CHAPTER 7

Assessing the Quality of Management—Background and Classification: Who Are They?

Most investors overlook the human aspect of operating a business, yet, in most cases, the future success of a business is directly tied to the quality of its people. Instead of focusing on management, many investors spend their time determining whether a business has a competitive advantage or if it is trading at a low valuation, because they believe that products or operational strengths are what set the most successful organizations apart, such as Microsoft's ubiquitous Windows operating system. The truth is that, over time, these advantages can be imitated, and if the talented managers who created these advantages leave the business, then the business will struggle to continue to innovate and create value.

In fact, Microsoft did lose many talented people who either called in rich or joined new businesses, such as Google. This is one reason that Microsoft has created fewer innovative products. Microsoft's stock price peaked during the tech boom at $60 per share on December 29, 1999, dropping to $22 per share only a year later. Since then, it has appreciated to $28 per share as of December 31, 2010—not exactly a great rate of return over a 10-year period.

As an outside investor, you cannot know every detail of what's going on inside a business. There are too many variables that impact the future valuation of a business. You must trust management to make the right decisions. More important, you must know that management can recover quickly from setbacks. In order to trust managers, you need to gain insight into their character and their ability to execute. This will help you improve your forecasts for the business going forward.

Think about how many great businesses of the past have faced ruin due to mismanagement—for example, energy business Enron. Early on, Enron held many high-quality assets, including pipelines. Over time, management transitioned the business into a trading firm, and Enron spun off or sold these high-quality assets. While Enron went bankrupt, many of these spin-offs, such as pipeline business Kinder Morgan Energy Partners (operated by highly capable chief executive officer Richard Kinder), went on to become extremely successful.

To appreciate how essential sound management is to the long-term success of a business, consider that top managers typically:

- Are responsible for designing the business.
- Determine the future growth rate of a business.
- Are in charge of choosing the right people and providing the right environment for these people to perform at their highest potential.
- Determine how to allocate the firm's capital.

Knowing the type of management team you are partnering with will help you forecast the future of the business, because the most logical predictor for the future success of a business is its management. A business does not need to have every manager be an allstar, but at the very least, the managers in key positions need to be allstars. Give yourself plenty of time to understand the quality of the management team running a business. This topic is so important that I've devoted three chapters to it: Chapters 7, 8, and 9.

It is best to evaluate a management team over time. By not rushing into investment decisions and by taking the time to understand a management team, you can reduce your risk of misjudging them. Most errors in assessing managers are made when you try to judge their character quickly or when you see only what you want to see and ignore flaws or warning signs. The more familiar you are with how managers act under different types of circumstances, the better you are able to predict their future actions. Ideally, you want to understand how managers have operated in both difficult and favorable business environments.

Your overall strategy should be to develop a working picture of a manager and the management team. You can start learning about management by gathering all of the historical and current articles written about each manager. These articles serve as a trail of evidence as to the past accomplishments of the management team, the type of people they are, and how they have dealt with different types of situations. You can answer a great number of questions in this book just by reading articles. You can use aggregated news archives, such as *Dow Jones Factiva* or *LexisNexis*, which archive historical articles as far back as the 1980s from publications including the *Wall Street Journal*, the *Financial Times*, the *New York Times*, and various trade journals. Look for articles that reveal how the top managers run the business and the type of people they are. Interviews are especially useful, because managers tell you a great deal about their business philosophy or how they operate the business. Use interview sources such as the *Wall Street Transcript* or the *Charlie Rose* show, which often feature roundtable discussion or lengthy interviews. Pay particular attention to what motivates the managers and why they are where they are professionally.

Some of the best sources of information are trade journals and local newspapers where a business is headquartered. Subjects often reveal more information to industry journalists than they will to a national publication such as the *Wall Street Journal*. Local journalists also have experience in covering the company and may ask questions that reveal deeper insights. The articles also tend to be longer because the local company is important to the community where it is based.

As you read articles, look for evidence in four basic areas: passion, honesty, transparency, and competence. Look for the ability of a manager to recognize and learn from mistakes and also try to see how quickly they are able to recover from mistakes. Look for articles that talk about how a manager helps employees become engaged in the business or keeps customers happy. If there are not many articles written, you either have to rely more on other sources or simply admit that you do not have enough information to assess a manager.

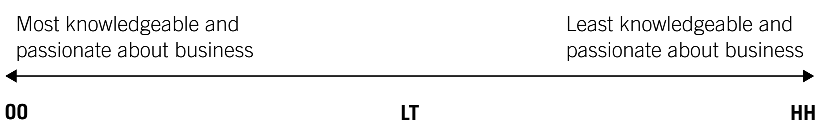
The questions in Chapters 7, 8, and 9 will help guide you in collecting the evidence you need to determine whether a management team is competent and proven.

- The first set of questions, in Chapter 7, helps you learn about the background of the managers and how to classify them.
- The questions in Chapter 8 help you understand how the CEO and other managers manage their business, which will help you determine if they are competent.
- The questions in Chapter 9 help you understand the personality and character of the manager.

Let's begin by exploring the background of the management team and how they are compensated.

❐ 33. What type of manager is leading the company?

It is important to classify the type of manager you are partnering with at a business. This way, you will be in a better position to gauge potential execution risk. If you are investing in a manager who has a long track record (i.e., more than 10 years) of successfully managing a business, the odds that he or she will continue to manage the business successfully are in your favor. On the other hand, if you are investing in a new management team that has limited experience serving the customer base of the business, the odds are not in your favor. Here is a simple classification system you can use:



This is a continuum, from left to right; here's a quick overview of what each means, followed by a more detailed description:

- OO is an *owner-operator*, typically the founder of a business.
- LT is a *long-tenured manager* or one who has worked in the industry for at least 3 to 10 years.
- HH is a *hired hand*, a manager who has limited experience serving the customer base of the business and has worked at the business for less than three years.

For example, on the far left side are owner-operators such as the late Sam Walton, founder of Wal-Mart. On the far right-hand side are hired hands who did not have any prior experience at the business before joining as CEO, such as Robert Nardelli, who joined Home Depot in December 2000 from General Electric. Most managers of publicly traded businesses fall into the long-tenured or hired-hand category, and these are the most difficult managers to evaluate. Let's take a closer look at each type, which is further broken down into sub-categories shown below.

Owner-Operator 1 (OO1) These are the ideal managers to partner with in a business. An owner-operator is a manager who has genuine passion for their particular business and is typically the founder of that business, for example:

- Sam Walton, founder of Wal-Mart
- Dave and Sherry Gold, co-founders of 99 Cent Only Stores
- Joe Mansueto, founder of Morningstar
- John Mackey, co-founder of Whole Foods Market
- Warren Buffett, CEO of Berkshire Hathaway
- Founders of most family-controlled businesses

These passionate leaders run the business for key stakeholders such as customers, employees, and shareholders alike, instead of emphasizing one constituency over the other. They typically are paid modestly and have high ownership interests in the business. For example, according to the Berkshire Hathaway 2010 proxy statement, Warren Buffett earns $100,000 in salary and directly owns 37.1 percent of the stock. These managers take a long-term perspective when making business decisions and identify their personal success with the survival and growth of their businesses. Much like a parent who will do anything to save a critically ill child, these CEOs will go to great lengths to ensure the survival of their businesses.

Owner-Operator 2 (OO2) This is an owner-operator who is passionate about running the business but is in between the two extremes of being completely stakeholder oriented and operating the business for his or her own personal benefit. These managers typically receive higher compensation packages than OO1 managers. For example, Leslie Wexner, founder of the Limited Brands (owner of Victoria's Secret), earned more than $10 million in total cash compensation in 2009, and he owns 17.7 percent of the business.

Owner-Operator 3 (OO3) OO3 managers are owner-operators who are passionate about the business but primarily run the business for their own benefit. They do not take shareholder interests into consideration and will often siphon off profits to themselves through egregiously large compensation packages. You can usually identify these types of managers by viewing the Related-Party-Transaction section found in the company's proxy statement, where you might find such items as personal use of company aircraft, estate planning, personal or home security, and real estate that is owned by the CEO and then leased to the business.

For example, in one business, the company's founder received a loan from the business that bore an interest rate of 1 percent over prime to buy a personal aircraft. Another CEO was reimbursed more than $2.6 million a year for security expenses. Both CEOs of these firms could easily afford to pay for these luxuries out of their own pockets, but they used the company to pay for them. You should be careful investing in companies with these types of CEOs because they typically fail to create a lot of value for shareholders over long periods.

Long-Tenured 1 (LT1) LT1 managers are those who have a long tenure at the existing business. These are managers who have been promoted from within the business and who have worked there for at least three years. The biggest risk with these types of managers is that sometimes they are the wrong manager for the position. Perhaps they were a great chief financial officer (CFO) or chief operating officer (COO), but once promoted to CEO, they fail to execute.

For example, when Kevin Rollins took the management reigns from company founder Michael Dell and became CEO of Dell computers in 2004, most investors believed that this would be a smooth transition, because Rollins had been Dell's COO since 2001. Yet Michael Dell took back the CEO role in 2007 after Rollins mismanaged the business and inflated Dell's cost structure. In April of 2008, Michael Dell spoke to analysts in Texas and explained how the company was going to regroup. He outlined the challenges he saw[1]:

- Declining market share. They had missed being in the fastest growing parts of the industry.
- The wrong cost structure, both in COGS (cost of goods sold) and OpEx (operating expenses).
- Eroded profitability. The result of the combination of the wrong cost structure, inefficiencies in the system, and missed execution.
- Too many priorities. The list of things to do was too long and the company needed focus.
- Incomplete product coverage. They were "trying to do too much with too limited a product line."

How could this have happened? Rollins had made enormous contributions at Dell, including implementing the negative working capital business model that Dell is so well known for today. Simply put, Rollins made a great lieutenant to Michael Dell, but he was not equipped to be CEO of Dell. He was the wrong manager for the position.

Long-Tenured 2 (LT2) LT2 stands for a long-tenured manager who joined from outside the business but who has worked in the same industry. The manager may have been recruited from a competitor or a business that serves a similar customer set.

