EQUITY STRATEGY AMERICAS

Equity Strategy

JEF's SMID-Cap Study—Buybacks & dividends rising, number of US stocks falling

Key Takeaway

We continue to emphasize that balance sheets are in great shape and thus M&A activity has really picked up. We have also seen a pickup in the number of companies reducing shares outstanding and paying dividends. Stocks that reduce shares and pay a dividend tend to outperform, and buybacks along with cheap valuations really outperforms. We have seen a reduction in the number of companies going public; this is the lowest number of companies since 1984.

The universe of US stocks and their float continues to dwindle thanks to a strong pick up of M&A coupled with very clean balance sheets, low interest rates, and access to the capital markets helping boost buybacks and dividend payments. We think this has real implications for active managers, as it seems investors are crowding into fewer names and trading volume has fallen, making it much more difficult to add or reduce positions. Currently, there are just 3,267 stocks in the University of Chicago's CRSP data, and this is the lowest since 1984. We have also seen over 31% of small caps reduce shares outstanding over the last year, and since 2011, large-cap companies have lowered their shares outstanding. Thus, we think this makes it tough for active managers to differentiate themselves and trade stocks.

Why reduce shares? It boosts performance

Companies that are in the drivers seat and able to use their cash to reduce shares outstanding have been able to help boost their stock price over time. Companies that reduce shares outstanding have returned 14.1% annually versus 6.7% for those that have increased shares or kept them stable, while the overall universe has risen 9.2%. Buybacks have added alpha this year; however, that has not been the case since the market bottomed in February (-3.6% relative) due to higher-beta outperforming.

Who are reducing shares—everyone except Energy and Health Care

Reducing shares outstanding has become all the rage, and it has been suggested to us that companies should forget their bond ratings, borrow as much as possible at very low interest rates, and reduce shares outstanding. We see some validity in this statement given how clean balance sheets are, the fact that capital markets remain wide open, and the cost of capital is cheap. Currently, 31% of small-cap companies have reduced their shares outstanding versus the average of 20% and peak level of 33.3% back in April 2000. In every sector, companies that reduce shares outstanding have outperformed those that do not. The biggest difference between the two occurred in Info Tech with those that reduced shares returning 16.1% annually versus 6.0% for companies that were flat or increased shares.

Do not overlook dividends—look outside the usual suspects

So far this year, dividend payers have swamped the non-payers but this is not just a 2016 phenomenon. Over time, companies that have paid a dividend have outperformed those that did not at 11.7% versus 6.0%. The relative performance of dividend payments has been lumpy based on market sentiment versus the consistency we see with buybacks.

Unsurprisingly, Financials, Real Estate, and Utilities have the highest percentage of dividend payers. Materials comes in fourth with 59.5% of names paying and a spread between payers and non-payers of 8.3%. Dividend paying Health Care stocks had the greatest return at 15.8%, and we suggest avoiding non-paying Utilities, which had a -3.3% annual return.

Adding buybacks to dividends helps—buying cheap really helps

We decided to put the two factors together and found that stocks that pay a dividend and reduce shares deliver better performance than just paying a dividend at 13.0%. However, this still falls a bit short versus straight buy backs.

Even better is finding stocks that are very cheap on E/P and reducing shares outstanding, as they have jumped nearly 20% versus stocks that kept share count constant or increased and were very expensive at just 0.6%.

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^Prior trading day's closing price unless otherwise noted.

Buybacks and dividends payoff in small

Buybacks and dividends have been scrutinized by numerous folks however it does help boost share price and with cost of capital cheap and easily accessible, we see this trend continuing.

