KIM: Stock buybacks can be a harmful "sugar high"

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CEOs are routinely bashed for their outsized pay, but companies are under intense pressure from Wall Street to produce steady, predictable gains in earnings-per-share (EPS) *every* calendar quarter (i.e. thirteen weeks). Pity the poor CEO who becomes the target of an "activist" investor who may have owned the stock for all of 15 minutes, but agitates for changes to end their pain by "maximizing shareholder value."

A company's earnings-per-share (EPS) is calculated by dividing earnings by the number of shares outstanding. If ABC Corp has $1 million of earnings and 1 million shares outstanding, it has EPS of $1. If ABC buys back 10% of its shares, voila, its EPS rises 11% to $1.11 ($1 million/900,000 shares).

Additionally, ABC's purchase of a large percentage of its stock will likely drive the price higher. It's not surprising demanding stock buybacks is a key component of "activist" investors' playbooks.

The combination of higher EPS and company buying usually provides a ***short-term*** boost to the stock. This makes Wall Street happy, keeps the activists at bay and helps management enhance the value of their stock options and meet bonus targets.

Buybacks may be helpful or harmful in the ***long-run***, but the facts are unambiguous. According to Standard & Poor's, U.S. companies spent more than ***$900 billion*** on buybacks and dividends in 2014, a record.

To put this in context, according to University of Massachusetts economist William Lazonick in a recent Brookings Institution paper, the 454 companies listed continuously in the S&P 500 between 2004 and 2013 used 51 percent of their earnings to buy back their own stock. An additional 35 percent of earnings funded dividend payments. In total, a whopping 86 percent of earnings were utilized for the ***immediate*** gratification of shareholders.

Returning cash to shareholders via buybacks and dividends can be part of a responsible capital allocation strategy, but when this use of capital causes firms to underinvest in innovation, skilled workforces or capital expenditures necessary to sustain long-term growth, that can lead to big problems for the firm and our economy.

That's the message Larry Fink, CEO of investment behemoth BlackRock, sent to each of the S&P 500 CEOs in a recent letter recognizing and bemoaning the acute pressure on companies to meet short-term financial goals at the expense of building long-term value. Fink said returning excessive amounts of capital to shareholders "sends a discouraging message about a company's ability to use its resources wisely and develop a coherent plan to create value over the long term."

In Fink's view, "corporate leaders' duty of care and loyalty is not to every investor or trader who owns their companies' shares at any moment in time, but to the company and its long-term owners." He urges CEOs to "engage with long-term providers of capital," "resist the pressure of short-term shareholders to extract value from the company if it would compromise value creation for long-term owners" and "clearly and effectively articulate their strategy for sustainable long-term growth."

One of Fink's solutions to combatting corporate "short-termism" is to change U.S. tax policy, which categorizes gains on securities held more than one-year as "long-term," subject to favorable tax rates. He favors granting long-term treatment after ***three-years*** and decreasing the rate each year until reaching 0% after ten years.

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