An example of this type of manager is Frank J. Williams, CEO of healthcare research business The Advisory Board Company. He joined Advisory Board in September 2000 as an executive vice president (EVP) and has been CEO and a director since June 2001. Before joining the business, he was President of MedAmerica OnCall, a consultancy for physician organizations, hospitals, and managed-care entities. In both businesses, he was in charge of advising healthcare businesses on how to run their practices, which means he had prior experience serving the same customer base.

Hired Hand 1 (HH1) An HH1 is a manager who joined the business from a related industry. Hired hands tend to jump from job to job. These managers typically make short-term decisions because they are not accountable over the long term. Most of these managers are cost cutters rather than revenue builders.

Hired Hand 2 (HH2) An HH2 is a manager who joined the business from a completely unrelated industry and typically has no experience with the customer base. HH2s have steep learning curves in the new business. Think of CEOs such as Robert Nardelli, who was CEO of Home Depot from December 2000 to January 2007: Prior to joining Home Depot, Nardelli worked at General Electric, an industrial conglomerate.

The Importance of Managers' Tenure in Operating the Business

As you move down the continuum from OO to HH, the less information you will have on how a manager will choose to operate the business. For example, if you invest in an HH with a limited track record operating the business, this increases your potential downside risk because when a new management team enters a business, the company's past results provide less insight into its future prospects. You will take less risk partnering with managers who have a proven track record of running a business because you can give more weight to the historical track record. These established management teams understand the intricacies of running the business day to day and most important of all, they understand the customer base. Outsiders typically do not have this depth of knowledge.

It is difficult to find CEOs who have operated their businesses for a long period. For example, consider these two statistics according to an analysis conducted by recruiting company Spencer Stuart for the *Wall Street Journal*:

- Out of the 500 businesses in the S&P 500, *only 28* have CEOs who have held office for more than 15 years.
- The typical CEO has held the title for *only 6.6 years.*

As confirmation that tenure improves stockholder returns, consider this: Of the 28 long-term CEOs above, 25 of them had total shareholders returns during their tenures that beat the S&P 500 index (with total shareholder return calculated as stock price change plus reinvested dividends).[2]

❒ 34. What are the effects on the business of bringing in outside management?

Many investors will bid up the stock price of a business when an outside manager or CEO enters the business. These investors believe that management skills are transferable and react positively when a new management team enters a business, especially one that has been mismanaged. These investors think outside managers can instill changes and improve underperforming companies, because the outside managers are objective and not married to the culture. If this person was a great manager at The Coca-Cola Company, the thinking goes, then he or she will be great at operating any other business. This is similar to saying that a great value investor would make a great trader because both are in the investment business. Obviously, these two styles of investment require different types of expertise and experience to execute properly.

Investors also often make the mistake of underestimating the importance of the support networks these managers had at their prior company that helped make them successful in the first place. When these managers then enter a new business, they often run into problems because they don't have that support network, and many fail to perform.

In addition, most of these managers are great cost cutters but fail when it comes to growing the business. There are very few cases where a manager is good at both cutting costs and building the business such as Steve Jobs, founder of Apple. When he returned to Apple in 1997, Apple was on the brink of bankruptcy. Jobs was able to cut costs to keep Apple out of bankruptcy and then rebuilt its entire product line and organization.

When you learn that an outsider has joined to lead the business, respond with extreme caution. RHR International, a Chicago-headquartered management consultant, states that 40 percent to 60 percent of high-level corporate executives brought in from outside the company will leave within two years. Many have problems and leave in just a few months.[3]

A manager with a lot of organization-specific knowledge is critical to generating long-term growth at a business, whereas an outsider needs a significant amount of time to learn the business. Jeffrey Immelt, CEO of General Electric, said, "You see that the most successful parts of GE are places where leaders have stayed in place a long time. Think of Brian Rowe's long tenure in aircraft engines. Four or five big decisions he made—relying on his deep knowledge of that business—won us maybe as many as 50 years of industry leadership. . . the places where we've churned people, like reinsurance, are where you will find we've failed."[4]

In addition, relative to managers who have been at the business for long periods of time, outside managers have a more limited understanding of a business's resources and constraints. The risk you take as an investor is that instead of *building on* an existing business's capabilities, they *deviate* from them. Therefore, a new management team creates unpredictability.

There are some industries where specialized knowledge of the business is especially critical: for example, pharmaceuticals, chemicals, and insurance. It is difficult for an outsider to successfully manage these types of businesses, and you should probably avoid investing in them if an outsider does become CEO.

For example, it is critical for the CEO of an insurance firm to have spent a lot of time in the insurance industry because there is a long learning curve in this industry. An insurance firm is insuring against risks that may occur in the future, and managers who have been in the industry for a long time have lived with the fallout of their mistakes. This helps them understand how to properly underwrite insurance. Without this experience, managers are likely to make many more mistakes, which *you*, as a shareholder, will pay for.

There are a few cases where outside managers tend to be good hires: For example, when a business needs to break from past strategies or needs to cut costs quickly. If the industry changes very quickly, this will also improve the odds that an outside manager will succeed, but if the industry is stable, then industry knowledge is more important. Most of these new managers tend to do well early on in their tenure as they cut costs, but later they start to do badly when it comes time to build the business. In other words, they are good at doing the rapid cost-cutting and divestment, but when it comes to building and sustaining long-term growth, they fail.

For example, Al "Chainsaw" Dunlap created a lot of value for his investors by quickly turning around and selling such companies as American Can, Lily-Tulip, Crown-Zellerbach, Diamond International, Consolidated Press Holdings, and Scott Paper. Dunlap's strategy was slash-for-cash, where he would take a floundering business and make it profitable within a year. He did this at Scott Paper, which had just lost $227 million in 1993: During his 20 months at Scott, Dunlap increased the company's market value by 155 percent, from $2.9 billion to $7.4 billion. He accomplished this turnaround by firing 11,200 employees (which consisted of 70 percent of its head-office staff, 50 percent of its management, and 20 percent of its blue-collar workers) and by cutting the research and development (R&D) budget in half, suspending corporate philanthropy, and deferring plant maintenance. He succeeded with this strategy for a few years and was lauded as a legendary turnaround artist and a role model for many managers.

So when he became CEO of appliance maker Sunbeam in 1996, the stock price promptly rose 60 percent, as investors anticipated that Dunlap would quickly turn around the fortunes of the business. At that time, this was the greatest jump due to a CEO change that had ever occurred in the history of the NYSE. Unfortunately, the techniques he used to turn around other businesses in the past—such as slashing expenses—worked against him at Sunbeam, and the company declared bankruptcy in 2001, two years after Dunlap was dismissed as CEO. In fact, after all the dust settled, Dunlap had to accept a lifetime ban from serving as an officer or director of any public company because the SEC alleged that Dunlap engineered a massive accounting fraud.[5]

When an outside manager enters the business, closely monitor his or her actions. The best types of outside managers are those who don't make changes quickly and make an effort to understand the business and its customer base as well as solicit the opinions of employees before they implement major changes. This way, they gain the support of the employees whom they will need to execute their plans; just as important, they avoid the problem of under- or over-estimating the capabilities of the employees. If instead, the manager joins the business and starts to make changes immediately, without getting buy-in from the employees or understanding their limitations, it is likely he or she will fail, and you should avoid investing in this company.

❒ 35. Is the manager a lion or a hyena?

Another simple way to categorize management is to classify management teams as either *lions* or *hyenas.* This idea was created by Seng Hock Tan, CEO of Aegis Group of Companies, a Singapore-based investment management organization, who came up with this classification while watching a Discovery channel program about lions and hyenas. As he learned about how lions and hyenas interact in the wild, he felt that their behavior was very similar to that displayed by managers.[6]

As he watched the program, he learned both are super predators and are often in direct competition with one another. However, here's the difference between the two. Lions typically hunt together in a group (called a pride), so that they can go after bigger game, which means more food for everybody. Instead of having a single dominant leader, as is commonly believed, males have equal status, as do females. In contrast, hyenas group together only when hunting is easy: After an easy kill, they disband. On their own again, they go back to scavenging carcasses. Status is extremely important to hyenas, with a higher rank netting more respect within the troop. They do not build a team under them except when it immediately benefits them, and loyalty is weak. If a hyena becomes wounded or weak, the troop abandons that hyena. Interestingly, the hyena recognizes the lion's status: As the hyena's only natural predator, the lion commands the hyena's respect.

Tan applied these differences in the animal world to management styles. Table 7.1 summarizes the contrasts.

Tan goes on further to explain that a lion manager is able to build the infrastructure for a 100-story skyscraper, whereas a hyena manager can construct only a five-story building because it can be done in less time: Investing and building a long-term infrastructure taxes the nature of the hyena. For example, investing in a team and sustainable infrastructure takes a lot of time, which a hyena manager does not have the patience to do. The hyena continually enriches himself by repeating the short cycle of building and selling five-story buildings. Hyena managers never build the more valuable 100-story building that lasts longer than a five-story building.

Table 7.1 Contrasting the Management Style of Lions and Hyenas

Lion Manager	Hyena Manager
Committed to ethical and moral values	Has little interest in ethics and morals
Thinks long term and maintains a long-term focus	Thinks short term
Does not take shortcuts	Just wants to win the game
Thirsty for knowledge and learning	Has little interest in knowledge and learning
Supports partners and alliances	A survivor and an opportunist; works mostly alone
Treats employees as partners	Treats employees as expenses
Admires perseverance	Admires tactics, resourcefulness, and guile

Source: Interview with Seng Hock Tan October 2010.

As Tan says, "The hyena manager is therefore an opportunistic trader, not an all-season builder of a lasting structure."

Although, the skyscraper will generate huge returns for its investors over long periods of time, the flipped five-story building, although profitable to the lone hyena, will generate more limited returns for outside investors.

Tan explains further: "How did Apple catapult from $5 billion in market capitalization in early 2003 to a market cap of $220 billion?" Tan contrasts Apple with Palm, which brought out the pioneering Palm Pilot product. Why was Palm, with a $90 billion market cap at its peak, bought out in 2010 by Hewlett-Packard, as Seng Hock asks, "for a mere $1.2 billion?" The difference was that Apple was run by a Lion manager: Steve Jobs.