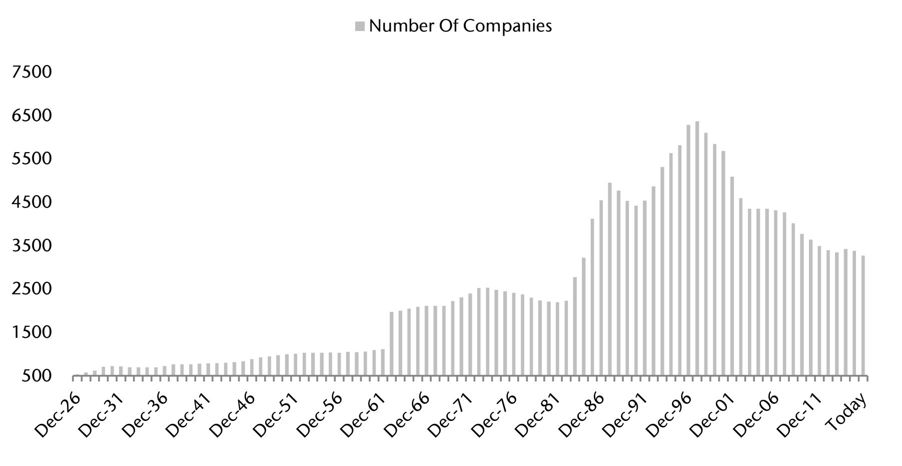
As we highlighted in our "Theme #5: M&A Activity is set to heat up" report, balance sheets are in great shape and we think companies have access to the capital markets (Theme #5 M&A Activity Picks Up). M&A is running at a record pace in small caps so far this year, but companies have other alternatives to use their cash as well. Companies can reduce shares outstanding and/or pay dividends. Inside of small caps, we have seen a real pick up in both of these strategies lately, but they have received much press over the years with not so glowing remarks. The criticism stems from the fact that buybacks and dividends do not create additional jobs and only boost stock prices and line the pockets of investors, including the management of the company. However, we do see that reducing shares outstanding and/or paying dividends do pay off in terms of delivering better performance in this size segment. Given that it does help performance, balance sheets are clean, companies can access capital, we see this continuing and is an overall positive for the market.

The US equity market is shrinking

Between the lack of IPO activity, the pick-up of M&A, and buybacks, the US equity world is becoming smaller and smaller, and this could be one of many reasons why active managers are lagging behind their indexes. Companies may not want to come public due to the additional cost of Sarbanes-Oxley or the fact that the private market has become a bigger source of financing than it has been in the past. It could be that investors are chasing the same stocks and are therefore unable to differentiate themselves much nor have access to enough liquidity. However, we will examine why managers are lagging more in detail at a later date. Just looking at the number of stocks in the US, we see that the University of Chicago's CRSP deciles 1-10 has just 3267 names, barely enough to fill out the Russell 3000 (Chart 1). The number of stocks has nearly been cut in half since 1997 when this figure peaked out at 6364. This is the fewest stocks in this universe since 1984.

The US equity market continues to slim down and is nearly half that of its peak. Today, "just" 3267 stocks reside in the CRSP deciles 1-10 compared to its peak in 1997 at 6364 names.

Chart 1: Number of stocks in CRSP data lowest since 1984.



Source: Center for Research in Security Prices (CRSP®), The University of Chicago Booth School of Business; Jefferies.

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The float in large caps has also been reduced

We also see that overall liquidity in the large caps has been reduced by the percentage change in shares outstanding. Over the last six years, including 2016, we have seen small reductions in the shares outstanding in the Russell 1000 when historically the index has averaged an increase of 1.3% (Table 1). However for the Russell 2000, we have seen an increase in shares outstanding in each year since 1997. This year the increase has been 2.1%, much less than the average of 4.8%.

The total shares outstanding have been reduced in each of the last six years in large caps, whereas small caps continue to increase their share count.

Table 1: Percentage change in total shares outstanding of index constituents.

	% Change In Shares		
	Russell 3000	**Russell 1000**	**Russell 2000**
2016	0.2	-0.3	2.1
2015	0.6	-0.5	4.9
2014	0.6	-0.5	5.4
2013	0.4	-0.9	6.0
2012	0.8	-0.2	5.4
2011	0.2	-0.7	4.6
2010	2.1	1.1	6.5
2009	4.6	4.4	5.9
2008	3.4	3.4	3.2
2007	-0.7	-1.4	2.7
2006	0.6	0.0	3.6
2005	1.4	0.6	4.9
2004	2.5	2.1	4.3
2003	2.4	1.6	6.5
2002	2.1	1.8	4.1
2001	3.3	3.0	4.9
2000	3.6	3.4	4.5
1999	3.9	3.6	5.2
1998	4.4	3.8	5.6
1997	2.9	2.3	5.4
Average	**2.0**	**1.3**	**4.8**

Source: FactSet Research Systems; Russell Investment Group; Jefferies

Small-cap companies are increasingly reducing shares outstanding, paying dividends, or doing both.

