to mean so much.

Our study also suggests that community trust, by shaping business practice, can affect the larger world. Ergo, the mixed ethical record of share buybacks – determined in part by differences in trust in the companies' home communities – can promote hasty generalisations about managers' spotty ethics. This could be one reason business institutions (particularly US-based businesses) have seen a **steep decline in public trust**.

Often, executives equate trustworthiness with grand gestures like claiming undervaluation in a press release or signing a **public statement of unclear relevance**. As our study shows, though, markets are also attentive to the undeclared laws of business ethics, such as the obligation to deliver long-term shareholder value. Adherence to these laws requires, first and foremost, executives who take such core principles seriously. And we know where they're most likely to be found: communities with a high degree of social capital.

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