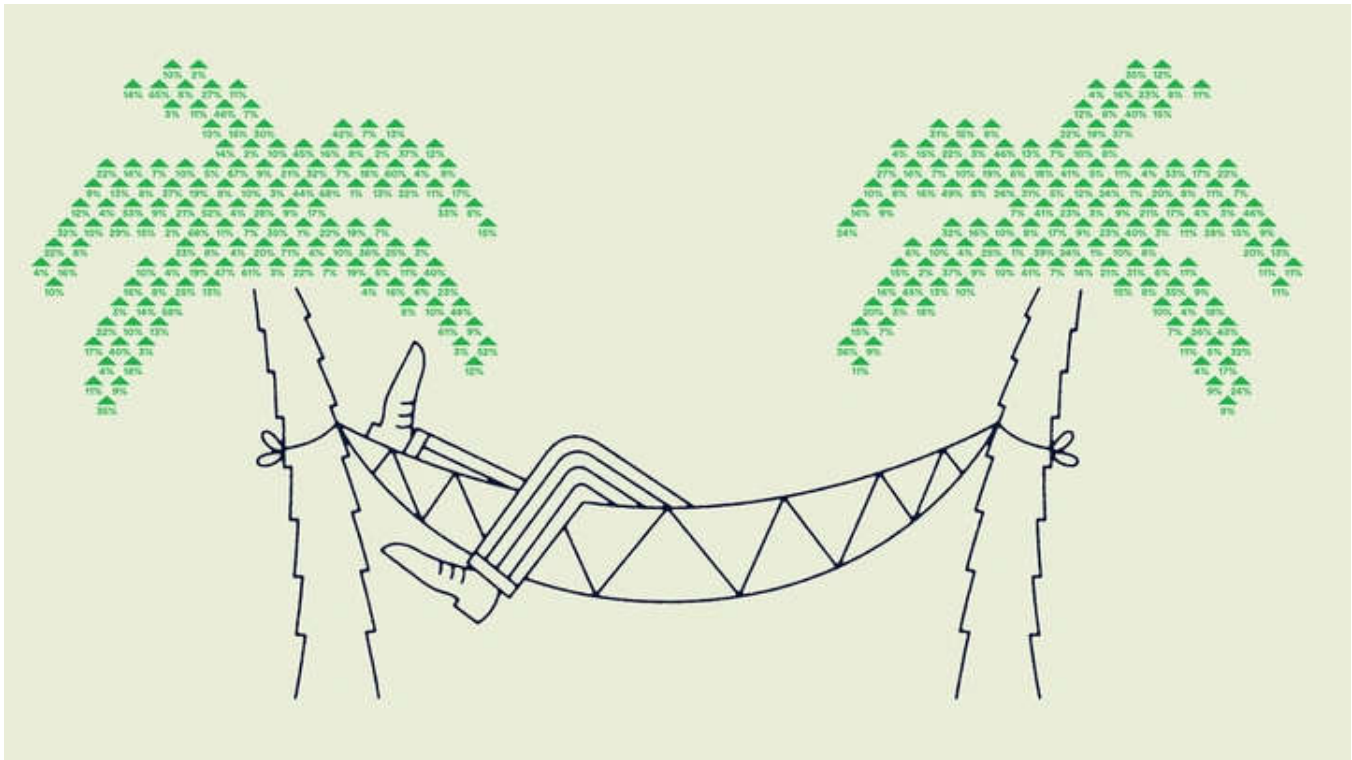


BUSINESS

The Stock-Buyback Swindle

American corporations are spending trillions of dollars to repurchase their own stock. The practice is enriching CEOs—at the expense of everyone else.

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IN THE EARLY 1980s, a group of menacing outsiders arrived at the gates of American corporations. The “raiders,” as these outsiders were called, were crude in method and purpose. After buying up controlling shares in a corporation, they aimed to extract a quick profit by dethroning its “underperforming” CEO and selling off its assets. Managers—many of whom, to be fair, had grown complacent—rushed to protect their institutions, crafting new defensive measures and lodging appeals in state courts. In the end, the raiders were driven off and their moneyman, Michael Milken, was thrown in prison. Thus ended a colorful chapter in American business history.