More small caps reducing shares, paying dividends

Given the amount of cash parked on company balance sheets and the fact that it is earning nearly zero, companies have been doing the right thing and returning it back to shareholders in the form of buybacks and dividends. Looking at the percentage of companies that are reducing shares, paying dividends, and doing both, we found that we are near all-time highs and above the historical average on all three measures. Currently, 31% of names have reduced shares outstanding over the last year versus the historical average of 20.5% (Chart 2). We also see just over 43% of companies in the Russell 2000 are now paying a dividend, the highest since May 1996, compared to the historical average of 39.3% (Chart 3). When we combine the two, reducing shares out and paying a dividend, we see that almost 17.5% of the Russell 2000 constituents are doing both, whereas only 10.9% have done so on average historically (Chart 4).

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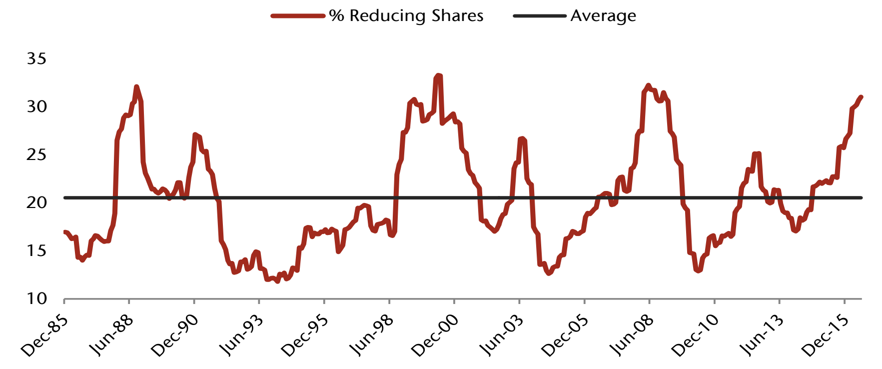
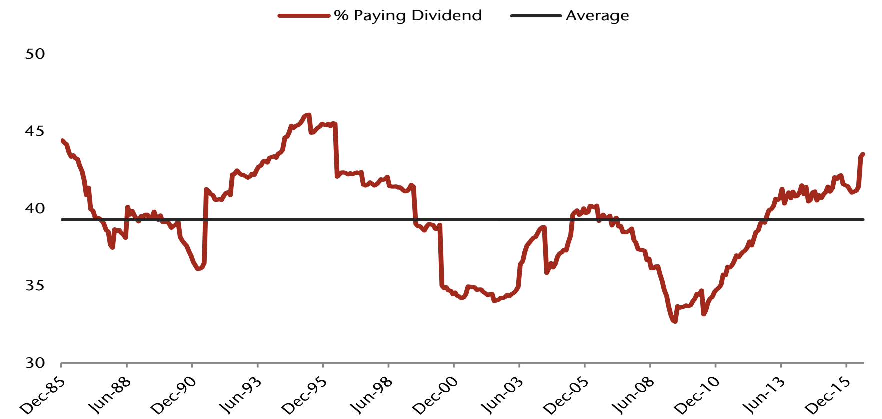
Chart 2: Percentage of companies reducing shares is near all-time highs…



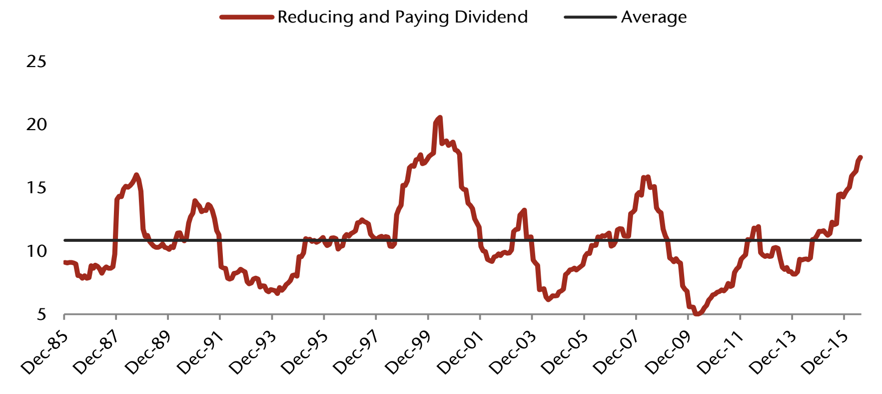
Source: FactSet Research Systems; Russell Investment Group; Jefferies

Chart 3: …And companies paying a dividend has spiked over last few months



Source: FactSet Research Systems; Russell Investment Group; Jefferies

Chart 4: The percentage of companies doing both is also nearing new highs



Source: FactSet Research Systems; Russell Investment Group; Jefferies

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Info Tech seeing increases in buybacks & dividends

Our overweight sectors of Discretionary, Industrials, and Tech have been substantially reducing shares outstanding, paying a dividend, or doing both.

