FROM THE FOUNDER OF
THE FALCON METHOD

BEYOND DIVIDENDS

An Evidence-Based Investor's Evolution from Dividend Stocks to Quality Compounders

DAVID SOLYOMI

Contents

2019

2020

2021

2022

Prologue: Why This Book and How to Make the Most of it?

Weeks after retiring at the ripe age of 33 to live off of my dividends, I realized I had made a huge mistake. Not financially, since that passive income stream could comfortably cover my family's living expenses; what felt wrong was the purposelessness. Luckily, one of my friends kept nudging me to teach others how I achieved financial freedom through stock investing. Timidly yielding to his request changed my life (and that of many others).

Long story short: I came out of retirement, wrote a best-selling book on dividend growth investing, published e-learning courses, and spoke at numerous financial conferences. What kept bothering me was a question that constantly came up at the end of my presentations.

> "Couldn't you just share the list of stocks representing the best investment opportunities according to your system? Not everyone would like to put in the amount of work you did, but your process looks logical, so we could surely use its results."

This is how the FALCON Method newsletter was born in response to the articulated demand. Back in 2017, when the service was launched, I already had more than 10,000 hours of investment-related reading and thinking under my belt, not to mention the firsthand experience of pricey and painful lessons (along with success stories). As per Malcolm Gladwell's principle, popularized in his Outliers: The Story of Success book, I easily qualified as a stock investing expert, although I'd never label myself as such. (A healthy dose of humbleness comes in handy if you are to survive and thrive in the markets.)

Looking back, I most certainly didn't foresee how operating a newsletter service with 1,000+ subscribers (from 33 countries at last count) could impact my then flattening learning curve over the years. The incoming questions and feedback made me think deeper and deeper, pushing me to explain complicated concepts in a digestible, easy-to-understand manner. Both my investing style and writing skills markedly evolved throughout this journey, which you'll hopefully notice. (As a shortcut, you can compare the original FALCON Method stock selection process in the Appendix with the latest version near the final pages. The difference is striking, but it took time to get there.

This book gives you a backstage pass to follow the learning process and gain valuable insights from my adventure.)

This publication contains all the opening pieces of the FALCON Method newsletter to date (May 15, 2023). Subscribers say these writings are both educational and entertaining. I can only hope you'll feel the same. Some parts of the newsletter's Closing Thoughts are also included, mostly covering macroeconomic, political, and company-specific events, thus giving a taste of how long-term investors translate them, filter out the noise, or react when appropriate. These latter writings were edited to strip them down to the timeless lessons I'd consider useful as a reader aiming to get better at investing or simply interested in the stock market.

While you are free to read the book from cover to cover, you may also jump around to the chapter that best addresses the questions you are currently interested in. To optimize your time, you can quickly find the information you may need on position sizing, the ideal cash balance in your portfolio, acquisitions, stock splits, market efficiency, and proven investment factors, you name it. That said, the evolution of the FALCON Method, the newsletter's underlying stock-picking process, will be much easier to follow and understand if you proceed in chronological order.

You'll understand how I stuck with the classic mean reversion style of value investing (with a strong dividend focus) for probably too long. Renowned "superinvestors" were also on a similar path, as illustrated by the numerous quotations on the following pages. It took time to develop a proven framework that could reliably identify extraordinary companies within the non-dividend-payer category, a minefield full of weak and risky businesses. Access to institutional-level EVA (Economic Value Added) data made it possible to remedy accounting distortions and analyze the real performance of thousands of companies on a global scale. As a result, our screening and analysis process came up with 60 firms (from 12 countries) that are worthy of our EVA Monster badge. These exceptional quality-growth companies deserve every long-term investor's attention regardless of whether they pay dividends. You are at the best place to learn about them.

The writings herein condense decades of experience and may help fast-track your evolution as an investor. You will find some non-conformist views on important topics on the following pages. As long as they make you think, you'll benefit immensely from reading.

The FALCON Method newsletter is my highest-value service, the culmination of a decades-long investment journey, with my heart and soul in it. This makes me believe anyone devoting the time to read this collection is in for a real experience. Learning never stops, and I'll never consider myself the finished article (neither in investing nor other realms). So I reserve the right to change some of my opinions, yet I pledge to keep sharing all my discoveries in the coming FALCON Method newsletters to the benefit of all who laid their trust in me. I'm forever grateful for every single one of you who made this adventure possible.

David

Hurricane Irma, my Kindle, and Some Valuable Lessons

Published in October 2017

> Historical data proves that value stocks (that are out of favor and thus priced cheap) outperform story stocks that are all over the news. Regardless of the facts, people have trouble buying cheap stocks and flock to the overhyped shares instead.

I arrived in Miami on September 5th, and right at the airport, an Uber driver told me that the city was preparing for a Category 5 hurricane named Irma. The situation seemed so serious that I couldn't even buy bottled water anywhere. Pretty exciting short stay I was looking forward to.

