CHANGING COURSE: Matt Happel, who was laid off from his job at a Deere & Co factory in April, is now studying to become an actuary at the University of Northern Iowa. REUTERS/Mark Kauzlarich

BUYBACKS FUELED BY CHEAP CREDIT LEAVE WORKERS OUT OF THE EQUATION

By Karen Brettell and Timothy Aeppel
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The story of two Iowa cousins - one a retired teacher, the other a laid-off Deere & Co worker - shows who benefits, and who doesn't, in the vast money-go-round powered by the chase for higher investment yields.

WATERLOO, Iowa—Matt Happel and Pam Egli are first cousins, part of a sprawling family so big it rents a church hall for Christmas parties.

They grew up close. Egli often babysat Happel and later loved going to his football games. He’s a natural athlete, she says, noting that he was quarterback all four years of high school.

The cousins have another connection that has nothing to do with their stolid Midwestern roots -- one that runs straight through Wall Street.

Happel, now a 40-year-old divorced father of three, was laid off in April from Deere & Co.’s transmission factory in

Waterloo, where he earned $21 an hour on the assembly line.

The Moline, Illinois-based tractor maker, hit hard by a slumping farm economy, has shed hundreds of workers as sales and profit have fallen. As conditions worsen, Deere has been raising record amounts of debt, helping to finance loans to buyers of its farm equipment, while also spending billions of dollars on share buybacks.

Egli, 16 years older, retired two years ago from teaching elementary school. The state pension fund that sends her a monthly check is among the many such funds that have gobbled up Deere's debt, as well as riskier investments, chasing the higher returns they need to keep paying retirees.

The Iowa cousins' Wall Street connection is a single, small strand in a vast web of massive financial flows, woven in the easy-money environment the U.S. Federal Reserve has maintained for years.

It begins with pension funds like the one Egli relies on. These big institutional investors are in a bind. To keep sending checks to rising numbers of retiring baby boomers, they are chasing higher returns than they can get from traditional fixed-income investments like U.S. Treasury securities. At the same time, they are wary of relying heavily on stocks after the market rout during the financial crisis bit deep into their reserves.

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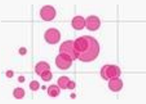

Interactive: Debt machine

Interactive: Corporate debt rises along with share repurchases

Part 1: Is buyback binge undermining corporate America?

Part 2: Buybacks juice executive pay

So they are turning to fixed-income investments. More than buying bonds directly, they are investing in private equity and hedge funds, which use borrowed money to increase returns on debt while also chasing higher-risk, higher-return investments such as junk bonds. Egli's retirement fund, the Iowa Public Employees' Retirement System, or IPERS, is among the many pension funds that have emerged as major investors in these alternative investments.

The demand from pension funds is helping to finance record levels of corporate debt. The low interest rates that have crimped returns on investments also make it dirt cheap for companies to borrow, and many of them are doing just that, often to buy back their own shares.

As reported in earlier installments in this series, corporate America is pouring unprecedented amounts into buybacks. Using debt to finance buybacks can produce tax or accounting benefits. The buybacks provide an alternative to capital investment or research spending when business conditions don't justify making long-term bets. Instead, buybacks return profits to shareholders – and often enhance executive pay – even when a company hits lean times and is laying off workers.

In fact, buybacks have become the fuel powering the more-than twofold increase in the stock market since the depths of the financial crisis in 2009. Together, U.S. non-financial companies have spent $2.24 trillion on buybacks since 2009, while borrowing an extra $1.9 trillion to help finance those purchases, according to a Reuters review of Federal Reserve data.

During the same period, mutual and exchange traded funds have bought less stock, at $1.24 trillion. Pension funds, meanwhile, have been net sellers to the tune of $1.05 trillion since 2009, while households and hedge funds have dumped an additional $558 billion.

