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Long-run returns following open market share repurchases

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Abstract

Past studies find abnormal returns to buying after repurchase program announcements. We analyze the profitability of trading after both program announcements and individual repurchase trade publication using different trading strategies – market and limit orders. The analysis of trades is possible because of a unique Canadian data set. The highest abnormal returns are earned by companies on their own repurchase trades which benefits the non-tendering shareholders. For the public investor, we find no strategies that, in practice, would earn abnormal returns to buying after program announcements. However, there is qualified evidence of abnormal returns to a limit order strategy following publication of individual repurchase trades.

JEL classification: G14; G35

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1. Introduction

Past studies have documented abnormal long-run rates of return following repurchase program announcements (Ikenberry et al., 1995, 2000; Chan et al., 2004). Those studies

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conclude that repurchasing companies' stocks are undervalued and that the market's reaction to the program announcement is "biased and incomplete" – the market ignores information implicit in the announcement.[1] The market's reaction to the announcement can only be judged to be incomplete if investors fail to take advantage of real opportunities – opportunities that are profitable net of transaction costs. Past studies base their conclusions on simulated trading strategies which ignore transaction costs. In this study, we analyze the profitability of trading after both program announcements and individual repurchase trade publication using different trading strategies – market and limit orders. We incorporate realistic estimates of trading costs.

The inclusion of transaction costs is critical when estimating returns using historical price data, because an investor cannot normally execute trades at those prices. For example, Mitchell and Pulvino (2001) estimate returns to a strategy of buying acquisition targets. They calculate returns of 16.05% without adjusting for transaction costs, but only 10.64% after adjusting for those costs. Our results reveal evidence of abnormal profits following repurchase announcements when transaction costs are ignored, but no evidence of abnormal returns when transaction costs are included.

The second contribution of the paper is that it is the first to measure the return earned by the firm on its own purchases and the returns outside investors might earn by replicating the firm's purchases. It is possible to compute these returns because Canadian regulations, unlike those in the US, require companies to disclose details of their repurchase trades (price, quantity, timing). We find that firms' purchases exhibit abnormal returns which means that non-selling shareholders profit from their firms' repurchasing as hypothesized by Barclay and Smith (1988). We also measure the return to several strategies of replicating the company's trades after they are publicly announced and find that market order strategies are generally unprofitable after accounting for transaction costs.

The third contribution of the paper is the analysis of the performance of limit order strategies.[2] This is the first market efficiency study, of which we are aware, that computes long-run returns based on limit order strategies. Limit orders have less price impact than market orders. Another advantage of limit orders is that they can be conditioned on the price paid by the firm in its repurchase trades. We compute the abnormal buy and hold returns to a limit order strategy of buying after program announcements (at the pre-announcement price) and after repurchase trade announcements (at the repurchase price). We find no abnormal returns to the strategy following program announcements and some evidence of abnormal returns following trade publication. The latter finding is qualified by the fact that we do not incorporate the cost of non-execution in computing returns.

This paper has five sections. Section 2 presents an overview of abnormal long-run return estimators. Section 3 describes our data. Section 4 presents four estimates of abnormal long-run returns following repurchase program announcements. Section 5 presents estimates of the abnormal long-run returns earned by the firm on its repurchase trades, as well as estimates of the abnormal returns earned by an outsider who tries to replicate the firm's purchases. Section 6 presents the conclusions.

[1] Chan et al. (2004, p. 17).

[2] We thank an anonymous referee for the suggestion of examining limit order strategies.