The Daily Dish

Some Financial Market Economics

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Eakinomics: Some Financial Market Economics

Let us take a firm step into fantasy and assume that Eakinomics is a profit-making endeavor. Specifically, let us imagine that it has $100 million in the bank, will make $200 million this year (which means you, the reader, is paying something — hint), will make $210 million next year, and will then shut down (don't get your hopes up!). To make the math easy, assume that the one-year interest rate is 5 percent, which means that the $210 million next year is worth $200 million this year (because if you deposit $200 million now, you end up with $210 million next year).

So, what is Eakinomics worth? Specifically, if I decide to sell 100 shares, what would each be worth? The logic is simple. If I sell the 100 shares as ownership of Eakinomics, the 100 shares entitle the holders to the value of Eakinomics. As noted above, if you own Eakinomics then you own the $100 million in the bank plus the earnings this year ($200 million) and next ($210 million — worth $200 million this year). Doing the math, the 100 shares permit claims on $500 million of value, or $5 million per share.

All good. But now let us imagine that Eakinomics decides to buy back 50 shares. What happens? First, the management of Eakinomics (me) has to shell out $250 million to buy back the shares. But at that same time, I have depleted the $100 million of current cash and another $150 million of this year's earnings. What happens at the end? The holders of of the remaining 250 shares have a claim on $50 million in this year's earrings and $210 million (worth $200 million) in future earnings. That is, 50 shares with a claim on $250 million — $5 million per share.

The point here is powerful and very simple. The financial transaction does not change the fundamental value ($5 million per share). It simply re-arranges who gets their money now and who gets their money later. If you want to sell, you get the money now. If you don't, it comes later. But that is <u>your</u> choice.

The one thing that share buybacks do is produce transactions. So if, for whatever reason, markets don't value Eakinomics at $5 million per share, the process of selling the shares will drive the price to the fundamental value. From this perspective, the share buybacks have a valuable social role in telling investors the underlying value of the firm.

It cannot be said more clearly that the <u>financial</u> transaction of buying back shares does not change the <u>economic</u> value generated by the assets and sales of Eakinomics.

A related issue is the impact of the recent Tax Cuts and Jobs Act (TCJA). Many have argued that the TCJA spawned stock buybacks that have inflated values — perhaps to the benefit of corporate executives. As the example above makes clear, it is not the stock transactions that drive up the value of the firm. Rather, the tax cuts make Eakinomics (and other firms) more attractive. Eakinomics would generate more that $200 million this year and more than $210 million next year, so its shares should be more valuable. But that has nothing to do with buybacks; it is the impact of the policy.

Too often, financial markets are portrayed as a glorified casino with a select patronage. In fact, they have an important economic function of identifying and pricing the value of investment opportunities. The transactions in the aftermath of the TCJA are doing exactly that. They are pricing the value of firms in the new environment, and the investment opportunities that they offer.