Looking across the sectors at who have become better capital allocators, we find it interesting that the groups we are overweight (Discretionary, Industrials, and Tech) have been reducing share count and paying dividends (Please see JEF's Sector Allocation).

- Tech is seeing the highest increase over its historical average in terms of percentage of companies paying a dividend or both paying a dividend and reducing shares.
- Discretionary has the highest percentage of companies reducing shares outstanding at nearly half of its companies and 22% are doing both.
- Industrials is a close second in terms of buyback activity, almost half are paying dividends, and a quarter are doing both.
- Of course Real Estate has the highest percentage paying a dividend and over 20% have reduced shares out over the last year.
- Given how cash strapped Energy is these days, it is no surprise that less than 10% of its names have reduced shares outstanding, but we still see 28.6% of the names pay a dividend and this is up from its long-term average.
- Health Care also needs cash and thus buybacks are below average at a measly 9.2% and companies paying a dividend is even less than that at 6.3%.
- Almost 30% of Financials have reduced shares and paid a dividend and this is 28.5% above its norm.
- Although part of our underweight to Materials is that balance sheets still need repair, 27.8% of its names pay a dividend and have reduced shares out over the last year.

Table 2: Tech is seeing a big pick up of buybacks and dividend payments; not the case for Health Care

	% Reducing Shares			% Paying Dividends			% Reduce Shares & Paying Dividends		
GICS Sector	**Current**	**Average**	**% Difference**	**Current**	**Average**	**% Difference**	**Current**	**Average**	**% Difference**
Discretionary	47.7	26.8	78.1	37.3	32.2	15.7	22.0	11.8	85.8
Staples	32.3	24.2	33.2	46.8	52.7	-11.2	19.4	15.5	24.9
Energy	9.5	12.7	-25.3	28.6	23.9	19.5	4.8	4.7	0.4
Financials	36.3	28.9	25.4	78.1	73.5	6.2	29.7	23.1	28.5
Health Care	9.2	10.9	-15.5	6.3	10.5	-39.8	2.0	2.5	-18.8
Industrials	45.2	23.6	91.3	49.4	44.3	11.7	25.1	13.8	82.0
Info Tech	31.4	17.0	84.1	19.0	11.8	60.2	9.2	3.5	164.4
Materials	38.0	24.1	57.3	59.5	56.6	5.0	27.8	17.4	60.3
Real Estate	20.8	12.9	60.3	91.5	81.8	11.9	18.9	9.6	96.8
Utilities	18.5	12.0	53.4	69.2	65.7	5.4	12.3	7.0	76.2
Russell 2000	**31.0**	**20.5**	**51.2**	**43.5**	**39.3**	**10.8**	**17.4**	**10.9**	**60.4**

Source: FactSet Research Systems; Russell Investment Group; Jefferies

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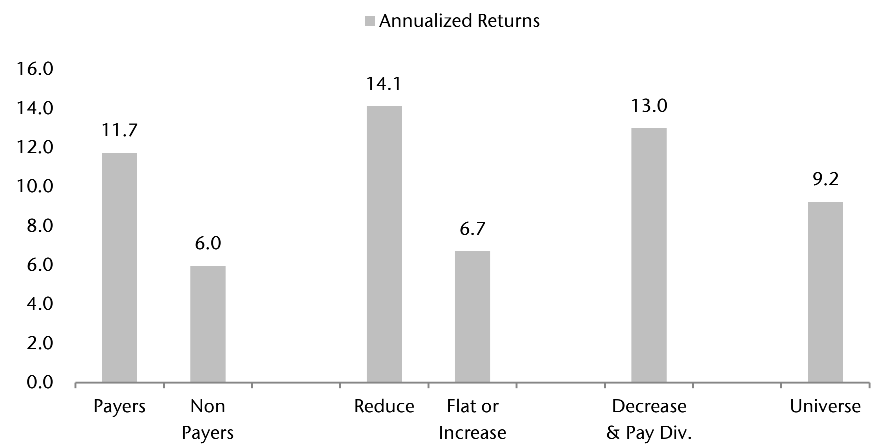
Buybacks is the best capital allocation factor

So why do companies reduce shares or pay dividends? Because it boosts performance! Looking at annualized returns, we see that companies that made shareholder distributions outperformed their non-distributing peers whether in the form of dividend payments, reducing shares via buybacks, or both. Interesting is the fact that buybacks have tended to perform best with an annualized return of 14.1% versus the universe at 9.2% (Chart 5). We see that dividend strategies also payoff with an annualized return of 11.7% versus non payers at 6.0%. When we put the two factors together, we found better performance than just yield at 13.0% but slightly lower than buybacks. We also found that buybacks seem to deliver consistent results versus dividend payments (Chart 6).