Most competent early-stage companies do not cross the chasm to an established business because they lack the lion manager's infrastructure—the teamwork, the know-how, the necessary institutional structures, and the culture. This is the groundwork needed to survive and grow sustainably, and it is why companies run by lion managers become multi-bagger investments.

As you look at the manager on a personal level, also note characteristics that indicate how likely they are to be able to build and lead an effective team. Look for their lion characteristics. Does the manager value people more highly because of power, influence, or what they can do for them? Or do the managers consider themselves to be better than those around them? Perhaps they are extremely nice to you and your friends, but when they deal with a waiter, for instance, they are rude. In other words, they are nice to people they consider to be important, but disrespectful to others whom they consider beneath them. If you are engaged in a conversation with someone and a higher-status person walks into the room, does your conversation end as they quickly leave to join the higher-status person? This is a hyena characteristic.

For example, I remember attending Berkshire Hathaway annual meetings and speaking with many of the CEOs who run subsidiaries of Berkshire Hathaway. Often, someone else would walk up to them and tell them that someone important, such as another CEO, wanted to speak with them. Even though they did not know me, they continued to answer my questions and didn't cut me off. In contrast, most of the money managers I knew well would immediately walk away mid-sentence if someone passed by whom they thought was more important. Look for managers that display the lion characteristic of showing respect for people, regardless of status. It is a strong predictor of their ability to command the respect of others, and an important leadership characteristic.

The hyena/lion metaphor is a powerful tool for evaluating managers. When Tan and his team interview managers, one of the first questions they ask themselves is whether the manager is a lion or a hyena. This is an easy-to-use and highly effective tool, and the mental imagery may be extremely useful for quickly summarizing the character of a manager.

❒ 36. How did the manager rise to lead the business?

To understand the management team's background, start by constructing a chronology of the careers of the top five managers, using the biography section found in the company's proxy statement. The goal is to get the details of a manager's career so you can map out the manager's professional life. You need to use historical proxy statements, going back at least five to 10 years, because in more recent proxy statements, earlier jobs are not emphasized. You can then fill in the gaps of the manager's career by reading articles written about the CEO and the other top four managers over a 10-year period.

For example, by using a combination of historical proxy statements and articles, my firm compiled the career of Larry Young, CEO of Dr. Pepper Snapple Group, shown here:

2008:	Remains CEO when Dr. Pepper Snapple Group spins from Cadbury
2007:	CEO/President of Dr. Pepper Snapple Group (Cadbury)
2006:	President and COO of Cadbury Schweppes Bottling Group (Cadbury acquires Dr. Pepper/Seven Up Bottling)
2005:	Joins as President/CEO of Dr. Pepper/Seven Up Bottling Group in Dallas
2005:	Leaves PepsiAmericas
2002:	EVP of Corporate Affairs for PepsiAmericas
2000:	President/COO combined company for PepsiAmericas/Whitman
1999:	COO of Pepsi General Bottling (operating company of Whitman)
1998:	EVP and COO of Whitman and Pepsi General Bottling
1997:	President, Pepsi General Bottlers—East European Division
1996:	President, International, Pepsi General Bottling
1995:	Vice President of Sales and Marketing—International, Pepsi General Bottling

1994: Director of Sales and Marketing—International, Pepsi General Bottling

1989: Director, On Premise Sales & Marketing for Springfield Pepsi General Bottling

1969: Begins his career with a Pepsi franchise (Pepsi General Bottling) as a route salesman in Springfield, Missouri.

This is a very detailed biography; in contrast, if we had used only the 2009 proxy biography for Larry Young, we would have a more limited view of his career, as shown below:

> Larry D. Young, President and Chief Executive Officer and Director, age 55, has served as our director since October 2007. Mr. Young has served as our President and Chief Executive Officer (our "CEO") since October 2007. Mr. Young joined Cadbury Schweppes Americas Beverages as President and Chief Operating Officer of the Bottling Group segment and Head of Supply Chain in 2006 after our acquisition of Dr Pepper/Seven Up Bottling Group, Inc. ("DPSUBG"), where he had been President and Chief Executive Officer since May 2005. From 1997 to 2005, Mr. Young served as President and Chief Operating Officer of Pepsi-Cola General Bottlers, Inc. and Executive Vice President of Corporate Affairs at PepsiAmericas, Inc.

By building a chronology of the career of a manager, you will understand how the manager came up through the ranks of the companies he or she worked for, and you can better determine whether the manager has a history of making deals, financial engineering, marketing, or creating new products. For example, if they worked for businesses owned by private equity firms for most of their careers, then the managers are likely to have a short-term mentality and may emphasize cutting costs over other initiatives.

Ask questions such as:

- Does the manager have a background in operations, marketing, or finance?
- Did the manager jump from job to job, or does he/she have a long tenure in the industry?
- Why are there gaps in his or her employment history?

Pay particular attention to how much interaction the manager has had with both customers and employees. For example, determine whether the manager has a lot of experience in operating the business or if the manager's career has been limited to the corporate suite. If the manager has been a controller, treasurer, or CFO, and was then promoted to CEO, then most of that manager's time has been spent in the corporate suite. In contrast, if the background of the manager is VP of Sales, VP of Marketing, COO, and then CEO, that manager has had more interaction with the operations and customer base of a business.

Be Aware of the Risks of a Manager with a Non-Operating Background

A related risk you may be exposed to is that managers who have risen from inside the corporate suite of the business often do not make good operators. This is because they have less experience with the day-to-day operations of the business. If the managers have spent most of their careers in the corporate executive office, then how will they know how to operate the business at the customer level? These managers have a narrow view of the business due to the fact that they have only viewed the business from one particular angle. This traps many managers into a constricted way of thinking about the business. Their past interaction with the employees of the business will have been more limited, as well.

For example, there is no doubt that new drug development has suffered in the pharmaceutical industry as more of the CEOs who lead these companies are promoted from within the corporate suite (such as managers who have been CFOs or General Counsels), or from outside, unrelated businesses instead of CEOs with science backgrounds. As a result, most pharmaceutical firms have not had many blockbuster drugs from 2000 to 2010 and many currently face their patents expiring, without any drugs in the pipeline to replace them.[7]

Merck's greatest stock market returns came during the time it was managed by Roy Vagelos, who was a scientist (both chemist and doctor) and worked as head of Merck's research department and then CEO, from 1978 to 1994. Vagelos changed the way Merck did research by emphasizing scientific discovery. Under his tenure, he brought in hundreds of new scientists and modernized Merck's labs. He also focused on new product categories like cardiovascular treatment. He sought and found what he termed "really better people who wanted to work in drug development." When Vagelos led the research department, he increased R&D spending by an average of 17.2 percent a year. Merck focused R&D on cures that were needed, instead of making questionable improvements to existing drugs, as most pharmaceutical firms did. During Vagelos's tenure, 10 major new drugs were launched, such as Vasotec and Prinivil for hypertension and Pepcid for heartburn. When Vagelos retired in 1994, Merck had the best and largest marketing staff, and led the pharmaceutical industry in sales.

However, Vagelos's replacement, who was chosen by the board (and not Vagelos), was Raymond Gilmartin, who joined Merck from Becton Dickinson, a medical device maker. He was an outsider who simply did not understand the culture of innovation. As a result, the talented scientists left the business, and Merck's ability to develop new drugs suffered dramatically.[8]

Similarly, take a look at General Motors. Alex Taylor documents the decline of GM in his book *Sixty to Zero: An Inside Look at the Collapse of General Motors—and the Detroit Auto Industry*. Taylor writes that GM's best years were when it was led by such innovators as CEO Harlow Curtice, who led GM from 1953 to 1958. Curtice had started out as a bookkeeper, but he gradually became a super salesman who developed a shrewd understanding of how design created buzz and sold cars. Under his tenure at Buick, sales doubled. As Taylor notes, "Curtice may have been the last GM CEO who wielded so much power in the design studio."

After Curtice, GM was run by managers who were mainly accountants and who therefore placed more emphasis on cutting costs, instead of worrying about what was coming out of the design studio. For example, Fred Donner was an accountant who directly succeeded Curtice, and he spent his entire career operating GM from New York City instead of Detroit. He seldom visited car factories, and most of what he knew about the operations was from executive meetings, balance sheets, and reports. He was focused on cost-cutting rather than designing cars that sold well. Taylor makes a good case for the idea that GM's failure took root during this period as these cost cutting CEOs kicked down the road many of GM's problems.

How Much Experience Does the Manager Have with the Customer Base?

If a business's success hinges to a great degree on management's capabilities, as it does in restaurant chains, you will typically take less risk if you invest in managers who have a lot of experience with the customer base. Avoid those who have spent most of their careers in the corporate suite or who have served customers in a different type of industry.

For example, in 2002, Jack Stahl left his job as president of The Coca-Cola Company to attempt a turnaround at cosmetics company Revlon. Stahl had been at The Coca-Cola Company for 22 years and Revlon's board had great faith in him, believing that his disciplined approach to operations was just the thing Revlon needed. He brought in financial experts and statisticians, and reduced the company's debt. Unfortunately, he also changed the way Revlon marketed its products. As Revlon launched new products, it lost many of its old customers. Some of the new products had higher prices and didn't use the powerful Revlon name. In the four years after Stahl assumed control of Revlon, the company suffered continued losses as well as a two-thirds decline in Revlon's share price. Stahl left Revlon in 2006.[9] Although Stahl had done an excellent job at The Coca-Cola Company, he was ill-equipped to deal with the nuances of running a cosmetics company.

Does the Manager Have Experience with Most Operations of the Business?

You want to get a sense of the manager's understanding of all the divisions and functions of the business. Ideally, a manager would have experience in multiple positions.

For example, Tom Folliard, CEO of used-car retail chain CarMax, joined CarMax in 1993 as a senior buyer and became director of purchasing in 1994. He was promoted to VP of merchandising in 1996, SVP of store operations in 2000, EVP of store operations in 2001, and president and CEO in 2006.[10] Therefore, he has led most of the major divisions at Carmax, and he understands what it takes to operate each division effectively. This experience reduces the risk to investors that Folliard will fail to execute. Even more important, it improves his credibility with employees within the company because he has managed most of their departments in the past.

