

**Testimony of Derik Dwayne Coffey, CFA  
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**Before Financial Services Committee  
Subcommittee on Investor Protection, Entrepreneurship and Capital Markets  
U.S. House of Representatives**

**On  
Examining Corporate Priorities: The Impact of Stock Buybacks on Workers,  
Communities, and Investment”**

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**Introduction**

Chairwoman Maloney, Ranking Member Huizenga, and Members of the Subcommittee, thank you for inviting me to testify. My name is Derik Dwayne Coffey. I am a Portfolio Specialist for Channing Capital Management.

**Channing Background**

By way of background, Channing Capital Management is a Chicago-based investment management boutique firm serving institutional investors that was founded in 2003. We currently have over \$2 billion in assets under management and are a diverse owned firm with the majority share of the company’s equity held by African Americans. We are a specialty investment manager focused primarily on Small/Mid cap investing with Domestic and International investment strategies. Long-term performance and tailored client service are long-standing precepts that drive everything we do. We firmly believe that by employing a research-intensive, fundamental, bottom-up process, we build portfolios positioned to generate solid long-term performance, with managed risk.

It is worth noting that while we have a diverse client base, a large portion of our clientele consists of public defined benefit pension plans. As you will see later in this presentation, our clients are heavily impacted by the capital allocation strategies employed by the companies underlying their investment portfolios. We take our fiduciary responsibility to our clients seriously as we execute our investment strategy to help them achieve their investment objectives.

## **What are stock buybacks and why do companies use them?**

Allow me to now move on to addressing the primary topic on the agenda today: Stock buybacks. I would like to establish a base line for understanding of what stock buybacks are and why companies do them.

When discussing capital allocation strategies such investments as dividends or stock buybacks, the old maxim, “A bird in the hand is worth two in the bush,” is often quoted. This ultimately means that investors generally prefer a dollar of dividends or share repurchases to a dollar of potential gains driven by capital appreciation. In short, investors view the certainty of upfront cash as less risky and generally prefer the assurance of receiving some cash in hand, which gives them options to decide where, when and how to deploy cash received to generate a higher return.

Capital allocation strategies such as dividends and buybacks are typically pursued after a company’s Board of Directors has exhausted its options for deployment into initiatives such as Property, Plant and Equipment, Debt Reduction, Human Capital Investment, Research and Development, and or Mergers/Acquisitions. When capital levels exceed a company’s expenditure needs, returning this capital to shareholders is considered a prudent strategy that enables and empowers investors to redeploy excess cash to areas where there may be more attractive growth opportunities. This keeps capital flowing so that our economy is always using capital it has available as efficiently as possible.

Buybacks are an important part of a company’s capital allocation strategy and a company may engage in this activity for a number of reasons that I will outline below.

### Reasons for Stock Buybacks

1. Management Capital Structure: A company’s capital structure is its unique mix of debt and equity that is used to fund its assets. There are times when corporate managers need to adjust their capital structure to optimize or maintain efficiency or to lower their cost of capital. Buybacks offer a means for responsible management teams to adjust their capital structure when appropriate.
2. Added Flexibility: Relative to dividends, buybacks offer management team’s flexibility as a form of capital return to shareholders. This is particularly true in an environment where earnings can fluctuate sharply from year-to-year. Dividends are extremely sticky and there is a large class of income sensitive investors that focus exclusively on dividend paying stocks. Any lowering or discontinuation of an expected dividend is typically met with an adverse reaction and most certainly a lower stocks price. Stock buybacks, on the other hand, give management teams more discretion to distribute excess capital opportunistically.
3. Offsetting Dilution from Employee Stock Options: For companies that compensate employees with stock options, buybacks offer an avenue to offset the potential dilution of earnings per share that could result from the exercise of stock options. For many companies the primary objective is to repurchase as many shares as have

been issued from the exercise of stock options to maintain a stable share count so as to not dilute existing shareholders interest.

4. Share Price Support/Signaling: This typically occurs when management views its own shares as undervalued. From a shareholder perspective, the announcement of a buyback program is often interpreted as a positive signal about the company's prospects and attractiveness. This is largely driven by the understanding that company's management has more information about the company's operations and future prospects than does an investor. Their commitment to the company gives investors' confidence that the management team has a more favorable outlook on the underlying business.

### **How Buybacks benefit our clients**

Now that we have established what buybacks are and why companies do them, I would like to shift the discussion to how our clients specifically benefit from stock buybacks. As I noted earlier in my introduction, a large number of our clients are defined benefit plans but we also have decent and growing exposure to endowments/foundations, wealth management platforms and corporate plans. Our clients include Union Workers such as Policemen/women, Firemen, Teachers, City and State Workers. The common thread across all of these clients is they all benefit from stock buybacks. Allow me to outline how these clients directly benefit from them.