Buybacks are the king of the capital distribution factors with dividends also producing solid returns.

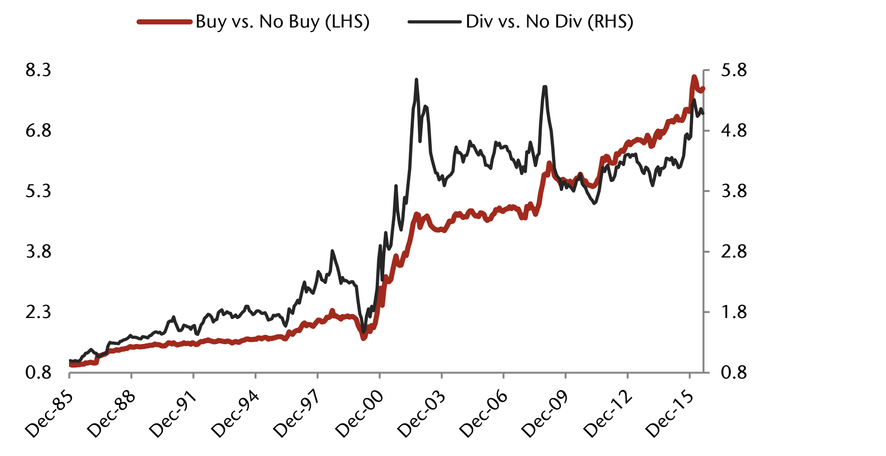
Chart 5: Buybacks and dividend payers beat the universe...



Source: FactSet Research Systems; Russell Investment Group; Jefferies

Dividend payers have had some fits and starts in terms of relative performance but buybacks have generally outperformed.

Chart 6: ...With buybacks delivering more consistent performance



Source: FactSet Research Systems; Russell Investment Group; Jefferies

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Reducers are an all-weather beater

We looked at the performance by the different buckets annually, in up markets and in down, as well as when returns were weak and when they were solid (Table 3). The interesting thing to us is that companies that reduced shares outstanding won in all types of markets. They held up better when small caps were down and even when they were up along with periods when performance was below median and when it was above (Charts 7 and 8). Dividend payers give investors more downside protection but lagged by a slim margin when the market was up and when it was up strong. As for buybacks and payers, they were very solid in downturns and held tough when the market rallied.

Annual performance by the factors versus the overall universe.

Table 3: In most down years, payers and reducers tend to hold up best

Year	Payers	Non-Payers	Reduce	Flat or Increase	Reduce & Pay	Universe
1986	12.3	-5.1	7.6	1.9	11.2	5.7
1987	**-4.8**	**-12.6**	**9.7**	**-13.3**	**-1.1**	**-8.8**
1988	30.4	21.2	30.9	22.2	31.2	25.0
1989	13.0	8.4	13.1	9.6	12.9	16.3
1990	**-17.9**	**-31.2**	**-23.5**	**-26.9**	**-17.6**	**-19.5**
1991	41.2	53.8	46.9	49.5	47.4	46.0
1992	25.9	19.3	24.4	20.9	23.4	18.4
1993	19.4	13.6	17.0	16.0	18.0	18.9
1994	**-0.4**	**-3.9**	**0.2**	**-3.0**	**2.4**	**-1.8**
1995	25.5	30.1	31.6	26.9	30.7	28.5
1996	24.1	9.0	24.5	13.7	23.8	16.5
1997	36.4	10.3	34.7	18.2	41.5	22.4
1998	**-4.1**	**-2.9**	**-0.8**	**-3.5**	**-1.2**	**-2.5**
1999	-3.7	32.4	5.5	21.4	-5.3	21.3
2000	**17.4**	**-28.0**	**16.0**	**-24.8**	**16.1**	**-3.0**
2001	22.9	12.8	33.6	11.7	28.1	2.5
2002	**4.0**	**-34.7**	**-3.9**	**-26.5**	**11.2**	**-20.5**
2003	38.2	71.3	54.4	60.7	35.2	47.3
2004	22.4	15.8	24.9	17.0	21.2	18.3
2005	3.5	1.6	3.7	2.0	1.4	4.6
2006	21.9	17.2	21.2	18.4	20.0	18.4
2007	**-12.5**	**-3.7**	**-10.1**	**-6.3**	**-14.4**	**-1.6**
2008	**-26.2**	**-45.0**	**-28.9**	**-42.5**	**-20.6**	**-33.8**
2009	15.4	65.5	43.0	47.8	17.7	27.2
2010	27.1	29.7	27.7	29.4	26.6	26.9
2011	**-1.6**	**-12.2**	**0.9**	**-10.3**	**0.5**	**-4.2**
2012	19.2	14.4	21.7	14.8	20.5	16.3
2013	36.7	46.7	44.0	42.4	37.6	38.8
2014	5.7	0.6	8.0	1.4	9.7	4.9
2015	**-2.7**	**-10.6**	**-4.6**	**-7.8**	**-3.0**	**-4.4**
2016	12.0	3.5	13.0	4.8	12.9	8.3
Annualized	**11.7**	**6.0**	**14.1**	**6.7**	**13.0**	**9.2**