What Is this Manager's Previous Track Record in Operating a Business?

As you read articles written about a manager, be sure to learn about their past accomplishments or lack of accomplishments. For example, James Adamson became CEO of retailer K-Mart when it entered bankruptcy in early 2002. Previously, he was a member of K-Mart's

Board of Directors. To determine whether Adamson had the ability to lead K-Mart, you could have reviewed his past history by reading both the proxy statement and historical articles. From 1995 to 2001, Adamson was CEO of the Advantica Restaurant Group, which owned Denny's. He was brought in when Denny's faced many lawsuits for discriminating against black customers, and he successfully transformed Denny's public image issues into a number-one ranking in *Fortune* magazine's "Best Companies for Minorities" category in 2000 and 2001.

However, during Adamson's tenure at Advantica, the company lost $98 million in 2000 and $89 million in 2001. After Adamson assumed control of K-Mart, he was equally unsuccessful at returning the retailer to profitability. Adamson's track record of losing money should have alerted investors that he was probably not the best choice for leading K-Mart through a restructuring.[11]

This wasn't the first time K-Mart had missed the mark on manager appointments. Before Adamson was promoted as CEO, K-Mart had brought in Charles Conaway as CEO and Wal-Mart veteran Mark Schwartz as CFO. Conaway was past president and COO of pharmacy retailer CVS Corporation and Schwartz joined from Wal-Mart (K-Mart's biggest competitor) where he had worked for 17 years. Many investors were excited to hear that Schwartz had joined the business because of his experience at Wal-Mart. Schwartz made many bold statements to investors on how he was going to tackle Wal-Mart head on.

However, Schwartz's track record wasn't as encouraging as his rhetoric. Had you studied his resume, you would have seen that two of the companies he ran before working at Wal-Mart—home products business Hechinger's and Big V Supermarkets—had landed in bankruptcy. Two years after Conaway and Schwartz were brought in, K-Mart declared bankruptcy.[12, 13]

Why Was the Manager Promoted?

You need to determine why a manager was promoted to his or her current position. For example, in 2010, Merck promoted Kenneth Frazier to CEO. Frazier had been with Merck since 1992, and had served in several roles including that of General Counsel. He was known for developing the controversial legal strategy of fighting every case filed against Merck's pain drug Vioxx, rather than settling all the cases jointly in a class action lawsuit. This strategy had helped save Merck hundreds of millions of dollars.[14]

In fact, Frazier was promoted to CEO because he helped Merck defend itself from lawsuits, not because he was successful in helping Merck develop new drugs. Frazier's background was in the corporate suite, and even though he was head of the global human health division (which is Merck's largest unit) from 2007 to 2010, Frazier's experience running the operations of the business was more limited. Therefore, this increases the risk that Frazier will fail to execute as CEO.

What Was the Culture Like at Businesses Where This Manager Worked in the Past?

You need to understand the culture of the businesses where the manager has worked in the past. For example, software and hardware business Oracle is known for a take-no-prisoners culture that is results oriented, whereas British Airways is known for an excessively bureaucratic culture.[15] This will give you tremendous insight into how he or she is likely to manage the current business, especially if the manager worked at the prior business for a long period of time.

Start by reading articles about the culture of the former business where the manager worked, as well as articles about the CEO this manager worked for. Were the CEO and the culture aggressive and hard-charging, or transparent and authentic? For example, if a manager worked at General Electric (GE), take a look at any of several books and articles written about "the GE Way." The GE Way is taught at GE's management school: It involves rotating managers through many jobs, teaches them how to grow a business through acquisitions, and teaches productivity and quality-control tools such as Six Sigma.

When Jim McNerney was passed over as CEO of GE, he was immediately recruited by 3M to be CEO (in 2001). Once he was CEO of 3M, he immediately began to look for acquisitions to make, and he instituted money-saving Six Sigma process-management systems companywide.[16] By reading about the GE Way, you would have had a great insight into how McNerney would likely manage 3M.

❒ 37. How are senior managers compensated, and how did they gain their ownership interest?

It is important to spend time reviewing the compensation and ownership interest of management by viewing the proxy statement.

You can gain great insight into the character and motivation of managers by understanding how they are compensated. You want to understand if the compensation package rewards for long-term or short-term performance. For example, if a CEO owns $100 million of stock, and he is paid $100,000 per year, then he is more likely to make long-term decisions. In contrast, if a CEO gets paid $5 million a year and owns $1 million of stock, then he will likely value his job more than the value of the company's stock.

Let's take a closer look at different compensation scenarios and what aspects you should pay attention to.

Look for CEOs Who Have Low Salaries and High Stock Ownership

Some of the best long-term performing stocks have been run by CEOs with low cash compensation and high stock ownership. These managers generally have a long-term view. Here are a few examples:

Robert Kierlin, founder of Fastenal (a distributor of industrial products), and his successor as CEO, Willard Oberton. Fastenal consistently ranks at the bottom of CEO compensation: For example, Kierlin made $63,000 in total cash compensation in 2001 and owned 5.87 percent of the business.[17] But take a look at how well the stock has performed: The stock price has appreciated from $0.32 per share on September 1, 1987 to $60 per share on December 31, 2010—that's a *huge* increase![18]

Dave Gold, co-founder of 99 Cent Only Stores, was paid $62,000 to $180,000 in total cash compensation (and did not receive any stock options or bonuses) when he was CEO, yet he owned approximately 40 percent of the business.[19] Under his tenure, the stock price increased from $3.81 per share at its initial public offering (IPO) on May 23, 1996, to $15.32 per share when he stepped down as CEO in January 2005—again, a huge increase: more than 400 percent.

Joe Mansueto, founder of Morningstar, is paid $100,000 in total cash compensation and owns 52 percent of Morningstar.[20] The stock price has increased from $21 per share at its IPO in May 2005 to $53 per share in December 2010—in other words, more than double in a little more than five years.

Russel Gerdin, CEO of trucking firm Heartland Express, earned $300,000 per year in total cash compensation, a salary that hasn't changed since 1986. He also owns 34 percent of shares and does not receive stock options. The stock price has increased from \$0.43 per share in 1986 to \$16 per share in 2010[21]—another enormous increase.

Be Wary of Managers Who Hold Stock Options

One of the most common ways that management is compensated is through stock options, which give the owner the right to buy shares at a specific stock price. They represent a potential payoff to the manager with no risk: The downside is zero (if the stock price doesn't increase, there's no payout to the managers, and if the stock price does increase, then they benefit). Investors believe that giving stock option grants to managers will motivate them to create shareholder value, because it gives them an ownership interest in the business.

The problem is that stock options often reward managers for things that they are not responsible for, such as broad economic gains or industry growth. As one investor said: "The argument that someone is worth tens of millions of dollars in compensation per year because his or her company's market value went up many times is so ludicrous that I've always been amazed anyone can espouse it as fair with a straight face."

In reality, most stock-option programs reward managers for short-term gains. This is because managers with a lot of options rather than actual shares are prone to adopt Wall Street's short-term focus in order to increase the stock price and therefore the value of their options. They can take several harmful actions to drive the price of a stock up in the near-term to the detriment of the long-term health of the business. Examples would be making acquisitions to boost short-term earnings or cutting too many costs. These short-term decisions can eventually cause the value of the business to deteriorate as one bad decision piles up on top of another.

Be Wary of Companies that Offer Mega-Equity Grants to CEOs or Other Managers

The highest pay packages are typically given to managers who are brought in from another company or industry. You need to be cautious of management compensation schemes that give out mega-equity grants that are out of proportion to the CEO's contribution, such as when Robert Nardelli was given \$30 million in restricted stock awards plus \$7 million in cash when he joined Home Depot as CEO. Furthermore, after pulling in \$38 million in 2006, Nardelli was also given an astronomical $210 million in severance when he exited the business. This was money that would otherwise have benefited shareholders. The stock price under Nardelli's tenure was $45 per share when he joined (in December 2000) and $39 per share when he left (on January 2, 2007).[22]

When Nardelli landed at Chrysler later that year, he also landed another lucrative compensation package. Under Nardelli, 35,000 workers at Chrysler were laid off and Chrysler headed for bankruptcy. Nardelli left after only 21 months. In both of these instances, Nardelli was paid not on the performance of the business, but instead was paid to join the business.

However, large compensation packages do not always necessarily indicate that a stock will underperform. For example, Larry Ellison, founder and chief executive of software maker Oracle, has been one of the highest-paid CEOs of any publicly traded business, earning in excess of $78 million in option awards alone in 2009, yet investors in Oracle would have made 3.5 times their money in the last 10 years ended 2010. (However, it is still difficult to argue that Ellison needs additional stock options to motivate him to do his job, as he owns 23.4 percent of Oracle, as of August 9, 2010.[23])

Look for Managers Who Don't Monopolize Stock Options but Offer Options to All Employees

You need to determine if the stock option plan of a company is geared to only a few of the top executive officers or if options are widely distributed among employees. This will give you an insight into the character of senior managers, because if they share the wealth with all of their employees through a widely distributed plan, this means they care about their employees. If, instead, they only award themselves a large option package, this means they care more about themselves.

For example, in a letter to shareholders, Richard Reese, former CEO of document-management company Iron Mountain, explained why he would not accept any stock options, saying that he preferred to use them to retain good people rather than compensate himself.

To find information on a company's stock option-program, look for a table in the proxy statement that lists the total number of options awarded to the top five executive officers. Add up the total number of options awarded to the top five executive officers. Then, in the 10-K or proxy, find the total number of options awarded to all employees. Calculate the percentage of options given to the top five executive officers compared to all employees. Determine if stock options are widely distributed or if they are concentrated within the top group.

For example, at Whole Foods Market, approximately 92 percent of the stock options granted under the plan since its inception in 1992 have been granted to employees who are not executive officers.[24] On the other hand, the management team at bond-rating firm Moody's awarded itself a large percentage of stock options when it was spun off from Dun & Bradstreet. Moody's 2000 proxy statement shows that CEO John Rutherfurd received 4.1 percent of all options granted to employees in the fiscal year, followed by Donald Noe, SVP of Global Ratings and Research, who received 3.0 percent. These two executive officers received about the same percentage of stock options as all of the top executive officers at Whole Foods Market *combined*. This should serve as a warning signal because it indicates that senior managers at Moody's view the business as one where they can personally benefit without sharing those benefits with their employees.