I always have my Kindle with me when I travel, and this time I was reading the book "Thinking, Fast and Slow" by Nobel Laureate Daniel Kahneman. This is a classic that explains the two systems that drive the way we think. (System 1 is fast, intuitive, and emotional; System 2 is slower, more deliberative, and more logical.) Our cognitive biases can be understood only by knowing how the two systems shape our judgments and decisions. This, of course, has much to do with investing, where 90% of the puzzle is about psychology and managing our inborn cognitive issues.

I thought it was a nice coincidence that I was reading about this particular topic while watching the hurricane panic unfold from the first row. I'm a practical guy, so let me bring up some examples that grabbed my attention and can be useful for investors.

First, consider the following description of a U.S. resident called Steve: "Steve is very shy and withdrawn, invariably helpful but with little interest in people or in the world of reality. A meek and tidy soul, he has a need for order and structure, and a passion for detail." Do you think Steve is a farmer or a librarian? Most people opt for the librarian answer as the described personality fits the stereotypical librarian. Nearly no one considers that there are more than 20 male farmers for each male librarian in the United States, which makes it almost certain that more "meek and tidy" souls will be found on tractors than at library information desks. The problem is that most of us never thought of the base rate (the underlying statistics) when picking an answer. We made a quick, intuitive decision (System 1) instead of activating our analysis mode (System 2).

The same is true for stock picking. Historical data proves that value stocks (that are out of favor and thus priced cheap) outperform story stocks that are all over the news. Regardless of the facts, people have trouble buying cheap stocks, and they flock to the overhyped shares instead. Look at the current top story titled “Retail is dead!” The standard reaction is to buy the prevailing story stock (in this case, Amazon, which is supposed to conquer the whole universe) and panic-sell the ones like Target that become dirt cheap as a result. The base rate clearly shows that your chances are better if you invest in the value stocks, just like picking the farmer answer in the previous question. The underlying odds will prevail, but most people simply ignore them and make up stories to support their emotional decisions. (System 1 thinking, again.)

Now back to Miami, where the story on the surface was scary. The media fueled the hysteria, and people were preparing to leave the city at all costs. (A fast, emotional decision, typical of System 1 thinking.) As a European, I’m not too familiar with hurricanes, so I first spoke with the locals, like our Airbnb host, to gather some information. I was told that as long as we observed the basic rules, the probability of personal injury was negligible. The only high-probability issue we had to face was being stuck in Miami for several days without electricity and water. So I knew what I could possibly expect, and I most certainly wanted to avoid such an inconvenient situation. But not at all costs! Now that I knew the base rate (that my life was not in danger), this hugely affected the price I was willing to pay to reschedule my flight back home. (This slower analytical thinking—the activation of System 2—requires that you overcome the instant emotional reactions of System 1.) Whoever neglected the base rate and got overwhelmed by the depressing “we’re all going to die” story ended up paying more than 10K euros for a one-way flight to Europe, while I could snatch a ticket at a reasonable price by keeping calm and refreshing the Skyscanner site minute by minute for the new flights added. Could you keep your cool in such a situation?

I consider this Irma example a mini-panic compared to what will happen in the media once the stock market enters a healthy correction phase (that is long overdue) or an outright bear market. That is the exact situation when you must be able to focus on the base rate and scoop up the quality stocks that go on sale regardless of the “end of the world” stories that will be all over the place. Freeing yourself from the emotional story and activating your System 2 thinking is easier said than done, as I experienced with Irma.

Base rate neglect is far from the only irrationality we are born with. Imagine that you discover a stock with a dividend yield higher than the market average and adequate dividend coverage. What’s your first impression? Kahneman observed that the sequence in which we observe characteristics matters, even if it is often determined by chance. The halo effect increases the weight of first impressions, sometimes to the point that subsequent information is mostly wasted. Regardless of how embarrassing it sounds, I am ready to admit that I had caught myself with stocks “almost bought” when I noticed that I hadn’t even run through all the steps of my system before making that decision. We absolutely need a checklist and a structured decision-making process; otherwise, we are doomed to failure. Sticking to an evidence-based approach like the FALCON Method is the best we can do.

I believe in lifelong learning; this is why I read 50–70 books per year. I absolutely loved how Kahneman described the process of learning, which is (in most cases) all about pattern recognition. Reading is about pattern recognition, where words are the patterns. Playing chess is the same, but situations there are like very long words, so the patterns take longer to recognize. Now you know why becoming a chess champion requires much more time than learning to read. While reading this part of the book, I instantly realized that what I’m doing with stock selection is also built on pattern recognition. There are some aspects of a “winning situation,” and the more experienced you are, the better you recognize them and can profit from the opportunities. It is no coincidence that the components of the FALCON Method focus on the most important elements of “winning situations.”

If patterns are difficult to recognize, learning can take extremely long. However, instant feedback can speed up the process. Imagine that a young schoolboy misreads a word, and the teacher instantly corrects him. It doesn’t take long to get the pattern recognition right under such circumstances: easy patterns plus instant feedback. Well, the stock market is not that kind to us. On the one hand, feedback is far from instant; on the other hand, even bad decisions can lead to good outcomes, and good decisions can lead to bad outcomes. Take a look at the process-outcome matrix!