Source: FactSet Research Systems; Russell Investment Group; Jefferies

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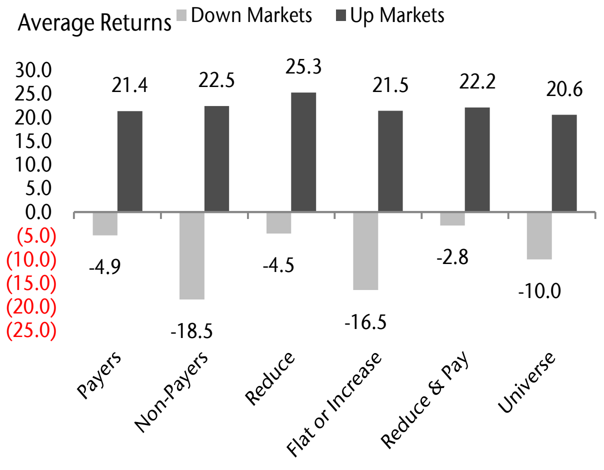
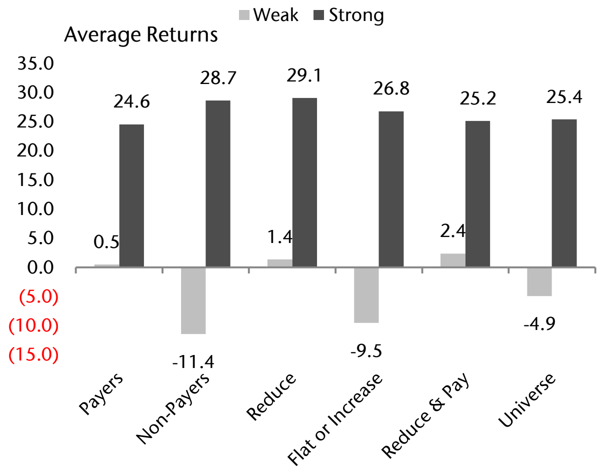
Chart 7: Share reducers win in up and down markets...



Source: FactSet Research Systems; Russell Investment Group; Jefferies

Chart 8: ...Along with weak and strong



Source: FactSet Research Systems; Russell Investment Group; Jefferies

All sectors benefit from buybacks and dividends

At the sector level:

- Dividends are important in Energy and Utilities.
- Companies that reduce shares out in Health Care and Tech have gained over 16% annually.
- In Real Estate, dividends matter more than buybacks.
- Buybacks and dividends are good differentiators in Materials.

Looking across the individual sectors at buybacks and dividend payers, we see that both of these factors work well on all of the groups.

- **In Discretionary**, reducing shares was a better strategy than dividend payers with the spread fairly narrow between payers and non-payers.
- **Staples** that both reduced shares and pay a dividend only marginally did better than those names that just paid a dividend.
- We saw a large difference between **Energy** companies that paid a dividend and those that did not.
- The best return in **Financials** was delivered by those names that both reduced shares and paid a dividend at 13.3%.
- Companies that reduced shares outstanding in **Health Care** gained 16.6% annually and those that paid a dividend gained 15.8% versus the sector's return of 10.1%.
- We saw a big spread between names **in Industrials** that reduced shares and those that did not or issued stock at 15.7% versus 6.5%.
- Reducing shares is certainly the way to go in **Tech**, as these stocks rose 16.1% versus those that did not gaining just 6.0%, while reducers and payers rose 15.5%.
- We saw fairly consistent spreads between buyback\non-buyback and payers\non-payers in **Materials** at 9.2% and 8.4%, respectively.
- We did not get much alpha in **Real Estate** from buybacks but names that did not pay a dividend only gained 4.2%.
- **Utilities** that failed to pay a dividend actually lost 3.3%, while those that did gained nearly 13% and the overall return was enhanced if a stock both paid a dividend and reduced shares at 15.4%.