Look for Compensation Plans that Reward Long-Term Performance

In order for a compensation program to reward long-term performance, it must tie compensation to long-term results. For example, at ExxonMobil, half of an executive officer's restricted shares vest over five years, and the other half must be held for 10 years or until retirement, whichever is greater. This rewards management for long-term results.

The ideal compensation structures are those that award for long-term value-creation factors, such as operating income or book value per share, instead of the stock price. Determine if the compensation is tied to variables that make the business better, rather than just bigger. For example:

- Expeditors International (a global logistics company) bases its bonuses on operating income, and these bonuses make up the majority of executive officer compensation.
- Reckitt Benckiser Group (a global manufacturer of household and healthcare products) links performance-based compensation for all executive officers to economic value added.

- Markel Insurance (a specialty insurer) uses growth in book value per share over a five-year measurement period to base its total compensation package.

Let's look at each of these companies' compensation structures in more detail.

Expeditors International's Compensation System Expeditors International ties its compensation system to operating profit instead of stock price by paying its top executive officers from a pool of 10 percent of pre-bonus operating income. This system has been in place since Expeditors International went public in 1984. If operating income drops (as it did in 2009, when operating income dropped 19 percent compared to 2008), then incentive compensation also drops by the same amount. Furthermore, the compensation system is also based on cumulative operating income, so if any operating losses are incurred, then these losses must be recovered before the executive team can earn a percentage of operating profits. This gives senior managers a longer-term incentive because if they engage in activities that increase short-term profits at the expense of long-term profits, then they will receive a lower bonus down the line. This creates a direct alignment between corporate performance and shareholder interests because the compensation is directly proportional to the profit responsibility of each manager.

Reckitt Benckiser Group's Compensation System Reckitt Benckiser Group links performance-based compensation for all executive officers to economic value added, measuring net sales growth, profit after taxes, and net working capital. The long-term incentive program requires that EPS has to grow by 30 percent over three years for the options and the shares to fully vest. When Chairman Peter Harf was asked why the compensation plan did not reward for stock price increases, he said, "We have stayed away from that [performance tied to total shareholder return], because it can lead to outcomes that are completely uncoupled from the company's performance."[25]

Markel Insurance's Compensation System Markel Insurance chose growth in book value per share over a five-year measurement period to set its compensation program for its executive officers. The executive officers at Markel believe that the primary creator of value for an insurance business is its book value per share, not the stock price. Markel uses a five-year period in order to discourage managers from taking unnecessary risks.

There are various other forms of compensation that are positive indicators that the compensation package is based on long-term results, such as restricted stock awards. Stock-ownership requirements also align management interests with the long term.

Look for Restricted Stock Awards because They Reward Long-Term Value Creation

Restricted stock awards reward long-term value creation more than stock options because they often are conditioned on such factors as longevity or performance. In other words, a manager must be employed by the company for a certain length of time or must meet specific performance goals. This is meant to encourage long-term ownership in the firm.

For example, at Goldman Sachs, 40 percent of the restricted stock an employee receives typically vests immediately, but it isn't delivered for three years. Therefore, if an employee leaves, then that employee risks losing his or her restricted shares.

Similarly, at insurance underwriter Markel Insurance Company, restricted stock is given to senior managers after they meet pre-established performance goals, which are granted based on growth in book value per share, over a five-year period. Markel believes that by paying a substantial portion of incentive compensation in restricted stock units (RSUs), it has both the advantage of increasing management's equity ownership and creating a retention incentive, because the manager must remain employed by the company to receive the stock.

Look for Companies that Require Stock Ownership

Some businesses have stock-ownership and retention guidelines that require management to own a certain amount of stock. For example, the 2009 proxy statement for Markel Insurance Corporation states:

> The Company places a strong emphasis on equity ownership by executive officers and other members of senior management. The Board of Directors has adopted stock ownership guidelines

> that require executive officers to acquire and maintain ownership of Common Stock with a value at least equal to five times base salary and other members of senior management to acquire and maintain ownership of Common Stock with a value at least equal to two or three times base salary, depending on position. Newly hired or newly promoted executive officers are expected to reach these minimum levels of ownership within five years.

If you find this type of compensation program in the proxy, then it is likely that the management has an incentive to perform over the long term.

Other Valuable Insights You Can Glean from Reading the Proxy Statement on How the Compensation System Is Set Up

The way a compensation system is structured can gave you valuable insights into the character and motivation of management. Rather than focusing on *how much* executive officers are paid, it is more useful to understand *how* an executive compensation plan is structured. Start by viewing the proxy statement section titled Compensation Discussion and Analysis, where the compensation committee of the board of directors communicates how it sets the compensation package for the top executive officers and employees. For example, an executive officer might be compensated even if he or she did not meet the performance targets. The former CEO of Shell, Jeroen van de Veer, received a $1.9 million bonus from an incentive program where he failed to meet the performance targets set for three years. Running across a compensation arrangement such as this would certainly provide insight into the type of management team you are thinking of partnering with.[26]

In contrast, the 2009 proxy statement for Morningstar states:

> In consideration of his status as our principal shareholder, Joe Mansueto believes his compensation as our chief executive officer should be realized primarily through appreciation in the long-term value of our common stock. Accordingly, at his request, he doesn't participate in our equity or cash-based incentive programs. In addition, since resuming his role as our chief executive officer in 2000, his annual salary has been fixed at $100,000.

You can evaluate Mansueto's character and that he manages the business in the interest of his shareholders, because he refuses to accept stock options. This gives you great insight into his character, and this is the type of CEO you should look for as a long-term partner.

Beware of Companies that Use Compensation Consultants

If a compensation package is determined by consultants hired by the board of directors, this should serve as a red flag. This kind of compensation benchmarking is usually not about the performance of the business, but rather a comparison to what others in the industry make. However, the peer groups used are often in completely unrelated business lines. You will find that the majority of compensation plans are determined in this way.

For example, in FY 2010, jewelry retailer Zale hired a compensation consultant who put together a list of 21 companies as a peer group. The consultant included such companies as Abercrombie & Fitch, American Eagle Outfitters, and Children's Place, which are specialty apparel companies, not jewelry retailers. The consulting firm then targeted compensation within a certain percentile range of the peer group. For example, the 2009 Zale proxy states: "Accordingly, base salaries generally were targeted between the 25th and 50th percentile of market, and annual performance-based bonuses generally were targeted between the 25th and 50th percentile of market."

Two red flags are raised here: That compensation was determined by comparison to loosely related peers, and the fact that base compensation does not have anything to do with the performance of the business.

Beware of Companies that Use Employment Contracts

Another red flag is when you find employment contracts in the proxy statement that guarantee that a manager will be paid a certain amount in total cash compensation. This guarantee of compensation does not directly align the executive officers with the long-term interests of the business.

For example, K-Mart handed out roughly $30 million in retention loans (retention loans are given when the company is failing, but often they are awarded after a bankruptcy filing) to its 25 top managers, including $5 million to then-CEO Chuck Conaway.

The loans were given to entice the managers to stay at the business. At the same time, however, management was firing thousands of employees and cutting the salaries of other managers. This likely decreased morale among the employees at K-Mart, and these managers were ultimately unsuccessful in turning around the business. Eventually, these executive officers were fired by the board of directors, but they had already been given millions of dollars in compensation because it was guaranteed.[27]

You should always watch for managers who demand extremely high compensation packages before joining a business or who demand them to remain at the business. There is a saying that people who demand the most up front are usually the ones who deliver the least at the back end. This is generally true because those who receive guaranteed salaries and bonuses, regardless of the performance of the business, do not have any incentive to create long-term value.

For example, the CEO and founder of an energy company was awarded a $75 million-option package to renew his employment contract with the company for five years and not pursue other entrepreneurial ventures. This is a warning signal. Why would a CEO demand to be paid $75 million to remain at a business he founded? If he were truly passionate about the business, it is likely the board of directors would not need to entice him to stay at the business with financial incentives. This is just plain common sense. Clearly, the interests of the shareholders and management were not aligned.

Look for Managers Who Continually Increase Their Ownership Interest in the Business

The best managers to partner with are those who continually increase or retain their ownership in the business. For example, the following CEOs have sold very limited quantities of their companies' stock during their tenures:

- Warren Buffett, CEO of Berkshire Hathaway;
- Bruce Flatt, CEO of Brookfield Asset Management;
- Dave and Sherry Gold, founders of 99 Cent Only Stores; and
- Henry Singleton, former CEO of Teledyne.

Singleton, for example, did not receive any option awards and only sold stock in 1987 and 1988 after continuing to buy it for more than 20 years.[28] Bruce Flatt was once asked what his hobby was, and he responded that it was collecting shares of his stock. All of these businesses have created tremendous value for shareholders over the long term.

Use the proxy statement to construct a manager's ownership of the stock by viewing the stock ownership section over a 5- to 10-year period. Note how the shares were acquired, either through direct purchases or through option issuances. Determine if the manager is increasing his or her ownership interest in the business rather than decreasing it. If the manager's ownership interest is declining over time, this is not a positive sign. Many times, managers will claim they are selling for diversification purposes: This is reasonable and certainly believable, but remember that at the end of the day, a sale is a sale.

❒ 38. Have the managers been buying or selling the stock?

It is important to keep up with the purchases and sales of stock made by management by continually monitoring Form 3, 4, and 5 filings (which are SEC filings related to insider trading) and schedule 13-D filings (which are required for anyone who acquires beneficial ownership of 5 percent or more of a public company). Insider transactions signal where senior managers really believe their companies are going, without the corporate spin. They can also be a useful indicator of whether a stock will out-perform or under-perform. In his 1998 book *Investment Intelligence from Insider Trading*, Nejat Seyhun examined insider activity from 1975 to 1995 and discovered that stocks bought but not sold by insiders outperformed the market by 7.5 percent, on average, during the 12 months that followed the insider purchases. In contrast, companies with insider selling underperformed the market by 6.1 percent.