Or so it seemed. Today, another effort is under way to raid corporate assets at the expense of employees, investors, and taxpayers. But this time, the attack isn’t coming from the outside. It’s coming from inside the citadel, perpetrated by the very chieftains who are supposed to protect the place. And it’s happening under the most innocuous of names: *stock buybacks*.

You've seen the phrase. It glazes the eyes, numbs the soul, makes you wonder what's for dinner. The practice sounds deeply normal, like the regularly scheduled maintenance on your car.

It is anything but normal. Before the 1980s, corporations rarely repurchased shares of their own stock. When they started to, it was typically a defensive move intended to fend off raiders, who were drawn to cash piles on a company's balance sheet. By contrast, according to Federal Reserve data compiled by Goldman Sachs, over the past nine years, corporations have put more money into their own stocks—an astonishing \$3.8 trillion—than every other type of investor (individuals, mutual funds, pension funds, foreign investors) combined.

Corporations describe the practice as an efficient way to return money to shareholders. By reducing the number of shares outstanding in the market, a buyback lifts the price of each remaining share. But that spike is often short-lived: A study by the research firm Fortuna Advisors found that, five years out, the stocks of companies that engaged in heavy buybacks performed worse for shareholders than the stocks of companies that didn't.

One class of shareholder, however, has benefited greatly from the temporary price jumps: the managers who initiate buybacks and are privy to their exact scope and timing. Last year, SEC Commissioner Robert Jackson Jr. instructed his staff to “take a look at how buybacks affect how much skin executives keep in the game.” This analysis revealed that in the eight days following a buyback announcement, executives on average sold five times as much stock as they had on an ordinary day. “Thus,” Jackson said, “executives personally capture the benefit of the short-term stock-price pop created by the buyback announcement.”

This extractive behavior has rightly been decried for worsening income inequality. Some politicians on the left—Bernie Sanders, Elizabeth Warren, Chuck Schumer—have lately gotten around to opposing buybacks on these grounds. But even the staunchest free-market capitalist should be concerned, too. The proliferation of stock buybacks is more than just another way of feathering executives' nests. By systematically draining capital from America's public companies, the habit threatens the competitive prospects of American industry—and corrupts the underpinnings of corporate capitalism itself.

THE RISE OF the stock buyback began during the heyday of corporate raiders. In the early 1980s, an economist named Michael C. Jensen presented a paper titled “Reflections on the Corporation as a Social Invention.” It attacked the conception of corporations that had prevailed since roughly the 1920s—that they existed to serve a variety of constituencies, including employees, customers, stockholders, and even the public interest. Instead, Jensen asserted a new ideology that would become known as “shareholder value.” Corporate managers had one job, and one job alone: to increase the short-term share price of the firm.

The philosophy had immediate appeal to the raiders, who used it to give their depredations a fig leaf of legitimacy. And though the raiders were eventually turned back, the idea of shareholder value proved harder to dispel. To ward off hostile takeovers, boards started firing CEOs who didn't deliver near-term stock-price gains. The rolling of a few big heads—including General Motors' Robert Stempel in 1992 and IBM's John Akers in 1993—drove home the point to CEOs: They had better start thinking about shareholder value.

If their conversion to the enemy faith was at first grudging, CEOs soon found a reason to love it. One of the main tenets of shareholder value is that managers' interests should be aligned with shareholders' interests. To accomplish this goal, boards began granting CEOs large blocks of company stock and stock options.

The shift in compensation was intended to encourage CEOs to maximize returns for shareholders. In practice, something else happened. The rise of stock incentives coincided with a loosening of SEC rules governing stock buybacks. Three times before (in 1967, '70, and '73), the agency had considered such a rule change, and each time it had deemed the dangers of insider "market manipulation" too great. It relented just before CEOs began acquiring ever greater portfolios of their own corporate stock, making such manipulation that much more tantalizing.

Too tantalizing for CEOs to resist. Today, the abuse of stock buybacks is so widespread that naming abusers is a bit like singling out snowflakes for ruining the driveway. But somebody needs to be called out.

So take Craig Menear, the chairman and CEO of Home Depot. On a conference call with investors in February 2018, he and his team mentioned their "plan to repurchase approximately \$4 billion of outstanding shares during the year." The next day, he sold 113,687 shares, netting \$18 million.* The following day, he was granted 38,689 new shares, and promptly unloaded 24,286 shares for a profit of \$4.5 million. Though Menear's stated compensation in SEC filings was \$11.4 million for 2018, stock sales helped him earn an additional \$30 million for the year.