“We are in a massive bull market that is being generated by credit-led financial engineering,” said Brian Reynolds, chief market strategist at brokerage firm New Albion Partners, who analyzes pension fund allocations for signals of stock market values.

Since 2008, Deere's total debt has risen by $2.72 billion to $4.93 billion -- and those figures don't include regular bond issues by the compangy’s financing arm to help underwrite customer purchases. During the same period, Deere has repurchased $12.33 billion of its shares.

Deere said that money for the buybacks came from strong cash flow, not borrowing, and that the company gives priority to spending on research and development over buybacks. The company increased debt in fiscal 2012 as a protective measure, Chief Financial Officer Rajesh Kalathur said, in case the impasse in Washington over raising the nation’s debt ceiling roiled markets. After that threat faded, he said, it would have been “unreasonable” to hold excess cash.

Many other companies have been borrowing heavily to help pay for buybacks.

INGOOD SHAPE: Retired teacher PamEgli, a cousin of Matt Happel, receives regular checks froma pension fund that has cut its weighting in publicly traded stocks in recent years. REUTERS/Scott Morgan

“Basically what you’re seeing in the stock market is a slow-motion leveraged buyout of the entire market.”

Ed Yardeni, founder, Yardeni Research

St. Louis, Missouri-based agrochemical giant Monsanto Co, for example, is caught in the same commodities downturn as Deere. It said in October that it would slash 2,600 jobs as commodity prices slump. But it has increased debt by $7 billion since 2013, helping to fund $8 billion in share buybacks in the same time frame.

San Diego-based chip maker Qualcomm Inc said in July that it would cut 4,500 full-time staff, or 15 percent of its workforce, as foreign competition pinches sales. The company raised $11 billion in debt this year, helping to finance $11.25 billion in buybacks for the year.

And Atlanta-based beverage maker Coca-Cola Co said in January that it would cut at least 1,600 white-collar jobs as it faced sluggish soda sales. It has added $9 billion in debt since the end of 2013 and bought back $6.13 billion of its shares in that time.

“Basically what you’re seeing in the stock market is a slow-motion leveraged buyout of the entire market,” said Ed Yardeni, founder of Yardeni Research.

Deere for a decade was riding high on a global surge in commodities. Farmers from India to Iowa eagerly snapped up Deere’s machines — many of which can sell for $250,000 or more — as they rushed to meet the world’s growing demand for corn and soybeans. The company also makes construction and forestry equipment.

But that boom has gone bust as growth in China and other emerging economies cooled over the past several years. Deere said in January that it would cut more than 900 workers in Iowa and Illinois, including 565 in Waterloo, as it rushes to curb output. The layoffs came on top of 1,100 job cuts last year.

In Waterloo, the layoffs hit like a tornado. Deere operates four factories in this city of 68,000 people and is by far the largest private employer around. The company’s roots here reach back to the early part of the last century, when the company started by an Illinois blacksmith named John Deere, who had invented a plow that worked well in the Midwest’s dense soil, decided to diversify into a new device called a “tractor.”

Rather than develop its own machine, Deere bought the company that made the Waterloo Boy tractor, establishing this city’s role as a production hub. Before the farm crisis of the 1980s, Deere employed 16,000 in Waterloo. Those numbers were down to about 4,000 before the most recent wave of cuts.

“We’re about as close as America still has to a one-company town,” said Dave Nagle, a local attorney who represented the area in Congress as a Democrat in the late 1980s and early 1990s.

Debt machine

Companies are borrowing record amounts as low interest rates make it cheap to raise funds, which is helping to finance the share repurchase boom. These companies have increased their total debt obligations since the financial crisis while also buying back shares.

Deere has outsourced much of the work once done in its Waterloo plants, he noted, including to some smaller operations in the area that pay much lower wages. “So the wage bracket of the whole community has taken a significant hit,” he said. “We really never came back from the farm crisis.”

Deere’s Waterloo workers are unionized — and proud of their American roots. A sign outside the United Autoworkers local union hall warns visitors to park foreign-built cars out of sight at the back of the lot.