You must be careful not to jump to conclusions from an executive officer who is buying or selling stock without first examining the motivation behind the purchases or sales and whether the buying and selling is material to the total net worth of that executive officer. For example, insider purchases have become less useful indicators than they were in the past. Many executive officers have learned that by buying stock, they can increase the price of the stock, because the media reports these purchases. You have to be aware that the top executive officers may be attempting to manipulate the stock.

In order to be a useful signal, the insider buying or selling must be significant compared to the total net worth of the insider—for example, representing 15 percent or more of their total ownership. Unless you see these high-conviction purchases, then purchases and sales are just noise, and you need to be careful not to regard them as useful indicators.

For example, one CEO bought $100 million worth of stock in 2008, which sounds like a big sum. However, when compared to his total net worth, which was estimated by *Forbes* magazine to be $17.3 billion in 2008, it represented a small amount.

Here are a couple examples where insider purchases were useful indicators:

- A good example of a strong buy signal is the insider purchases of Carl Kirkland, founder of specialty retailer of home décor Kirkland's. On March 23, 2006, Kirkland owned 1.3 million shares. A few months later, on September 10, 2008, in a 13-D filing, Kirkland disclosed that he purchased 3,464,032 shares of stock for $6,754,862 (i.e., at an average price of $1.95 per share) by taking out a loan using an airplane he owned and his vacation home as collateral. The 13-D filing listed a business loan agreement between Bank of America and Kirkland Aviation, which owned a Hawker Beechcraft B200GT for a loan in the amount of $4 million. He also took out a loan in the amount of $3.5 million, using his Avon, Colorado, vacation home as collateral. Whenever you see a former founder buying so much stock using loans to fund his purchases, this is a strong buy signal. The stock price of Kirkland's shortly increased in price to more than $14 per share at the end of 2010.
- Three days before Jamie Dimon joined Bank One as CEO, he acquired two million shares for nearly $60 million, using his own capital. When asked why he bought so much stock, he said he felt a CEO should eat his own cooking. This is a clear signal that you and the CEO are aligned. The stock price increased from $30 per share when Dimon joined in March 2000 to $51 per share when Bank One was acquired by J.P. Morgan on January 15, 2004.[29]

Examples of Good Sale Indicators

If you see senior managers or board members selling a lot of shares, this is not a signal that you should sell your stock, but it *is* a signal that you should question their long-term faith in the business. You are looking for extremes rather than an insider selling a portion of his or her holdings: After all, that manager could be remodeling a house or have other reasons that have nothing to do with his or her confidence in the business. The following are a few examples of useful warning signals:

- If you see a stock whose price is continually dropping, yet insiders are selling, this is a warning sign.
- In two quarters alone, nine executives and directors of Novatel Wireless sold more than half of their holdings in 2007, at prices ranging from $17 to more than $20 per share. One year later, the stock price dropped below $10 per share and traded as low as $3 per share on December 1, 2008.[30]
- Five board members at Jones Soda Company disposed of nearly all of their shares of company stock over a three-month period in 2007 as the stock price reached $27 per share. That year, Jones Soda was developing into a mainstream brand with a national distribution contract, and the company had just announced strong fourth quarter earnings. The CEO also announced that the company would be in 25 percent of the retail market by selling at stores such as Wal-Mart, Kroger, and Safeway. Shortly thereafter, Jones Soda released 2007 first and second-quarter earnings that disappointed investors, causing the stock price to drop to $7 by the end of 2007. Most of the directors were able to sell their shares at prices ranging from $10 per share to $25 per share, while those stockholders who kept the stock suffered a decline in their net worth.[31]
- CEO John Hammergren of McKesson (a healthcare information technology company) owned 4.5 million shares as of June 1, 2010, including options and restricted stock holdings. He sold more than 2.9 million of these shares in 2010 (64 percent of his holdings), realizing more than $98 million in profits, according to SEC filings. This significant reduction in Hammergren's ownership should serve as a warning signal to investors that he does not have long-term confidence in the business.

Determine the Motivation When Management Purchases or Sells Company Stock

You should also examine further the motivation of stock purchases or sales. To gain full perspective on insider purchases and sales, read the notes to Forms 3, 4, and 5, which often disclose the reason for the purchase or sale. If you are unable to determine the motivation behind the purchases or sales, then you do not have enough information to draw a conclusion, and you need to be careful to not make assumptions. Some of the most common reasons are listed here and described in more detail in the following paragraphs:

- 10b5–1 programs
- Tax purposes
- Margin calls
- Personal reasons, such as commitments to charities that need to be funded

Executive Officers Who Sell Shares under the Terms of a 10b5–1 Program A 10b5–1 program is set up under SEC regulation designed to allow insiders to buy or sell company shares in an orderly pattern without having to worry about allegations of improper use of insider information. The plans vary in complexity, but they generally specify the amount, price, and date of the purchase or sale of a stock. Many investors make the mistake of ignoring purchases and sales of stock in a 10b5–1 program because they believe there is an orderly pattern to trading the stock, but the executive officers have the ability to change the terms of the program at any point. Whenever you note significant deviations from the trading plan, this should serve as a warning signal.

For example, the co-founder of subprime mortgage lender New Century Financial Corporation, Edward Gotschall, sold more than $15.4 million in stock from August 2006 to the first quarter of 2007, just before the company disclosed accounting problems related to reserves, and the business eventually filed for bankruptcy. This sale was conducted under a 10b5–1 plan and was ignored by most investors[32]—but it shouldn't have been. If investors had paid attention to the historical sales pattern in the 10b5–1 program, they would have noticed that Gotschall changed the terms of the plan to dramatically accelerate his stock sales.

Managers also sell stock for reasons that are unrelated to their confidence in the business. The following two examples represent two of the most common reasons.

Managers Who Sell Stock for Tax Purposes When a manager exercises a stock option, it generates a tax liability for the difference between the price the option was originally granted and the price the stock is sold for. Therefore, the manager has two ways to handle this. One way is for the manager to sell all or a portion of the exercised stock and use the proceeds to pay the tax. The other way is for the manager to take out a loan, using the stock as collateral, to pay the tax, which has the effect of deferring the tax. The main risk to this is that if the stock price drops below a certain price, the manager will face a margin call.

Managers Who Sell Stock to Meet Margin Calls During 2008, when the S&P 500 dropped by more than 37 percent, many managers had to sell stock to meet margin calls. One of the more noteworthy sales during this time was from Aubrey McClendon, co-founder and CEO of Chesapeake Energy Corporation, who was forced to sell 94 percent of his holdings for $569 million to meet margin calls when Chesapeake's stock price dropped 65 percent.[33]

Key Points to Keep in Mind

Learn about the Background of Senior Managers

- The most logical predictor of the future success of a business is its management.
- If you are investing in a manager who has a long track record (i.e., more than 10 years) of successfully managing a business, the odds that he or she will continue to manage the business successfully are in your favor. It's easier to predict what managers will do in the future if you have already seen what they do in both difficult and favorable environments.
- Outside managers who join the business and make major changes immediately, without fully understanding the customers and soliciting input from the employees, are more likely to fail.
- You can quickly judge several qualities in managers by using the lion/hyena metaphor.

(*continued*)

- Managers who have risen from inside the corporate suite (e.g., CFOs and General Counsels) often do not make good operators because they have less experience with the day-to-day operations of the business; they have a constricted way of thinking; and their past interaction with the employees of the business is limited.

How Managers Are Compensated Is Important

- Some of the best long-term performing stocks are run by CEOs with low cash compensation and high stock ownership.
- If a business has a widely distributed stock-option plan, this indicates that managers care about employees rather than just themselves.
- The ideal compensation structures are those that reward for long-term value creation factors, such as operating income or book value, instead of just the stock price (e.g. stock options).
- If a compensation package is determined by consultants hired by the board of directors, this should serve as a warning signal. This kind of compensation benchmarking is usually not about the performance of the business, but rather a comparison to what others in the industry make.
- People who demand the most up front are usually the ones who deliver the least at the back end. Watch for those managers who demand high compensation packages before working at the business.
- Insider transactions signal where managers really believe their companies are going, without the corporate spin.

CHAPTER 8

Assessing the Quality of Management—Competence: How Management Operates the Business

In addition to researching the backgrounds of senior managers, so that you'll know more about their careers, how they were promoted, what functional experience they have (or don't have!), and the corporate culture of the companies they worked at previously—all of which Chapter 7 focused on—it's also helpful to assess how managers actually operate the business, which is the focus of this chapter. Here, we'll look at management styles; strategic planning and day-to-day operations; organizational structures (i.e., centralized versus decentralized); how managers treat their employees and whether they know how to hire well; whether management knows how to intelligently manage its expenses; and whether management is disciplined or undisciplined in making capital allocation decisions.

By looking at how managers actually operate, you will be better able to assess how competent they are. Competency matters for many reasons, but one of the most compelling is that truly competent managers are able to quickly adapt to changing environments. For example, during the stock market downturn in 2008, when the S&P 500 dropped 37 percent, my firm strictly maintained its commitment to investing in proven and competent management teams. With so much uncertainty in the economy, there was very little visibility into the future earnings power of many companies. Therefore, we partnered with management teams that had the ability to adapt their businesses to the changing economic environment. And we avoided investing in management teams that had a limited track record running their business.

For example, we did not invest in an online retailer of diamonds and fine jewelry, because the founder had recently passed the chief executive officer (CEO) title to the chief financial officer (CFO) (February 2008). Even though the CFO had been at the business since 1999, we could not judge her competence in running the business in her new role.

In contrast, we had strong conviction in regard to the competence and abilities of the management team at Whole Foods Market, because that team had operated successfully together since 2001. Faced with declining same-store sales, which the management team had never encountered before, management strengthened the balance sheet and increased free-cash flow.

Another less direct but substantial benefit of partnering with proven and competent management teams is that it frees your time to focus on other investment opportunities. If you partner with incompetent management teams, you have to spend a lot of time monitoring their actions.

