"Look at the Cannibals"

Berkshire Hathaway Inc. (NYSE:BRK.B) director and octogenarian billionaire Charlie Munger once advised investors to "look at the cannibals." Munger used this colourful metaphor to convey that investors should watch companies doing share buybacks for potential investment opportunities. At Armstrong Schmidt Investment Management, we like to see companies doing share buybacks in some circumstances. We have noticed that many investors do not understand buybacks, so we are going to explain some of the basics.

Publicly traded companies typically have a large number of shares outstanding that are owned by numerous shareholders. A share buyback happens when a company purchases some of its own shares from its shareholders and cancels them, causing the number of its outstanding shares to decrease. So why would share buybacks be positive? Well, they are not *always* positive, but when a mature, financially strong company buys its own shares at undervalued levels, it will usually benefit shareholders. Since there are fewer shares outstanding after a buyback, the remaining shareholders will typically enjoy higher earnings *on a per share basis*. In other words, share buybacks can help a company grow its earnings per share and consequently the value of its shares. Also, on the rare occasion when a company can buy back shares below book value, a share buyback can increase book value per share.

We emphasize that the company should be mature and financially strong, and its shares should be undervalued. It may not make sense for an emerging growth company to buy back shares if high-return growth opportunities are consuming all of its available capital. Likewise, it may not make sense for a company in a precarious financial position to buy back shares if this would consume scarce capital. Also, share buybacks may not benefit shareholders if a company simply buys back the number of shares it grants to employees as annual compensation. And share buybacks could even harm shareholders if a company pays too much for its own shares, as the funds could be put to better use.

Let's look at some real-world examples of share buybacks. According to a June 2012 Credit Suisse study, from 2004-2011, dollar store chain Dollar Tree Inc. (NASDAQ:DLTR) purchased nearly 70 million of its own shares at an average price around US$28. Compared to today's price of US$54, this buyback program appears to have benefitted shareholders. The same study reveals that aluminum giant Alcoa Inc. (NYSE:AA)

purchased around 116 million of its own shares during that time period at an average price around US$35. Compared to today's price of US$8, shareholders cannot be pleased.

Let's look at a more current example. American International Group Inc. (NYSE:AIG) is a large property and casualty insurer that is still recovering from the 2008-09 financial crisis. On Aug. 1, the company announced it would purchase up to US$1 billion of its own shares. This looks like a shareholder friendly move, as AIG shares were trading around US$47 at the time, and the company's book value per share was around US$61. Only time will tell. Like Munger advises, we "look at the cannibals." We like to see mature, financially strong companies purchase their own shares at seemingly undervalued levels. On the other hand, those companies that do buybacks in the wrong circumstances are better off going hungry.

Michael H.F. Armstrong *BA, CIM, FCSI*
Portfolio Manager

Andrey Schmidt *BA, LLB*
Investment Advisor

This article was first published in Sounding Board, the official monthly publication of The Vancouver Board of Trade. Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. Their clients may own securities mentioned in this column. The views of Michael Armstrong and Andrey Schmidt do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015.