1. Better Management Alignment with Shareholders: Another advantage for buybacks over dividends is that the buybacks better align corporate management teams with shareholder interests particularly in cases where management owns a share of the company's equity. As buybacks reduce the number of shares outstanding, they also give management teams a greater share in the company's ownership structure. Numerous studies highlight that greater CEO ownership tends to lead to better long-term returns, which in our view, aligns well with the long-term interest of shareholders.
2. Boost in Share Price: When a company's shares decline in price, a management team that announces a buyback program can generally get a boost in the stock price. The benefit is generally driven by the positive signal to investors that management has a more optimistic view of its business than the market does. A second benefit is the potential uptick in demand for the shares in lieu of less shares being available to purchase. In this instance a lower share count coupled with positive affirmation from management should typically lead to higher share prices.
3. Tax Benefits: This argument applies specifically to taxable accounts. When excess cash is used to repurchase company stock, shareholders have the opportunity to defer capital gains if share prices increase. Moreover, buybacks are taxed at a capital gains tax rate, whereas non-qualified dividends are subject to ordinary income tax. If the stock has been held for more than one year, the gains would be subject to a lower capital gains tax rate.
4. Investor Choice: Buybacks give investors an opportunity to choose to sell their shares back to the company. A rational investor is less likely to sell their shares if there is no attractive alternatives means for deploying excess cash. In short, buybacks give investors a means to

receive and redeploy capital toward better growth opportunities and companies that are seeking capital.

### **Instances where Buybacks should require greater scrutiny**

With that said there are definitely instances where stock buybacks do warrant greater scrutiny to prevent loss to investors. Buybacks that are used exclusively to achieve short-sighted goals via financial engineering are especially harmful. Examples of these activities typically occur in companies where management teams have performance incentives focused primarily on short-term targets. Many of these gimmicks include using stock buybacks to reduce shares outstanding to inflate earnings per share growth or to increase Return on Equity, a popular shareholder return metric. In these cases buybacks could contribute to giving investors a false impression that a company is adding value when it actually is not.

A second example where buybacks could be viewed as less advantageous are instances where a company has a long history share repurchases but continues to lose shareholder value despite these efforts. In these instances, investors, employees and politicians are right to question whether the buyback activity was the most prudent use of capital and if there were better uses for it.

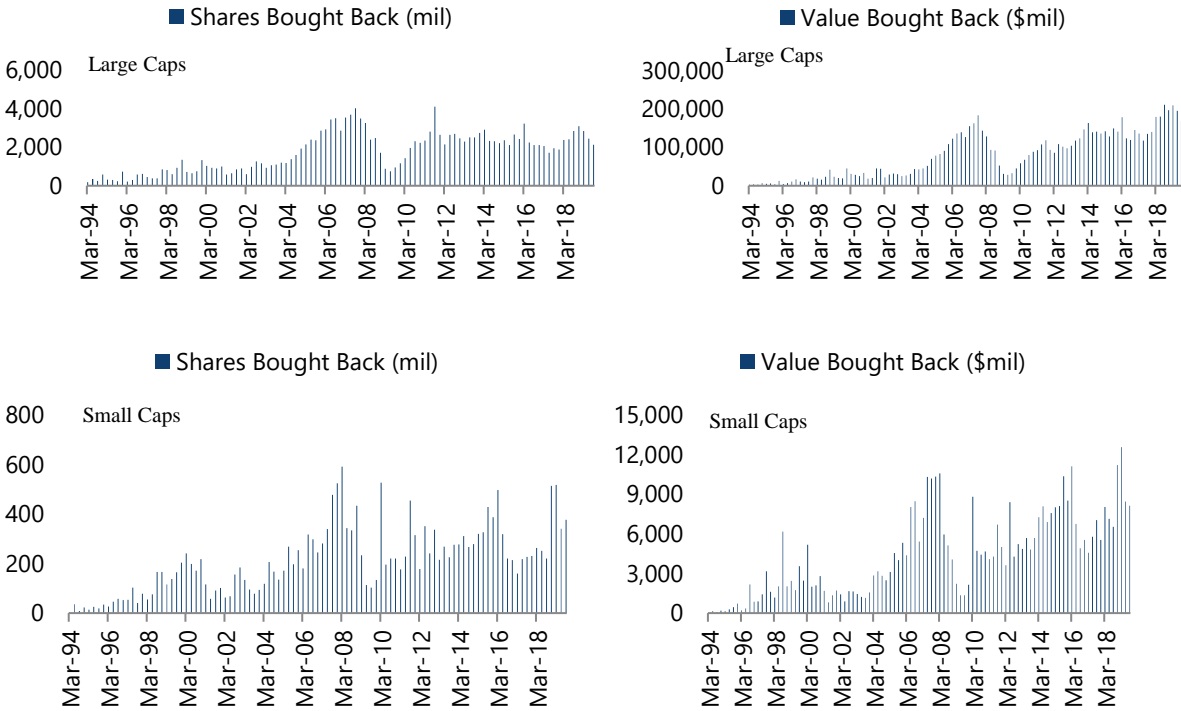
From Channing's perspective, we have to evaluate a business's forward outlook to make two determinations: 1) Is a stock buyback is the correct capital allocation decision? 2) Is the company's buyback strategy achieving the desired result? If management cannot garner shareholder support or drive value, we would eventually have to consider other options for our client's portfolios in order to generate higher returns.