	Good Outcome	Bad Outcome
Good Process	Deserved Success	Bad Luck
Bad Process	Dumb Luck	Deserved Failure

Because of complex patterns and delayed feedback, it can take ages to figure out how to do things right on the stock market. Kahneman's words: "Skill doesn't become perfect all at once, and on the way to near perfection, some mistakes are made with great confidence." Some very expensive mistakes, I must add. Learning never stops; I am continuously fine-tuning my process and humbly accept what psychologist Jonathan Haidt said: "The emotional tail wags the rational dog." I know that my best chance of success is concentrating on an evidence-based stock selection system and not letting the many biases throw me off the right track. I hope I can help you on this journey. As Daniel Kahneman reveals, brain recordings indicate that buying at especially low prices is pleasurable.

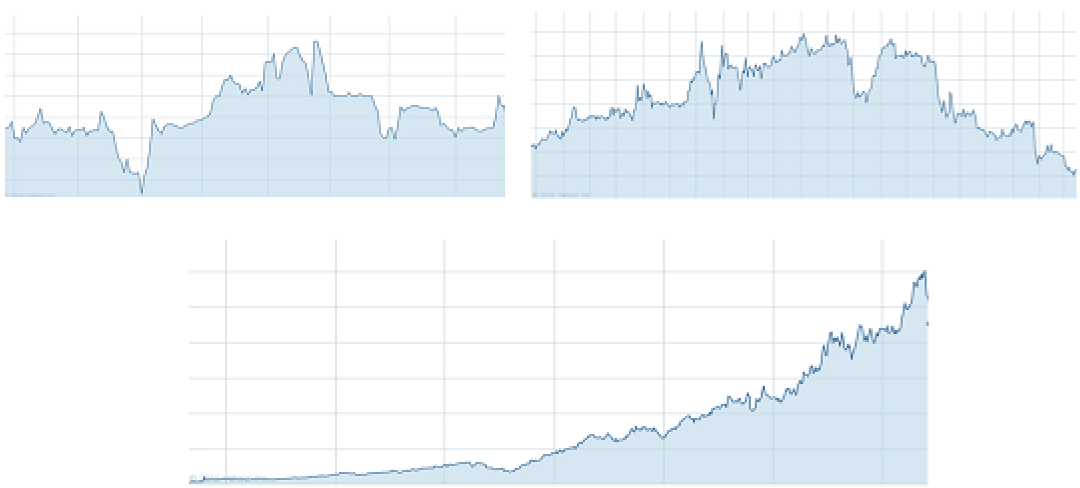
Zoom Out

Published in December 2018

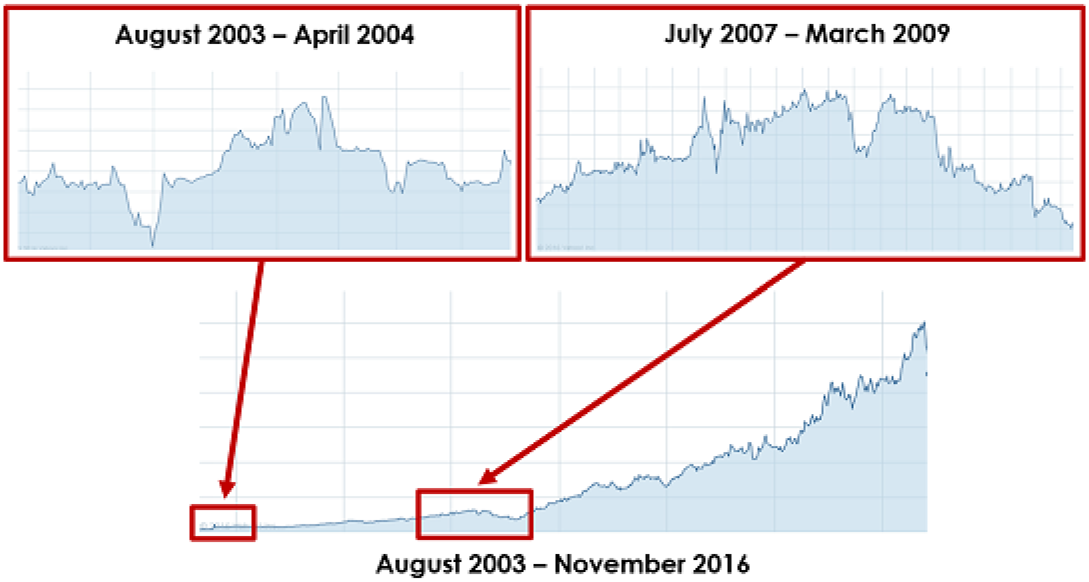
> The problem is that investors try to match long-term strategies with a short-term time horizon.

Do you know how Ben Graham, the father of value investing, used to open his famous course at Columbia? According to one of his students, Marshall Weinberg, this is what Graham said at the very beginning: “If you want to make money on Wall Street, you must have the proper psychological attitude. No one expresses it better than Spinoza, the philosopher. Spinoza said you must look at things in the aspect of eternity.” Before elaborating on the importance of these lines, let me invite you to take a quick test.

Vishal Khandelwal teaches value investing in India, and he has some thought-provoking slides, two of which we are about to use here. First, look at these charts and write down which of the three stocks seems to be the best in terms of performance.