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Buybacks and dividend payers work across all small-cap sectors.

Table 4: Annualized performance by GICS sector for firms participating in shareholder distributions.

							Annualized Performance (In %)		
GICS Sector	**Reduce**	**Flat or Increase**	**Overall**	**Payers**	**Non-Payers**	**Overall**	**Reduce + Pay**	**Everyone Else**	**Overall**
Discretionary	10.9	4.0	6.3	9.0	4.7	6.3	11.1	5.8	6.3
Staples	14.8	9.6	10.8	12.7	8.6	10.8	14.5	10.3	10.8
Energy	7.4	3.3	3.8	10.7	1.9	3.8	9.8	3.7	3.8
Financials	11.9	7.5	8.8	11.3	2.9	8.8	13.3	7.6	8.8
Health Care	16.6	9.3	10.1	15.8	9.6	10.1	14.5	10.1	10.1
Industrials	15.7	6.5	8.7	11.6	6.2	8.7	12.7	8.0	8.7
Info Tech	16.1	6.0	7.2	12.5	6.7	7.2	15.5	7.1	7.2
Materials	15.6	6.4	9.1	12.5	4.1	9.1	15.1	7.2	9.1
Real Estate	10.4	8.8	9.0	10.2	4.2	9.0	10.6	8.8	9.0
Utilities	13.8	5.5	6.8	12.9	-3.3	6.8	15.4	6.1	6.8
Russell 2000	**14.0**	**6.2**	**9.2**	**11.6**	**5.3**	**9.2**	**12.9**	**7.3**	**9.2**

Source: FactSet Research Systems; Russell Investment Group; Jefferies

Cheap and reducing is an even better strategy

Being cheap and reducing shares outstanding delivered a gain of nearly 20%, while expensive and increasing or keeping shares constant barely broke even.

In an effort to boost buybacks, we looked across valuations looking at forward E/P and found that stocks that are really cheap and reducing shares outstanding gain nearly 20% versus the universe's return of 9.2% (Table 5). Those names that reduced shares and sat in Q2 based on valuations delivered a gain of 13.5%, nearly the same as those stocks that kept share count constant or increased but sat in Q1. Stocks that were very expensive and increased or kept shares constant barely broke even over the backtest period.

Table 5: Enhance buybacks by adding cheap to the criteria

FY1 E/P	**Decrease**	**Flat or Increase**
Q1 (Highest)	19.8	13.4
Q2	13.5	10.6
Q3	12.3	8.4
Q4	11.9	7.7
Q5 (Lowest)	4.2	0.6
Russell 2000	**9.2**	**–**

Note: FY1 E/P series starts from September 30, 2001.
Source: FactSet Research Systems; Russell Investment Group; Jefferies

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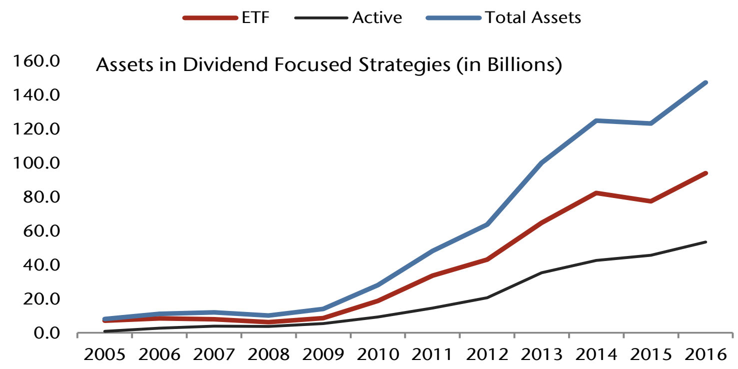
Everyone wants dividends, even in small caps

Assets have poured into dividend related strategies in small caps with nearly $150 billion dedicated to the strategy.