Union president Tom Ralston said Deere offered laid-off workers generous support — as well as the opportunity to get retrained or go back to college for up to two years through a federal grant that covers all costs, including commuting in some cases. “But at the end of the day,” he said, “it’s hard to be laid off and out of work.”

Happel agrees. He came to Deere after he got laid off from a local printing company during the depths of the last recession. Deere was one of the few places hiring at the time, and he thought he landed well. He figured he might eventually retire from there, like many of members of his extended family.

But the stress of that previous layoff still haunts him. He was having troubles in his marriage at the time, he said, and the “financial pressures of that definitely added to them.” The couple divorced in 2010.

He initially ruled out going back to school after Deere cut him, he said, because he knew it would mean at least two years of financial hardship — and he worried what that would do to his current relationship (he’s now engaged to be married) and his children.

His fiancée’s daughter lives with them, and his own three teenagers split their time between his home and their mother’s. All he could see were mounting bills. His oldest daughter heads to college in the fall, he said, and they have no savings set aside for that.

"We're meeting with a financial adviser this week on that," he said, after settling into a booth at a diner across the street from the University of Northern Iowa's starkly modern campus, just a few miles up the road from Deere's transmission plant.

Happel is now studying at the University of Northern Iowa to become an actuary — someone who helps insurance companies and others measure and manage risk and uncertainty.

COMMAND CENTRAL: Deere, with headquarters in Moline, Illinois, has spent $12.33 billion on share buybacks since 2008. REUTERS/Eric Thayer

A study this year by consultants Towers Watson found that pensions accounted for 33 percent, or $1.14 trillion, of total assets of the world's 100 largest alternative asset managers.

He still worries. His fiancée is an information technology specialist for an insurance company. A few days earlier, he said, she was called in for a meeting where the company announced cutbacks. Her job is safe, he said, "but it's a scary thing."

He paused for a moment, and then asked: "We're not supposed to be in a recession now, are we?"

Many laid off Deere workers end up across town, at the Displaced Worker Transition Center — a glass-walled building on the edge of Waterloo's community college campus — where counselors help Deere workers pilot their retraining or college options.

Longtime Deere workers said it can be hard to jump into other factory jobs. Other local employers know that the workers— who can be recalled to their old jobs for a period equal to however long they worked there — are unlikely to stick with lower-paying jobs if Deere beckons them back. For that reason, some employers refuse to even consider Deere workers for job openings.

Robbie Hadaway, who was laid off in April, now works as a counselor at the displaced worker center. "I just think they could have impacted fewer people's lives — if they'd done a better job of projecting sales," he said.

Deere said the last six years have seen the most rapid fluctuation in demand for its products in the company's history. "Recently, there have been layoffs as Deere balances the size of its manufacturing workforce with market demand for products," said Ken Golden, a Deere spokesman. "Even so, Deere employs several thousand more people today than in 2009."

When local employers slash jobs, the hardships of people like Happel and Hadaway reverberate through the entire community.

Michelle Weidner, Waterloo's chief financial officer, said the town never fully recovered from the massive 1980s downturn in the U.S. farm economy. The town gets most of its income from property taxes, which tank when there are big layoffs and a sudden rush of people trying to sell houses at the same time. The latest cuts at Deere have yet to hit their budget, she said, "but we know it is coming."

The town has shed a few fire and police personnel as it absorbs the impact of new tax rules mandated by the state, which limit how much they can collect on property taxes from businesses. The library has maintained hours, Weidner said, but it's "become a very heated budget conversation every year." The library now gets by with the help of donations and bequests to help preserve services.

The town contributes to teacher pensions, as well as those for about half of the town's employees through the Iowa Public Employees' Retirement System, or IPERS, which manages retirement funds for public employees throughout the state.

