Knowledge

The Buyback Fund That Gives Back

By Theo Vermaelen and Urs Peyer , INSEAD Professors of Finance

A buyback fund we launched in 2011 has continued to grow in 2014 and is now open to small investors.

In June 2011 we launched the PV Buyback USA fund, **a fund based on our research findings** that small beaten-up value stocks that announce a buyback programme are very good long-term investments. The fund charges a 10 percent performance fee over the Russell 2000 Index. 10 percent of this fee is donated to INSEAD to help MBA students with financial needs.

The theory behind the strategy is that when you invest in a company, there are two things that you can't find in financial statements. First, is the CEO committed to shareholder value, or is she a stakeholder value maximizer? Second, does she have confidence in the future? As buybacks tend to be bad for other stakeholders, companies that buy back their own stock show

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commitment to shareholder value. Indeed, creditors don’t like buybacks as they increase credit risk; labour unions prefer that the excess cash is spent on hiring new workers or increasing their salary; managers may prefer to use the cash to make acquisitions as this will increase their power and compensation; the government may not like buybacks if the buyback is financed with debt, thereby lowering corporate income taxes, or perhaps lower personal taxes if the buyback is a substitute for a dividend. Therefore it’s not surprising that buybacks are often **criticized by the anti-shareholder value crowd**.

Second, as a buyback is an investment decision, this investment would be bad for long-term shareholders if the stock is overvalued. As insiders tend to be significant long-term investors, especially in small firms, it is unlikely that a buyback will be made if managers have no confidence. Managers who lack confidence prefer to issue equity, which explains why equity issues are followed by negative abnormal returns. Moreover, when a company is beaten up, it is more likely that the buyback is driven by undervaluation than by other reasons such as, for example, capital structure adjustment. Note that the undervaluation assessment has to be based on company-specific information. We can’t expect that CEOs can predict overall market movements. So the critique that many companies bought back stock before the 2008 crash is misplaced as it is based on hindsight.

Figure 1 shows the performance since inception until December 31, 2014. Since the start of the fund in June 2011, we realised a return of 58.4 percent and outperformed our benchmark (Russell 2000) by 16.4 percent (See figure 1). It also was a fortunate period for our euro-based investors as the dollar appreciated by 19 percent over his time period so that our original investors earned a return of 77 percent in euros. The fund outperformed its benchmark by 7 percent in 2012, 10 percent in 2013 and 1.6 percent in 2014. Originally, the fund was only accessible to large investors, i.e. investors who invest at least 125,000 euros and the fund had weekly liquidity. In December 2014, we converted the fund into a UCITS (*Undertakings For The Collective Investment Of Transferable Securities),* managed by Degroof Gestion Institutionnelle, a leading Luxembourg player. Under the new structure, a new share class has been created with no minimum investment. The initial share class is still accessible in case of investment in excess of 250,000 USD and will provide a lower management fee 1.0 percent instead of 1.5 percent. The liquidity of the fund has been improved allowing investors to subscribe and redeem on a daily basis.

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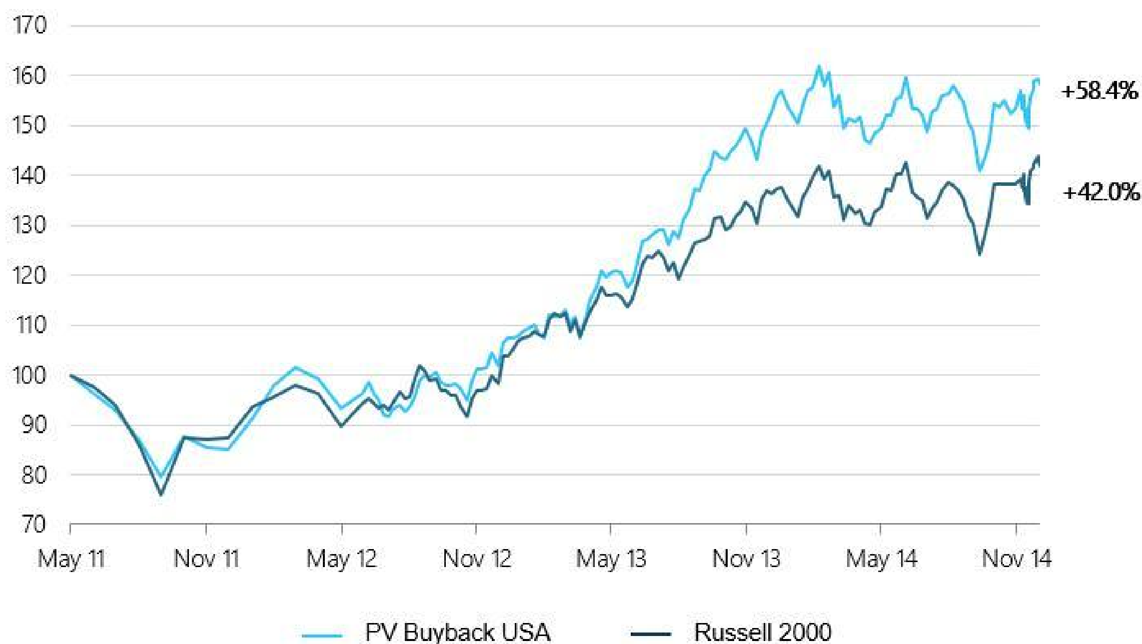
Distribution of the fund is subject to restrictions in some geographies.



2014 was also a seminal year for the fund for other reasons: we obtained a 4-star rating from Morningstar and our assets under management grew to US$20 million. However, small stocks had a difficult time in 2014. Although we beat our benchmark (the Russell 2000) by 1.6 percent, the Russell 2000 underperformed the S&P 500 by 8 percent. This illustrates once more the well-documented “size effect” in stock returns. Small firms behave differently from large firms. Although in the long run small stocks beat large firms, this is not true every year.

Buybacks have increased in importance, especially in the U.S. where the money spent repurchasing shares approached US$1 trillion in 2014, so much so that journalists of **respectable media have been criticising them**. The critique is that buybacks are made at the expense of long-term investments and therefore are bad in the long-term for these companies. Obviously the empirical evidence is inconsistent with these fears: on average, buybacks are followed by positive short-term as well as long-term abnormal returns, **both in the U.S. as well as globally**. The critique ignores that buybacks are financed with excess cash, when firms have more cash than they need to make investment decisions. Or with excess debt capacity: borrowing money to buy back stock lowers corporate taxes. The fact is that U.S. companies

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are very profitable, have more cash than they need for investments and have a lot of debt capacity, especially in the current low interest rate environment.

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