I once invested in a business because the stock was cheap, but I knew the management team was somewhat incompetent. I continued to hold the stock because I believed it was substantially undervalued. Each time the business issued a press release, my stomach churned, as I anticipated bad news. The CEO never let me down and continually reported bad results. This investment failed to create any value for my fund.

In contrast, when I have partnered with competent managers such as Bruce Flatt, CEO of asset-management-holding company Brookfield Asset Management, I do not have to scrutinize each management decision in detail. I know that if the top managers make a mistake, they will quickly recognize the mistake and correct it. By investing in proven and competent management teams, you will rarely be disappointed. This will help you maintain an opportunistic attitude.

Now let's take a look at questions that will help you determine if the management team is competent.

❐ 39. Does the CEO manage the business to benefit all stakeholders?

If you were to ask investors whether shareholder value is more important than customer service at a business, most would answer that it is. What they fail to consider is that shareholder value is a byproduct of a business that keeps its customers happy. In fact, many of the best-performing stocks over the long term are the ones that balance the interests of *all* stakeholder groups, including customers, employees, suppliers, and other business partners. These businesses are managed by CEOs who have a purpose greater than solely generating profits for their shareholders.

In the book *Firms of Endearment*, David Wolfe, Rajendra Sisodia, and Jagdish Sheth studied 30 companies that view success as more than just maximizing shareholder returns. These companies instead try to maximize value for all stakeholders. Interestingly, these companies outperformed the S&P 500 over the 10 years that the authors tracked them. The companies returned an astonishing 1,026 percent for 10 years ending in 2006—the S&P 500 returned only 122 percent.

It is surprising how few CEOs manage the business for the benefit of all stakeholders. The reason is that it is harder to do. It is easier to focus on one constituency, such as stockholders, rather than many.

John Mackey, co-founder and CEO of Whole Foods Market, has coined the term *conscious capitalism* to describe businesses designed to benefit all of their stakeholders, such as customers, employees, investors, and suppliers. Instead of subscribing to the theory that the only purpose of a business is to maximize profits, conscious capitalism proponents believe that increases in shareholder value are the by-product of helping customers, employees, and vendors reach their highest potential.

Mackey compares profits to happiness to illustrate his point. Just trying to be happy doesn't usually work. Instead, we're happy due to a host of other reasons: a strong sense of purpose, meaningful work, good friends and good health, loving relationships, and the chance to learn, grow, and help others. Like happiness, profits are also the result of other things, and aren't achieved by making them the primary goal of the business. "Long-term profits," says Mackey, "come from having a deeper purpose, great products, satisfied customers, happy employees, great suppliers, and from taking a degree of responsibility for the community and environment we live in. The paradox of profits is that, like happiness, they are best achieved by not aiming directly for them."[1]

Some examples of businesses that manage the business for customers and other stakeholders instead of maximizing profits are below:

- At Costco, CEO Jim Sinegal says that by treating employees fairly and making sure that customers receive a good value, shareholders will benefit over the long haul.
- Robert Wilmers, CEO of M&T bank, lived a business philosophy that could be a primer for sound banking: "Know your markets and employees, watch credit quality relentlessly, don't gamble with interest rates, and focus on serving your community."[2] You will note that none of the goals were to increase shareholder value. Even Warren Buffett, CEO of Berkshire Hathaway, held a long-term stake in M&T.[3] Under Wilmers' tenure, the stock appreciated from less than $3 per share when he joined the bank in 1983 to $87 per share on December 31, 2010,[4] making it one of the best-performing bank stocks in the last two decades. Wilmers did not focus on the profits of the bank, but instead focused on those things that *generated* the profits.
- David Packard, co-founder of Hewlett Packard, was also known for taking a broader view of stakeholders. One story describes the 37-year old Packard in 1949 listening to a group of business leaders who were apparently focused solely on profits. Uncomfortable with their views, Packard told them plainly, "A company has a greater responsibility than making money for its stockholders!" Of course, Hewlett-Packard went on to become the premier technology company under Packard and Bill Hewlett.[5]
- Similarly when Robert Silberman took over as CEO of Strayer Education in 2001, he said he was not going to focus on any of the metrics that generally drive public company valuations, such as revenue growth, operating income growth, and margin expansion. In an interview, I asked him why he focused on academic outcomes instead of profits, and he said, "It evolved from looking at the asset of the enterprise. It was pretty clear to me that the only thing that was going to drive real sustainable long-term value to my owners was the intangible value of Strayer University. So then I sat back and said, how do you increase the intangible value of Strayer University? And the answer to that is, you increase the level of learning outcomes."[6]

❐ 40. Does the management team improve its operations day-to-day or does it use a strategic plan to conduct its business?

Most investors seek out superstar CEOs who can seemingly change the business overnight with a well-planned strategy. In essence, the investor believes that business transformation is the result of brilliant ideas and clever plans. One reason investors think great performance results from brilliant strategy is that it is often reported to seem that way in the popular business media. These stories are popular for a couple of reasons: First, they are easy to write; second, people enjoy stories about flash and charisma far more than stories about CEOs who grow their business through continuous improvement. These articles often contribute to increases in the stock price as investors buy into the hopes and dreams of the charismatic CEO. Investors tend to have short memories, and they forget that many of these businesses eventually derail in dramatic fashion later on.

Beware of the CEO who believes that one strategy or a single stroke will transform their business. These CEOs typically make big announcements, such as they will take their business from the number-three position to number one in five years, by revolutionizing the way they conduct business, by making a transformational acquisition, or by leaping into a hot new market. These ambitious plans hinge on making rapid, sizable market-share gains.

For example, Nortel's strengths had traditionally been in voice transmission when CEO John Roth decided that he would transform the company into a much bigger data networking company. He did this by quickly acquiring 19 new businesses from 1997 to early 2001. Nortel's stock price rose, reaching a market cap of $277 billion in July of 2000. By the end of 2001, the stock price had fallen 90 percent from its peak the previous year. Most of the 19 acquisitions were eventually sold for less than Nortel originally paid or were written off entirely.[7]

A strategic plan is a detailed roadmap to success, such as a five-year plan that sets specific targets that must be met. As a result, a strategic plan can also be an inflexible plan that outlines how a business will operate for the next 2, 5, or 10 years. If a project or product does not meet the goals of the plan, then it is dismissed. Therefore, seizing opportunities becomes less of a priority for the business.

Contrary to popular belief, most successful businesses are built on hundreds of small decisions, instead of on one well-formulated strategic plan. For example, when most successful entrepreneurs start their business, they do not have a business plan stating what their business will look like in 2, 5, or 10 years. They instead build their business day by day, focusing on customer needs and letting these customer needs shape the direction of their business. It is this stream of everyday decisions over time that accounts for great outcomes, instead of big one-time decisions. These businesses don't attempt new initiatives until existing ones are thoroughly absorbed by the employees of the company. For example, Apple's approach is to put every resource behind just a few products and make them exceedingly well. Can you even imagine Apple making a cheap, poorly made product?

Another common theme among businesses that improve day by day is that they operate on the premise that it is best to repeatedly launch a product or service with a limited number of its customers so that it can use customer reactions and feedback to modify it. They operate on the premise that it is okay to learn from mistakes and that it is critical to obtain customer feedback to shape their strategies.

For example, Coach conducts more than 10,000 customer interviews every year before it launches new luxury handbag and accessory products. Based on the information it collects, Coach will alter the design of the product or drop items that test poorly. As a result, Coach has a direct line to the pulse of its customers and is able to avoid numerous market misfires. Coach believes that the millions of dollars it spends on customer interviews represent a low-cost form of insurance against getting blindsided by customers' shifting priorities. Instead of setting up a strategic plan, Coach lets customer input shape its strategies.[8]

You need to determine if the management team you are investing in works on proving a concept before investing a lot of capital in it or whether it prefers to put a lot of money in all at once hoping for a big payoff. Proving a concept does not need to be expensive. For example, Reed Hastings, founder of movie-rental-by-mail business Netflix, mailed himself a CD in an envelope when he was developing the business. When the envelope arrived undamaged, he had spent only the cost of postage to test one of the business's key operational risks.[9]

Similarly, Tom Perkins, founder of Kleiner Perkins, an early investor in companies such as biotechnology business Genentech, counsels, "First, eliminate the risk. Then, grow the business." Perkins would not make any significant financial commitments to a new venture until certain risks were reduced. This model is commonly used in the Venture Capital (VC) industry where startups are given capital in multiple rounds. After a start-up reaches certain milestones, then the VC investors will invest more money. For example, Genentech outsourced a lot of its work to labs instead of investing in its own lab as it developed its products. As Genentech became more successful and proved its product it then invested in its own lab.[10]

In contrast, businesses that rely on strategic plans often spend millions of dollars on research data compiled by consultants (instead of customers) over a long period of time before they launch a product or service.

For example, when Motorola launched its Iridium phone, only 50,000 people subscribed to its services instead of the millions of subscribers that Motorola had anticipated. It was one of the largest fiascos in business history, and Iridium declared bankruptcy in 2000. Motorola had devised a long-term strategic plan to develop a service where customers could make cellular phone calls from anywhere on earth. This technology took more than 10 years to develop and Motorola invested more than $5 billion in the project to launch 66 low-flying satellites.

Unfortunately, when the company was ready to launch the service, the phone needed to receive the satellite signal was the size of a brick and users had to be outdoors to get reception. Both of these were major stumbling blocks that Motorola had not fully considered when it was developing the service.[11] Motorola had focused so much on achieving its strategic goal that it neglected the basics of getting good customer feedback early on.

Here are a few examples of businesses operated by CEOs who do not follow well-formulated strategic plans but instead improve the business day by day.