Although one does not associate small caps with income, we have seen investors pour money into dividend related strategies in this size segment especially the ETFs. Assets have grown to $147.5 billion as of June 30 from just $11.2 billion back at the end of 2006 (Chart 9). As with anything related to flows and growth, the biggest driver the pick-up has been ETFs with assets now standing at $94.1 billion versus just $8.4 billion in 2006.

Chart 9: Assets in dividend strategies in small caps have risen dramatically



Note: 2016 is as of June 30.
Source: EPFR; Jefferies

Dividend payers/reducers in SMID; 17 on screen

Given the strength in performance by those stocks that reduce shares and pay a dividend, we looked across our coverage universe here at Jefferies and found 17 Buy rated names that fit our criteria. We also wanted the stock to fit two other themes of ours—domestically oriented and higher quality. Of the 17 stocks, 11 are from our Overweight groups of Discretionary, Industrials, and Info Tech (Table 6).

Table 6: 17 Buy rated SMID Caps pay a dividend, reduced shares, and fit our domestic and quality themes

Ticker	Name	Price	Market Cap	Dividend Yield	Sector	Analyst
FL	Foot Locker	65.64	8,876.3	1.7	Consumer Discretionary	Randal J. Konik
AEO	American Eagle Outfitters	18.54	3,375.3	2.7	Consumer Discretionary	Randal J. Konik
SMP	Standard Motor Products	44.81	1,012.7	1.5	Consumer Discretionary	Bret Jordan
LAD	Lithia Motors	82.77	1,910.9	1.2	Consumer Discretionary	Bret Jordan
NXST	Nexstar Broadcasting	52.72	1,601.3	1.8	Consumer Discretionary	John Janedis
DF	Dean Foods	17.21	1,546.2	2.1	Consumer Staples	Akshay Jagdale
FLO	Flowers Foods	14.91	3,119.6	4.2	Consumer Staples	Akshay Jagdale
FII	Federated Investors	32.30	3,346.0	3.1	Financials	Surinder Thind
HBAN	Huntington Bancshares	10.01	10,730.3	2.8	Financials	Kenneth Usdin
OA	Orbital ATK	75.43	4,449.2	1.6	Industrials	Howard A. Rubel
OSK	Oshkosh Corp	53.93	3,989.5	1.4	Industrials	Stephen Volkmann
FBHS	Fortune Brands Home	63.56	9,797.4	1.0	Industrials	Philip Ng
KAR	KAR Auction Services	42.28	5,816.8	2.8	Industrials	Bret Jordan
MMS	MAXIMUS, Inc.	58.82	3,835.1	0.3	Information Technology	David Styblo
SAIC	Science Applications Int'l	63.81	2,858.9	1.9	Information Technology	Amit Singh
GPK	Graphic Packaging	14.34	4,617.6	1.4	Materials	Philip Ng
PKG	Packaging Corp. of Amer.	78.63	7,483.8	2.8	Materials	Philip Ng

Source: FactSet Research Systems; Russell Investment Group; Jefferies

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Investment Recommendation Record

(Article 3(1)e and Article 7 of MAR)

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- American Eagle Outfitters, Inc. (AEO: $18.57, BUY)
- Dean Foods Company (DF: $17.10, BUY)
- Federated Investors, Inc. (FII: $32.45, BUY)
- Flowers Foods, Inc. (FLO: $15.08, BUY)
- Foot Locker, Inc. (FL: $65.60, BUY)
- Fortune Brands Home & Security, Inc. (FBHS: $63.66, BUY)
- Graphic Packaging Holding Company (GPK: $14.47, BUY)
- Huntington Bancshares Incorporated (HBAN: $9.89, BUY)
- KAR Auction Services, Inc. (KAR: $42.17, BUY)
- Lithia Motors, Inc. (LAD: $81.66, BUY)
- Maximus (MMS: $59.10, BUY)
- Nexstar Broadcasting Group, Inc. (NXST: $52.18, BUY)
- Orbital ATK (OA: $75.98, BUY)
- Oshkosh Corporation (OSK: $54.29, BUY)
- Packaging Corp of America (PKG: $79.42, BUY)
- SAIC (SAIC: $63.78, BUY)
- Standard Motor Products, Inc. (SMP: $44.58, BUY)

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			IB Serv./Past 12 Mos.	
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BUY	1094	52.29%	323	29.52%
HOLD	840	40.15%	165	19.64%
UNDERPERFORM	158	7.55%	19	12.03%

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