We have very little patience for management teams that use buybacks or other means to engage in short-sighted financial engineering schemes. If our analysts determine that a company's actions and incentives are myopic and/or not focused on long-term growth, our team voices these concerns to management. Ultimately we eliminate companies from our portfolio that fail to execute well and/or fall short on corporate governance.

## Why buybacks have surged over the past several years

A question often asked in the news lately is why the pace of buybacks has accelerated over the past several years. I would like to offer our take on why buybacks have become a more popular means to distributing capital to shareholders in recent years. In our view the increase is driven by two things: 1) The extended duration of the bull market that started in 2009; and 2) the tax reform legislation that has encouraged more repatriation of overseas profits.

### 1) The extended duration of the bull market that started in 2009



Source: FactSet; Standard & Poor's; FTSE Russell; Jefferies

Per the charts above, stock buybacks have historically been more prolific during periods of economic expansion. In periods of economic growth companies are generally flush with cash to engage in capital investment and hiring. During these periods cash levels may actually exceed a company's capital expenditure needs. These are typical times when buyback activity increases. As the cycle matures and the economy slows down, buybacks tend to slow down commensurately with the need for businesses to preserve capital. Given these facts, it is no surprise that buybacks have surged across large and small capitalization stocks since the beginning of the current economic expansion that started in 2009. It is worth noting that stock repurchase activity was highest among large capitalization stocks during this period.

### 2) Tax reform legislation has encouraged more repatriation of overseas profits.

Prior to the 2017 Tax Cuts and Jobs Act (TCJA), the United States generally taxed its corporations and residents on their worldwide income. One way that businesses got around this potential tax liability was to leave the excess capital indefinitely in foreign subsidiaries. If a company decided

to repatriate profits, these earnings would likely be taxed at a 35 percent rate and with credits provided for foreign taxes paid.

Following the passage of the TCJA, the United States government allowed the repatriation of overseas profits at preferred lower rates. There are two tax-preferred rates for the foreign earnings deemed repatriated: foreign earnings held in cash and cash equivalents were taxed at 15.5 percent and those not held in cash or cash equivalents at only 8 percent. The TCJA permits a US corporation to pay any tax on the deemed repatriations in installments over eight years.

Again it is worth noting that this activity was most rampant among large cap companies within the Technology Sector with substantial amounts of dollars trapped overseas before the tax reform legislation. The lower tax rates gave these businesses the incentives needed to bring this cash back to the U.S. while returning excess capital to shareholders.

### **Risk of Increased Restrictions on Buybacks**

Any proposed legislation that is designed to stymie or retard buyback activity could result in negative outcomes for investors, the economy, and the optimal allocation of capital. The key question one should ask is whether it is better to legislate an issue that is cyclical, or one that reflects a structural imbalance. I would argue that the recent buyback activity is much more cyclical in nature. Allow me to outline some of the potential pitfalls to investors of legislation that could potentially curtail buybacks.

- 1) Restrictions could trap capital in businesses that could lead to activity that deploys capital in a less efficient manner. One example of this would be a company making a less than optimal acquisition or overpaying for said companies. Decisions such as these ultimately cost jobs and waste capital while destroying shareholder value.
- 2) A buyback limitation could also impede the movement of capital from those that have it to those who need it. Many of our institutional clients benefit from this capital allocation activity as a source of funds to deploy capital.
- 3) Restrictions could also force businesses to increase the use of dividends as means for distributing excess capital. This could be less ideal for two reasons: 1) Dividends offer less flexibility for businesses to curtail once started; especially during weaker environments; 2) Investors with shorter holding periods, or Non-Qualified dividends, would be taxed at the ordinary income tax rate rather than the lower long-term capital gains rate.
- 4) Another consequence of a potential restriction on buybacks is the loss of a powerful signaling tool that investors rely upon to get a sense of confidence from management in the underlying business. A management team that is willing to buy shares, especially in a down market, helps to communicate optimism in the underlying fundamentals of the business.

## **Conclusion**

In conclusion, I would like to thank the sub-committee for inviting me to address this important and timely topic.

To recap, buybacks play an essential role in how businesses deploy excess capital to shareholders. Second, a number of pension plans, and the employees that participate in them, directly benefit from buybacks. Buybacks provide an important source of capital to shareholders which allow us to redeploy the excess cash received to other productive uses. Third, companies that use buybacks to achieve short-sighted goals or to boost short-term metrics are heavily frowned upon. Our team seeks to own businesses focused on driving long-term shareholder value. Companies that invest in their business to gain market share, employ sound capital allocation and practice strong corporate governance, deliver better long-term results for our clients. Finally, legislation that is designed to restrict or limit buyback activity must be measured against negative externalities that could impair capital allocation that is critical for normal functioning markets.

I am happy to answer any questions you have.