

Everyone is paying price for share buy-backs

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During the stock market boom of the 1980s and 1990s the argument that “maximising shareholder value” results in superior economic performance dominated corporate governance debates. Economists argued companies should disgorge their “free cash flow” to create value for shareholders, rather than hoard cash or invest in productive capacity that was insufficiently profitable.

Traditionally companies distributed cash to shareholders through dividends. Increasingly, however, the payouts of US companies have taken the form of stock repurchases – total repurchases surpassed total dividends in 1997. Over the past five years, stock buy-backs have increased at a remarkable rate. Combined, the 500 companies in the S&P 500 index in January 2008 repurchased \$120bn in 2003 and \$597bn in 2007; in 2007 repurchases represented 90 per cent of their net income, while dividends were another 39 per cent.

These buy-backs are a measure of the grip that shareholder value ideology has on corporate America. Economists argue that among all stakeholders, only shareholders are risk-bearing “residual claimants”. The returns they get depend on what is left over after other stakeholders have been paid for their contributions according to guaranteed contractual claims. However, it is not true that all stakeholders receive guaranteed returns. Workers, for example, supply their skills with an expectation of long-term rewards such as promotion, but without these being contractually guaranteed. Governments often subsidise businesses without guaranteed returns to taxpayers. The shareholder-value perspective provides a simplistic answer to a complex problem: how to reward stakeholders so that their contributions raise living standards and provide economic gains that can be shared equitably.

Cash dividends are fundamentally different from stock repurchases. Dividends provide a return to those who hold stock, and hence maintain a commitment to the company. Yet executives have become enamoured by stock repurchases. Their abundant stock options give them an incentive to do buy-backs to boost stock prices even if this undermines long-term value.

The adverse impact of these decisions goes beyond the unseemly explosion in executive pay. The crisis in the US financial sector offers one example. Having spent billions on stock repurchases, some of the oldest Wall Street banks find that the subprime crisis has left them in need of cash to stay afloat.

In November 2007, the \$7.5bn equity investment that [Citigroup](#) secured from the Abu Dhabi Investment Authority was almost as much as it spent on buy-backs in 2006 and 2007. [Merrill Lynch](#) did more than \$14bn in repurchases in those two years, but by January 2008 had given up a 12.7 per cent equity stake to raise \$9bn from foreign investors. [Morgan Stanley](#), which did over \$7bn in buy-backs in 2006-07, traded a 9.9 per cent equity stake with China’s sovereign wealth fund for \$5bn. It has now agreed to a takeover. [Lehman Brothers](#), which repurchased more than \$5bn in 2006-07, is now bankrupt.

The taxpayer is also paying the price of buy-backs. When the US government bailed out [Bear Stearns](#), by assuming the risk of \$29bn of its subprime mortgage assets, there was almost \$6bn less cash on Bear’s balance sheet because of buy-backs during 2003-07. So too with the government takeover of [Fannie Mae](#) and [Freddie Mac](#), the government sponsored housing entities. They have spent \$10bn on repurchases since 2003, including \$4bn in 2006-07.

The crisis in the US financial sector demonstrates that the so-called “free cash flow” distributed as buy-backs was not really free. Wall Street banks could use that cash now to avert financial crisis rather than turn to foreign governments and the US taxpayer for a [bail-out](#). Cash spent on buy-backs could also find better uses in other sectors. Leading pharmaceutical companies do buy-backs that sometimes exceed their R&D budgets even as they argue in Congress against the regulation of US drug prices contending they need to pump their profits into drug research.

The \$1,700bn that S&P 500 companies spent on buy-backs in 2003-07 represents a huge manipulation of the stock market. US executives who allocate corporate resources to them reap the benefits as they exercise stock options. In the 1980s, executives learnt that greed is good. Now, their mantra could be “in buy-backs we trust”.

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