The obvious answer is the third, which looks like a one-way ride up. At this point, Vishal reveals to his students that the first two charts are just short periods in the third stock’s long journey. See it for yourself!



What does this have to teach us? In the long journey of the stock of a high-quality business, the short-term price fluctuations that make people nervous are non-events. In the larger scheme of things, most of what worries us is of relative insignificance, and this holds true for all areas of our lives.

After having reached thousands of people with my books, courses, and newsletters on investing, I'm widely aware that most people hate short-term underperformance, so they tend to zoom in on the charts and focus on the short periods instead of the long journey. If investment managers (or newsletter providers) underperform for six months, they start to get questions about the efficacy of their strategy. If the underperformance continues longer, those questions get louder, and by the time the bad period reaches five years, there won't be many clients left. The problem is that investors try to match long-term strategies with a short-term time horizon and assume that if a strategy doesn't work over three years, it doesn't work long term. (Factually incorrect!)

Let me clear this up for you, as this is the single most important reason why most people have difficulty following evidence-based investment approaches like the FALCON Method. Value stocks (those that are priced cheap based on various valuation metrics) tend to outperform the market in the long run. This is a fact that is not to be disputed by anyone who has studied the historical data. Having read this proven statement on long-term performance, would you be upset if your carefully constructed value portfolio underperformed the market in any single year? You shouldn't be, as this tends to happen 37% of the time, according to the data compiled by author and investor Larry E. Swedroe. In fact, we are currently in a period where the value approach has underperformed for a long time, and statistics show that even this is perfectly normal. The longer the horizon, the lower the odds of underperformance, but it can still happen at horizons of 20 years! According to Swedroe, the value factor underperforms in 14% of ten-year periods, so staying the course during that type of extended underperformance is required to benefit from the long-term outperformance of the approach. Most people can't do that, and that is why factor investing is much harder than many think. After all, when it comes to judging the performance of an investment strategy, most people believe that three years is a long time, five years is a very long time, and ten years is an eternity. When Ben Graham used the word eternity, he must have had something different in mind.

Investors get paid for experiencing pain. If a certain approach worked all the time, everyone would follow it, and it would eventually stop working. The pain you experience in pursuing a strategy is the price of admission to get its long-term outperformance. Periods of underperformance are part and parcel of the game. Adopting this mindset would most certainly help investors maximize their long-term returns, although I'm not too optimistic about the possibility of this ever happening on a large scale.

Now it's Mark Hulbert's turn to draw your attention to another important issue. He has been tracking the advice of more than 160 financial newsletters since 1980, so he does know a thing or two about this industry and its subscribers. Here's his question: Which of the following two advisers would you more likely follow? (A) An adviser with a decent but unspectacular track record who merely matches the market's return when it's going up but loses less when it is declining? (B) Another adviser at the top of the performance sweepstakes, but who suffers big losses in a bear market? Hulbert says, "If you're like the typical investor, you'd jump for the second one. Yet the first is more likely to help you reach your long-term financial goals. That's because the key to long-term financial success is sticking with an adviser or strategy through thick and thin. And most investors who follow high-flying advisers end up discovering that they don't have the level of commitment and intestinal fortitude that are required. As a result, most investors who start following such advisers get rid of them at or near the end of the next bear market. As a result, they suffer almost all of those advisers' bear market losses yet benefit from only a fraction of their bull market potential. That's why the first, less glamorous, adviser is to be preferred. Even though his track record appears to be inferior, you most likely will make more money following him over the long term than by going with the one whose track record appears to be superior. To put this another way: Slow and steady wins the race. Most investors know all this already. And yet, they continue to prefer advisers who are like the second one above. Why? Because they're addicted to excitement."

Short-termism and excitement addiction undermine your investment performance. You can subscribe to an evidence-based approach, the factors of which have been proven to work for decades (if not centuries), yet, you will most likely abandon it if you keep asking questions about the short-term performance. This is by no means an excuse in disguise to defend the FALCON Method since the last time I looked at the data (that was 20th November), our FALCON Portfolio had a time-weighted return that beat the S&P 500, the Dow Jones, the Russel 2000, and even the tech-laden Nasdaq. (Since inception, assuming an equal-weighted portfolio.) Do you know what conclusion I draw from these results? Absolutely nothing! This is a meaningless snapshot, just like looking at the score of a football match in the fifth minute. The odds are on our side, and you don't need these interim results to be confident of this. In fact, I would never use short-term performance to advertise the FALCON Method and get more subscribers as this would attract those types of people who would bombard me with questions only to give up on our systematic style of investing later on.

The best advice I can give you is to zoom out: forget your portfolio's daily, monthly, and even annual performance! Focus instead on the process and its underlying factors. Nothing spectacular will happen with the FALCON Method in the coming years, so seek entertainment and excitement elsewhere. "Investing shouldn't be about glamour," as Howard Marks puts it, and when he speaks, we all should listen. Buffett states, "When I see memos from Howard Marks in my mail, they're the first thing I open and read. I always learn something."