IPERS owns two bonds sold by Deere's financing arm in 2012, part of the $28 billion fund's allocation to lower-risk fixed income investments. The fund also invests 11 percent of its portfolio in private equity and debt, and 5 percent in higher-yield, high-risk credit such as junk bonds.

It has reduced the weighting of publicly traded stocks to 41 percent from 48 percent in 2005.

That pattern has been repeated at many pension funds. A study this year by consultants Towers Watson found that pensions accounted for 33 percent, or $1.14 trillion, of total assets of the world's 100 largest alternative asset managers.

Corporate debt rises along with share repurchases

U.S. companies are selling record amounts of debt, in many cases to help finance share repurchases. Pension funds, which are struggling to meet aggressive investment targets, are helping to finance the share buybacks by increasing investments in debt and alternative investments, even as they sell stocks.

"Pension funds are the single most important investor base," said Oliver Wriedt, co-president of CIFC Asset Management, which has $14.2 billion under management and specializes in corporate loans.

Cities and states across the country have been cutting jobs and services as they devote more money to pension plans. Illinois, which is more than $100 billion behind on its obligations, is in the worst shape with a funding ratio of assets to liabilities of only 39 percent. It is followed by Kentucky, Connecticut and Alaska.

Mr. Reynolds, the market strategist at New Albion Partners, said: "There is a cash call on cities and towns. Instead of hiring cops or teachers, more money gets diverted to the pensions from the city."

The hunt for higher returns can make a pension fund more vulnerable to losses if markets seize up. Their recent emphasis on leveraged investments – those made with borrowed money to boost potential returns -- can create contagion across markets because fund managers often need to sell assets to meet margin and redemption calls.

Illiquid debt can also pose dangers when fund managers face a wave of redemptions. Just this month, a Third Avenue Management LLC fund that invested in risky and illiquid loans collapsed, leading to losses across the junk bond market as investors fretted over whether the damage would spread.

Based on similar concerns, some pensions have switched out of higher-risk strategies. That's what the San Diego County pension fund did this year, only a year after boosting leverage and investing in less liquid assets.

“We’ve gone from a levered position to an unlevered position,” said Stephen Sexauer, chief investment officer at the fund, who was hired in May to reallocate the pension’s resources.

Egli said she is not worried about the durability of IPERS. She taught and still lives in Waverly, Iowa, about 21 miles north of Waterloo, and she said her town weathered both the recession and a natural disaster that made life tough for everyone. In 2008, a flood inundated the area – damaging 700 homes and 100 businesses.

Wage increases were meager to nonexistent for nearly five years, said the 56-year-old, and teachers had to pay more for their insurance. There were also changes to the retirement plan that meant slightly smaller checks for retirees like her. One change: The pension switched from calculating retirement pay based on the average of her three highest-earning years to the five highest, which nudged down the number.

“But my sense is that IPERS has done a really good job,” she said. “They took a little bit more from us to be sure they could cover it.”

She’s right. The IPERS pension is 84 percent funded — up from a low of 80 percent in 2011, though it remains below the 89 percent level it was at a decade ago.

Egli is secure. Her husband, a self-employed attorney, is still working and she now substitute teaches about half of the school days each month.

Her cousin is having a tough time making ends meet. Happel will collect unemployment insurance as long as he is enrolled in classes, but the $400 a week he receives is only a fraction of what he earned at Deere. The family has cut out extras: no movies, no dinners out. He dipped into his 401(K) retirement savings account to pay off credit cards, but notes ruefully that those card balances are now drifting back up as he scrambles to cover expenses.

Being part of a big family eases the strain. His family still owns the 1,200-ACRE farm that was homesteaded by his great-grandfather and is now operated by his father and brother. “I go over there when they need a hand,” he said. “That extra money helps, but it doesn’t get us caught up by any means.”

An earlier version of this article incorrectly attributed Deere & Co’s expansion into tractors to the company’s founder.

Additional reporting by David Gaffen and Sam Forgione.

The Cannibalized Company

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