By contrast, the median worker pay at Home Depot is \$23,000 a year. If the money spent on buybacks had been used to boost salaries, the Roosevelt Institute and the National Employment Law Project calculated, each worker would have made an additional \$18,000 a year. But buybacks are more than just unfair. They're myopic. Amazon (which hasn't repurchased a share in seven years) is presently making the sort of investments in people, technology, and products that could eventually make Home Depot irrelevant. When that happens, Home Depot will probably wish it hadn't spent all those billions to buy back 35 percent of its shares. "When you've got a mature company, when everything seems to be going smoothly, that's the exact moment you need to start worrying Jeff Bezos is going to start eating your lunch," the shareholder activist Nell Minow told me.

Then there's Merck. The pharmaceutical company was a paragon of corporate excellence through the second half of the 20th century. "Medicine is for people, not for profits," George Merck II declared on the cover of *Time* in 1952. "And if we have remembered that, the profits have never failed to appear." In the late 1980s, then-CEO Roy Vagelos, rather than sit on a drug that could cure river blindness in Africa but that no one could pay for, persuaded his board of directors to manufacture and distribute the drug for free—which, as Vagelos later noted in his memoir, cost the company more than \$200 million. More recently, Merck has been using its massive earnings (its net income for 2018 was \$6.2 billion) to repurchase shares of its own stock. A study by the economists William Lazonick and Öner Tulum showed that from 2008 to 2017 the company distributed 133 percent of its profits, through buybacks and dividends, to shareholders—including CEO Kenneth Frazier, who has sold \$54.8 million in stock since last July. How is this sustainable? "It's not,"

Lazonick says. Merck insists it must keep drug prices high to fund new research. In 2018, the company spent \$10 billion on R&D—and \$14 billion on share repurchases and dividends.

Finally, consider the executives at Applied Materials, a maker of semiconductor-manufacturing equipment. As is the case at many companies, its CEO receives incentive pay based on certain metrics. One is earnings per share, or EPS, a widely used barometer of corporate performance. Normally, EPS is lifted by improving earnings. But EPS can be easily manipulated through a stock buyback, which simply reduces the denominator—the number of outstanding shares. At Applied Materials, earnings declined 3.5 percent last year. Yet the company still managed to eke out EPS growth of 1.9 percent. How? In part, by taking more than 10 percent of its shares off the market via buybacks. That move helped executives unlock more incentive compensation—which, these days, usually comes in the form of stock or stock options.

Corporations offer a variety of justifications for the practice of repurchasing stock. One is that buybacks are a more “flexible” way of returning money to shareholders than dividends, which (it’s true) once raised are very hard to reduce. Another argument: Some companies just make more money than they can possibly put to good use. This likewise has a smidgen of truth. Apple may not have \$1 billion worth of good bets to make or companies it wants to acquire. Though, if this were the real reason companies are repurchasing stock, it would imply that biotechnology, banking, and big retail—sectors that hold some of the biggest practitioners of buybacks—are nearing a dead end, idea-wise. CEOs will also sometimes make the case that their stock is undervalued, and that repurchases represent an opportunity to buy low. But in reality, notes Fortuna’s Gregory Milano, companies tend to buy their stock high, when they’re flush with cash. The 10th year of a bull market is hardly a time for bargain-hunting.

CAPITALISM TAKES many forms. But the variant that propelled America through the 20th century was, at its heart, a means of pooling resources toward a common endeavor, whether that was building railroads, developing new drugs, or making microwave ovens. There used to be a healthy debate about which of their stakeholders corporations ought to serve—employees, stockholders, customers—and in what order. But no one, not even Michael Jensen, ever suggested that a corporation should exist solely to serve the interests of the people entrusted to run it.

Many early stock certificates bore an image—a factory, a car, a canal—representing the purpose of the corporation that issued them. It was a reminder that the financial instrument was being put to productive use. Corporations that plow their profits into buybacks would be hard-pressed to put an image on their stock certificate today, other than, perhaps, the visage of their CEO.

** This piece previously stated that Craig Menear sold 113,687 shares the same day as his conference call with investors.*

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