"Thoughtful investors can toil in obscurity, achieving solid gains in the good years and losing less than others in the bad. They avoid sharing in the riskiest behavior because they're aware of how much they don't know and have their egos in check. This, in my opinion, is the greatest formula for long-term wealth creation—but it doesn't provide much ego gratification in the short run. It's just not that glamorous to follow a path that emphasizes humility, prudence, and risk control. Of course, investing shouldn't be about glamour, but often it is." These thoughts from Howard Marks highlight how I aim to manage my investing operations along with the FALCON Method.

Look-Through EVA to Soothe the Nerves

Published in August 2022

> "In investing, just as in baseball, to put runs on the scoreboard one must watch the playing field, not the scoreboard." (Warren Buffett)

Since the turn of the year, market sentiment has changed dramatically. The upsurge in inflation, the consequent need to raise interest rates, and the ensuing risk of recession, coupled with the war in Ukraine, brought down global equity markets. The portfolios of superstar investors are anything but unaffected, so here's our chance to discover what they are focusing on when the fear is palpable around them. Spoiler alert: these guys don't disappoint when it comes to cool-headed rationality, so there's much to learn from them if you've caught yourself worrying about your investments lately.

Rob Vinall's Business Owner Fund lost 40.2% since the start of the year. In response, he intends to put the main focus of his first-half 2022 letter to investors on the development of the companies in the fund's portfolio and, in particular, whether their steep price declines are a function of a change in market sentiment or decreases in intrinsic value. The last time I checked, Terry Smith's Fundsmith was also down year-to-date (20%+ in dollar terms). In his latest letter to shareholders, he wrote: "Inflation, rising interest rates, and an increasingly likely recession have two obvious effects on equity investments; fundamental effects and valuation effects." Here's an important takeaway: separating sentiment change and fundamental business performance is crucial when evaluating results and making portfolio management decisions. So this is what we'll dive into.

As for how investors should track their portfolios' underlying business performance, Warren Buffett's 1991 letter has some useful suggestions: "investors can benefit by focusing on their own look-through earnings. To calculate these, they should determine the underlying earnings attributable to the shares they hold in their portfolio and total these. The goal of each investor should be to create a portfolio (in effect, a 'company') that will deliver him or her the highest possible look-through earnings a decade or so from now. An approach of this kind will force the investor to think about long-term business prospects rather than short-term stock market prospects, a perspective likely to improve results. It's true, of course, that, in the long run, the scoreboard for investment decisions is market price. But prices will be determined by future earnings. In investing, just as in baseball, to put runs on the scoreboard one must watch the playing field, not the scoreboard."

Crunching the numbers reveals that the EVA Monsters in the FALCON Method's investable universe fare remarkably well in terms of fundamental business performance. On the other hand, regarding valuation, not only did the former tailwind disappear, but a significant headwind materialized in short order. Assuming you invested $1,000 in all the 48 EVA Monster names at the end of 2019 (thus starting with an equal-weighted portfolio of $48,000), your portfolio's value would have skyrocketed to $84,400 by the end of 2021. That's 76% up, or a ~33% annualized return! A considerable part of that "insane rally" can be explained by the fact that your portfolio's look-through EVA grew 54% over those two years (or 24% annualized), while in NOPAT terms, the growth came in at 43% (a CAGR of ~20%). The appreciation part unexplained by the otherwise outstanding fundamental business performance comes from the valuation component. While our EVA Monsters traded at an average NOPAT yield of 3.1% at the end of 2019, this metric declined to 2.8% over the following two years, meaning that the shares of these quality companies became more expensive by the end of 2021 even after adjusting for their stronger business performance.

One could argue that the wackiest experiment in monetary policy drove interest rates to zero and created an environment where "fear of missing out" (FOMO) and "there is no alternative" (TINA) encouraged market participants to speculate to the point where valuations exceeded those of 1929 and 2000, but this point gets us nowhere, so let's keep focusing on the math that is quite telling. Retrieving the numbers near the end of July 2022 shows that your original end-of-2019 EVA Monster portfolio of $48,000 would be worth $62,800. (Had you opted for rebalancing at the end of 2021, your portfolio value would stand at $64,200.) Any way you look, the loss compared to the 2021 peak ($84,400) is painful. Let's see what's behind this decline! The original portfolio of 2019 saw its look-through EVA increase (!) 1% since the end of 2021, while the growth is 2.5% in NOPAT terms. Business fundamentals actually improved, if only slightly. (For the portfolio that was rebalanced at the end of 2021, look-through EVA grew 0.7%, and look-through NOPAT increased 2%.)

This number crunching made it glaringly obvious that, at this point, the change in the sentiment (or valuation) is responsible for the decline of our theoretical EVA Monster model portfolio's value. The average NOPAT yield climbed to 3.7% (from 2.8% at the end of 2021), while the Future Growth Reliance fell from 46% to 29%. Paraphrasing Terry Smith, it may seem little source of comfort at the moment, but our EVA Monster companies continued to deliver decent underlying business performance in the first half of 2022. "If these were our privately owned family businesses, we would still, for the most part, be applauding the growth they had delivered in much the same way as we were six months ago, albeit we might well be concerned about their ability to replicate this performance over the next couple of years." (Looking ahead, there can be temporary setbacks, but last month's "Supertrends vs. Business Cycles" piece is there to provide the right perspective.)

