BROADHURST Financial Advisors, Inc.

Benefits of Buybacks

June 25, 2024

The U.S. Congress imposed, as of last year, a 1% tax on stock buybacks—that is, on the amount of its own stock that a company purchases in the marketplace. The goal was to discourage companies from buying back their own stock—a practice that has been heavily criticized in the press, where it is frequently noted that dividend payments have been going down at the same time that companies have been purchasing their own shares.

But the mathematics of stock buybacks actually work out better than dividends for shareholders and investors—not just because they reduce shares and increase demand (and, therefore, stock prices), but more importantly because of how the taxes work. When a company pays dividends, the investor is likely to be taxed at a 15% (sometimes more) tax rate, and the share price goes down by the amount of the dividend. But if the company buys back shares, it creates an incremental increase in your long-term capital gains and reduces the total number of shares outstanding.

A recent article illustrates the difference. Suppose you were to own 100 shares of a company, purchased at $10 a share, and this hypothetical company has 10,000 shares outstanding. The bull market drives the share price up to $12, and the company pays you a $120 dividend. The 15% tax rate would mean you'd receive, after-tax, $102, and you'd still own 1% of the company.

If the company decided, instead, to buy 10% of its outstanding shares at the current $12 price, then you could sell 10 shares (10% of your holding), for the same $120, leaving you with 90 shares. But now you would be paying a 15% tax on your $20 long-term gain ($120 - $100 = $20), or $3, resulting in $117 in your pocket or purse. And you would still own 1% of the company—your 90 shares is 1% of the company's reduced amount of 9,000 shares.

The article calculated the declining dividend yield plus a 'buyback yield' from all the buyback activity that has taken place since 2017 and determined a total yield to shareholders from the S&P 500 companies' excess cash. This 'total yield,' properly calculated, helps us realize just how much shareholders have been receiving above the actual cash distributed toward the end of each year: 6.01% in 2018, 4.54% in 2019, 3.17% in 2020, 3.45% in 2021, 4.63% in 2022, and an estimated 3.46% in 2023. This is during a period when the dividend yield has fallen from an average of 2.17% to 1.47%.

But the 1% excise tax is going to kill this buyback activity, right? Apparently not. Goldman Sachs has estimated that S&P companies will buy back nearly $1 trillion of their own stock this year, and more next year. This is compared to the $44 trillion total value of their aggregate stock—not exactly a tiny percentage.

Sources:

https://www.advisorperspectives.com/articles/2024/05/23/why-stock-buybacks-great-for-clients-allan-roth

If you have any questions about this article or want to discuss your family finances, investment portfolio, or financial planning advice, please call on me anytime at my number (215) 325-1595 or you can click here to schedule a meeting.

Please feel free to forward this article and offer to anyone you know who might have financial questions or need some unbiased advice. Most financial advice is sales advice. In stark contrast, we are fee-only (non-commissioned) fiduciary advisors. We just provide truthful, unbiased advice to our clients.

Jeffrey Broadhurst
MBA, CFA, CFP
Broadhurst Financial Advisors, Inc.

*****PRIVACY NOTICE*****

Our physical and mail address:
1911 West Point Pike
P.O. Box 301
West Point, PA 19486-0301

Contact us:
Phone: (215) 325-1595
Email: jeff@broadhurstfinancial.com