While we are not invested in privately owned family businesses, it is still the fundamental performance side that we must focus on. Looking at the playing field instead of the scoreboard makes me confident that the FALCON Method's EVA Monsters will perform relatively well over an inflationary and recessionary cycle. I claim no insight into how far the headwind to valuations caused by rising interest rates will go, but as long as we get the stock selection right by limiting ourselves to the best quality-growth names with seemingly unassailable moats, we will emerge with the intrinsic value of our investments maintained or enhanced. Sooner or later, share prices reflect fundamentals, not the other way around.

In his book Margin of Safety, Seth Klarman used a funny analogy when highlighting the difference between thoughtful investing and speculation: "There is an old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. The commodity traders bid them up, and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller said, 'You don't understand. These are not eating sardines, they are trading sardines.' Like sardine traders, many financial market participants are attracted to speculation, never bothering to taste the sardines they are trading."

Ignoring quality and value, attempting to pull off decades of compounding in a matter of months by mindless speculation is more likely to leave one poorer and with a horrible taste in the mouth. At the FALCON Method, we're not interested in trading sardines; we eat our own cooking and invest in the stocks we cover.

We are in this together, and with more than 90% of my liquid net worth invested in the stock market, I still sleep well at night. So should you if you put in the time to bring your understanding of our strategy to a level that corresponds with how heavily you are invested in the FALCON stocks. The key is to keep your eyes on the underlying business performance of the companies in your portfolio, not the wildly fluctuating stock prices. As you see, this is what renowned investors also do. In such periods when there's a palpable fear in the market, the likelihood of making successful long-term investments goes up dramatically. Our job is to pick the right businesses, and your part is to ride the waves up and down instead of trying to time the market. For me, this riding part comes easier with EVA Monsters I intend to hold through several business cycles, while Fallen Angel stocks often get me frustrated when the "I should have sold earlier" feeling creeps in. I still lose no sleep over such matters, though.

Absolutely no change here: we aim to assemble a portfolio of high-quality companies and hold onto them so that their inherent ability to compound in value will determine how we perform over the long term, not the vagaries of the market. (Look for the "eye-opening math example" in this article to see how reinvestment rates and profitability drive long-term results.) Ultimately, the compounding of our businesses will be reflected in our numbers; it just takes time.

Buybacks Undemonized

Published in May 2023

> "When you are told that all repurchases are harmful to shareholders or to the country, or particularly beneficial to CEOs, you are listening to either an economic illiterate or a silver-tongued demagogue (characters that are not mutually exclusive)." (Warren Buffett)

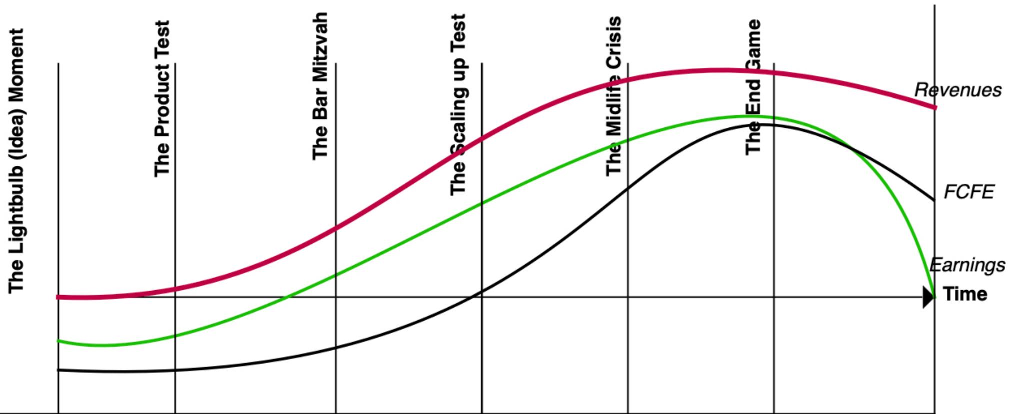
Warren Buffett rarely gets involved in political disputes. Even more rarely does he use harsh or judgmental language. His latest annual letter is an exception after President Biden's proposal to quadruple the tax on share repurchases shows intense hostility toward buybacks. The Oracle of Omaha is directly concerned, with Berkshire repurchasing ~10% of its stock over the past three years. Yet, he may have a point, as dividends and buybacks are perhaps the most misunderstood and misplayed elements in the corporate finance toolbox.

President Biden specifically criticized big oil companies for using record profits "to buy back their own stock, rewarding their CEOs and shareholders." I'm a facts-over-fallacies type of guy, so how about dissecting the anti-buyback arguments one by one? They say repurchases are used to hype stock prices artificially. The "Share Repurchases on Trial" study, published in January 2023, analyzes the stock returns of thousands of companies from 1988–2020, comparing those that repurchased shares against firms that didn't, adjusting for their size and other factors. Data shows, in the year when large or frequent buybacks were done, returns were lower (!) at those companies, while returns were indistinguishable over longer periods. A 1967 research came to similar conclusions.

They say already overcompensated CEOs use share repurchases to make themselves even richer. The S&P Dow Jones Indices data is thought-provoking: while the raw dollar amounts of buybacks have risen, as a percentage of the total value of the U.S. stock market, they have shrunk by almost half since 2007. The prior mentioned 2023 study also concludes that CEOs of companies doing buybacks don't earn noticeably more compensation than those at comparable companies that aren't repurchasing shares. On average, CEOs doing buybacks don't even earn 1% more in total pay. As Roger Lowenstein writes, "It is true that CEOs in diverse industries use buybacks to goose the stock with their (often ill-conceived) stock option packages in mind.

The problem is with the boards that approve such packages. […] But to penalize companies for repurchasing stock because doing so might boost the share price is insane. Would you penalize corporations for inventing new products, or selling more goods, or earning higher profits? They raise the share price, too.” And this brings us to our next points.

They say companies doing buybacks invest less in capital expenditures or research and development. This observation completely ignores the corporate life cycle theory, summarized on this Damodaran chart.



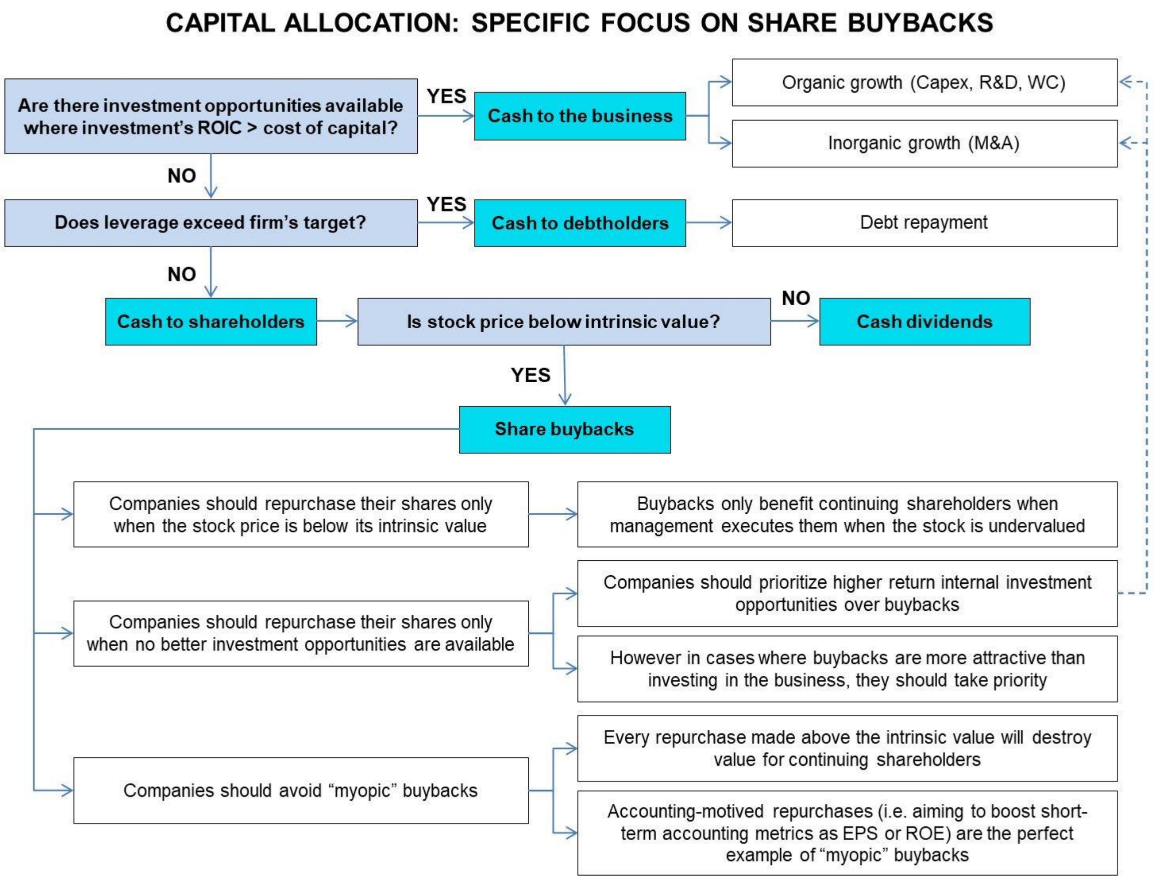
Lifecycle Stage	Start-up	Young Growth	High Growth	Mature Growth	Mature Stable	Decline
Earnings	Large net losses	Net losses narrow	Net profits turn positive	Net profits grow quickly	Net profits level off, with debt as wild card.	Net profits decline
Reinvestment needed for growth	Very High	High	Remain large, but scale down in percent.	Continue to decrease on scaled basis.	Low	Divestment (creating positive cash flows)
Debt cash flow (Debt issued - repaid)	Usually none	Usually none	If debt exists, net positive, but small.	Net debt cash flow positive.	Net debt cash flow neutal.	Net debt cash flow negative.
Free CF to Equity (Potential cash return)	Negative	May get more negative, with growth	Turns positive as growth slows	Positive & growing (faster than earnings)	Positive & more stable	Positive & higher than earnings.
Cash from/to Equity	Equity Issuances		Self-funding	Equity Buybacks	Dividends + Buybacks	Liquidating Dividends

Source: [Musings on Markets]

Although most of us could come up with anecdotal evidence seemingly contradicting this concept, [data does back it up]. “As companies mature, their growth opportunities dwindle and their business generates more cash than they need, making share repurchases an appropriate choice for the surplus. […] In general, it isn't that companies invest less because they're doing buybacks. It's that they do buybacks because they have less left to invest in." At the FALCON Method, we are well aware that some capital-light compounders may initiate buybacks earlier in their life cycles simply because their businesses cannot soak up the amount of cash they gush out. Others in the reinvestment moat subcategory of EVA Monsters often succumb to the pressure to return cash to shareholders and thus may opt for premature buybacks while EVA-positive projects are begging for corporate capital. One should evaluate this on a case-by-case basis instead of a broad generalization.

They say buybacks starve companies of capital they could deploy to grow, benefiting the economy and society. This is essentially the previous argument dressed somewhat differently, and thus still misses the fact that investing in bad businesses, just for the sake of investing, is not good for anybody. Back to Lowenstein: "Pressuring companies to retain unwanted capital would be like pressuring firms to keep their capital in rotary phones." Also, this critique basically implies that the same management we shouldn't trust to allocate excess capital correctly in a buyback will allocate it superbly for other purposes. History tells us otherwise. Even "big oil," lambasted by President Biden, is guilty of squandering capital when they had vastly more of it than they could plow back into their existing wells. (Exxon bought an electric-motor maker and invested in futuristic office equipment, while its then-rival Mobil Oil acquired a company that made cardboard boxes and ran the Montgomery Ward department-store chain. Unsurprisingly, all these ventures flopped.) Oodles of surplus cash tends to burn a hole in the typical CEO's pocket. My favorite "diworsification" examples are well summed up in Warren Buffett's 1996 letter: "Would you believe that a few decades back they were growing shrimp at Coke and exploring for oil at Gillette?"

Of course, there are situations when excessive buybacks go terribly wrong. (Bailed-out banks and airlines come to mind.) Paraphrasing Buffett, economic literates know that moat-maintaining/enhancing investments are non-negotiable. No amount of financial engineering will save a company that loses focus and/or underinvests in its core competencies. Intel and IBM serve as excellent examples. Yes, several companies lit billions of dollars on fire by ill-suited repurchases, but lawmakers, journalists, and investors shouldn't generalize. Buybacks are neither bad nor good; they are just a tool, useful in the right hands and dangerous in the wrong ones. Take a look at Josh Wolfe's flowchart (based on Michael Mauboussin's work) and see how capital allocation decisions should come down to the question: where's the next dollar best applied? (As written in the February 2019 opening piece of this newsletter.)



Source: https://twitter.com/wolfejosh

Buybacks don't create value, just redistribute it, period. No additional EVA is produced, meaning we are essentially slicing up the same cake somewhat differently. Of course, a shrinking share count increases per-share EVA and thus affects remaining shareholders, yet the company as a whole doesn't become more valuable as a result of share repurchases.

Data undeniably shows that U.S. firms have moved away from dividends toward buybacks as their primary mode of cash return. This shift may be driven by the recognition that earnings and cash flows have become more volatile (even at mature companies), and dividends are sticky while buybacks can be flexible. On the one hand, a dividend payment is often regarded as a promise for the future, so once initiated and set, it is difficult for companies to suspend or cut dividends without a backlash. On the other hand, repurchasing shares is an option that can be used as a benchmark to assess other capital allocation opportunities. Starbucks' founder Howard Schultz illustrates this point perfectly: "Returns on our digital investments are consistently among the highest returns we generate, which brings us to the decision we will revisit in fiscal '23 to suspend stock buybacks. Buying back stock yields us, on average, about a 10% return. With Starbucks' treasure trove of global assets, a 10% return is not satisfactory to me."

Buybacks should remain a weapon in the capital allocation arsenal, and penalizing share repurchases would have pernicious consequences for efficient capital allocation throughout the economy by impairing how markets function. Just as the government doesn't try to legislate (encourage or discourage) stock issuance, nor should it get into the business of regulating repurchases. These are mirror images of the same transaction.

As Aswath Damodaran concludes, "the most vehement criticism of buybacks come from people who least understand business or markets, and the legislative solutions they craft reflect this ignorance. Taxing buybacks because you are unable to raise corporate tax rates may be an effective revenue generator for the moment, but pushing that rate up higher will only cause the cash return to take different forms." (If buybacks get heavily taxed, it's not hard to foresee special dividends gaining ground as a means of flexible and "not too tax disadvantaged" way of returning capital to shareholders.)

For the facts-over-fallacies type like me, here's a collection of the best reads on the topic. As a closing, from the Share Repurchases on Trial study: "We find no evidence that CEOs of repurchasing firms are paid excessively or that repurchases crowd out valuable investment opportunities. Because repurchases do not appear to be systematically abusive, enforcement action should be sufficient to deal with any bad actors, and significant regulation seems unwarranted." Let's hope that sanity prevails over political grandstanding.