- Henry Singleton, CEO of Teledyne Inc. from the 1960s through the 1980s, believed the best plan was no plan. Under his tenure, Teledyne's stock compounded at more than 20 percent for more than 20 years. He believed it was better to approach an uncertain world with an open mind. Singleton once remarked at a Teledyne annual meeting, "... we're subject to a tremendous number of outside influences, and the vast majority of them cannot be predicted. So my idea is to stay flexible. I like to steer the boat each day rather than plan ahead way into the future."[12]

- Dave and Sherry Gold, co-founders of 99 Cent Only Stores, started the business in 1982 and grew it to more than $1 billion in sales in 2005. Dave Gold said, "The people who are making long-term projections usually do not have accountability, and people often forget what they said years before. If you have a strategy for growth for the next 5 or 10 years, it gets changed so much in that time period. I don't think you can plan out more than 2 years from now. I don't think that far ahead. If you do, you just get into dreaming."[13]
- Thomas Stemberg, founder of office retail chain Staples, said, "I don't get hung up on business plans. I read them, of course. But whatever the plan says, the company will end up looking different. When we started Staples in 1986, for example, our business plan proclaimed we would never deliver. Delivery added costs; we figured we couldn't afford it." Today, a large portion of Staple's profits are derived from its delivery operations.[14]
- Bob Graham, co-founder of AIM Management Group Inc., one of the nation's largest mutual fund companies said, "When we started AIM Management Group Inc., we never had a plan. We followed opportunities as they came along. Our plan changed along the way, depending on what opportunities presented themselves. We had no idea that we would be in the money market funds business or in the equity funds business, nor did we have an idea of how big they would get."[15]

Why Do Strategic Plans Fail?

When CEOs set a strategic plan, they risk becoming committed to it and may fail to consider other alternatives. In the book *Influence*, author Robert Cialdini writes about "the commitment and consistency principle." After making a commitment or taking a stand, people are more willing to agree to requests that are consistent with their prior commitment. In other words, once you make a public statement, it makes it difficult for you to change your mind. Setting strategic plans has the same effect: A CEO is very likely to do things to remain committed to meeting his or her stated plans because the consequences of not meeting them are that the stock goes down, thereby reducing the value of stock options or tarnishing the reputation and credibility of the management team. The management team thus becomes committed to only one way of doing business.

Strategic plans fail because they often shut out other opportunities. When an opportunity comes up and it does not fit into the strategic plan of a business, then the management team will likely pass it up. The truth is that most management teams often stumble upon their best ideas.

For example, in the 1990s, Pfizer stumbled upon one of its best-selling drugs, Viagra. The company was developing a treatment for angina (the painful heart condition caused by constricting or clogging of heart arteries), when the users of this drug began to report that it improved their ability to have erections. So Pfizer made a very smart move and refocused on the newly discovered opportunity.[16]

Another reason they fail is that a business may focus on strategic targets instead of on what the customer wants. This is the same as telling a customer "That's not how we do things," instead of asking "How do you want it done?"

For example, Fannie Mae and Freddie Mac bought billions of dollars' worth of sub-prime mortgages. Instead of focusing on the true needs of the customers, they helped banks lend money to customers who could not afford the loans. Later, as these sub-prime mortgages defaulted, both of these businesses had to be bailed out by the government.

Do Not Confuse Strategic Plans with Long-Term Planning

Do not confuse a strategic plan with goals or long-term planning. You can think of long-term planning as a vision that is always in the head of the CEO as he or she builds the business. For example, a CEO may have a long-term plan to become the highest-rated business in customer satisfaction or to have the lowest employee turnover rate in its industry.

Highest-Risk Strategic Plans: Setting Financial Goals

The strategic plans that are most prone to failure are those that have an overly narrow focus, such as those that set a financial target. Many CEOs often make such announcements as "the business will generate $100 million in revenues in three years" or "we will sell 1,000 units per week by the year 2012." However, what happens in most of these cases is that when the CEO focuses on a specific financial target, they neglect other areas or take on more risk. The single plan will dominate all of the activities of the business at the expense of other important areas.

For example, in 2003, General Motors executives wore lapel pins and buttons with the number "29" as a reminder of the company's goal of obtaining a 29 percent U.S. market share. To meet the number that year, GM even offered rebates of up to $5,500 and 0 percent loans over 6 years on some of their cars. Six years later, GM's U.S. market share was below 20 percent, and the company was bankrupt. Why?[17]

The reason GM failed is because it focused on market share, and it had built a cost base structured for at least that level of market share. In other words, it was locked in. To try to make that number, the company burned through billions of dollars, launching new models in many market segments. By 2005, their U.S. share was at 26 percent—which was the lowest since 1925. By 2007, they were down to 23.7 percent, only barely ahead of Toyota. Furthermore, GM's cash losses during its high-growth years had left few cash reserves for years with declining car sales, and little or no cash to deal with the downturn of 2008 to 2009. By competing in too many market segments, and not leaving the segments where they couldn't adapt quickly enough to make money, GM lost the gamble it had made to try to gain market share from Toyota and the other import companies.[18]

Paul Larson, editor of Morningstar *StockInvestor*, offers a great analogy of why it is dangerous to set specific financial targets: "It's like you're driving somewhere and you tell yourself you will drive to a certain destination at an average speed of 63 mph. Instead, the way you should do it is to go as fast as road conditions will allow. If you have a set projection, you might go too fast and crash, or maybe it is a wide open road and you can gun it."[19]

When a management team sets specific financial goals, it may resort to such actions as managing earnings to meet those goals or making costly acquisitions. Some examples of CEOs who have failed after setting specific financial targets are:

- Hugh Grant, CEO of agricultural biotechnology company Monsanto, once declared that his goal was to double profits within five years. To meet this goal, he needed to shift the businesses focus away from herbicides to its more profitable biotech seed business. By 2010, Grant announced that they were unlikely to meet such a goal and that he was abandoning those plans. Grant later declared, "I'll tell you from the school of hard knocks, I don't think you're going to be seeing us laying out long-term targets."[20]

- In 1976, Continental Bank was the eighth-largest bank in the United States. The chairman of Continental announced that within 5 years, the bank's lending would match that of the other largest banks. To reach this goal, Continental shifted its strategy from conservative corporate financing to aggressively pursuing borrowers. Continental did become the largest commercial lender in the country, and it became a much larger bank, but in the process, it made several critical mistakes. Continental took in more volatile foreign deposits, loosened lending criteria, and sent the wrong message to its employees, who relaxed documentation standards. The bank also lost its historically conservative discipline and cut its pricing on loans. By 1984, Continental was in trouble, and it needed the largest bailout in U.S. history up to that time.[21]
- In the late 1960s, Ford had begun to lose market share to its competitors who were making small fuel-efficient cars. Ford CEO Lee Iacocca decided to challenge his engineers to produce a car that would cost less than $2,000, weigh under 2000 pounds, and complete it by 1970. Talk about specific goals: This was a trifecta! The result was the Ford Pinto, best known as the car that could ignite on impact. Not only was the car design defective, lawsuits later revealed that Ford's top managers knew that the car could ignite. So committed were Ford's managers to their strategic plan that instead of fixing the faulty design, they decided to go ahead and manufacture the car. They figured the costs of the lawsuits from the Pinto fires would be less than the cost of fixing the design.[22]

❒ 41. Do the CEO and CFO issue guidance regarding earnings?

Guidance is when management predicts earnings per share or other business metrics over the next quarter or next year and shares this information with investors, either through a press release or a conference call. Wall Street analysts then tend to fixate on whether a business will meet or beat these quarterly earnings estimates. The majority of businesses that are publicly traded give guidance. The National Investor Relations Institute (NIRI) compiles responses from more than 500 public companies regarding earnings guidance and reports that 60 percent of companies provided quarterly earnings guidance in 2009.[23]

Guidance can have the most damaging effects on a business when it begins to represent the organizational goals of the whole business. If meeting guidance represents the only goal the business has, then other valued activities will not be prioritized and are often ignored. Meeting guidance will therefore *drive* the operations of the business, rather than the earnings of the business being a byproduct of the business's operations. For example, a CEO and CFO who give guidance may be tempted to achieve dependable period-to-period growth by masking the volatility inherent in a business. Unfortunately, in the real world, a business does not grow in a constant fashion. The majority of businesses face a lot of volatility that CEOs and CFOs cannot make disappear. Growth is almost always subject to seasonality, cyclicality, and random events.

Once a business begins to set guidance, it may also adopt a short-term outlook at the expense of long-term growth. A CEO and CFO may fear disappointing Wall Street analysts because if they do, their stock price plummets. If management falls short of a guidance goal, they may do things that are not in the best interests of the business to make up the difference. Once they start this process, it is difficult to stop it. Then management begins to borrow from the future in order to sustain the present and begins to participate in the earnings game. The game has little to do with running a business and instead becomes a major distraction that detaches the CEO and CFO from the fundamentals of the business.

For example, a CEO may push more products onto its customers in order to meet the current quarter's guidance. Or the CEO may refuse to invest in long-term capital projects that do not contribute to profitability in the short term. At some point, it becomes impossible to manage earnings as usual, and the stock price falls. The CEOs and CFOs at such failed businesses as Enron, WorldCom, Tyco, Adelphia, and HealthSouth, which were stellar performers, succumbed to the pressure to meet the numbers.

Enron is a case in point. At one time, it had strong global assets such as pipelines, but it then sought to transform its business model by becoming a market maker of natural gas and energy. As Enron's stock price increased due to the company's ability to continually exceed its guidance, it had to seek new avenues for growth and moved away from its core competence to areas where it had no expertise, such as broadband, water, and weather insurance. As these operations began to generate losses, Enron's management began to use off-balance-sheet partnerships in order to continue increasing their earnings per share by taking debt off of its balance sheet. At its peak in August 2000, Enron had a valuation of $69 billion[24]—yet it declared bankruptcy in 2002.

You need to be cautious with businesses that issue guidance. Ideally, you should look for managers who promise only what they can realistically deliver and do not bow to analysts' demands for highly predictable earnings. If management is constantly worried about its stock price, then this is an indicator that management is worried more about managing the perception of the business than operating the actual business. Instead, management should be clear about all of the risks and uncertainties involved and should outline how a business is progressing toward meeting its long-term objective.

Some businesses have even stopped issuing quarterly financial targets because they no longer want to subject themselves to the unnecessary pressure to meet external goals. Here are just a few examples:

- Gillette: At one time, Gillette promised investors that it would grow its earnings at 15 percent to 20 percent. But after it acquired Duracell in 1996, it began to have problems meeting this goal. Gillette's management began to resort to such actions as channel-stuffing products to its distributors in order to meet its projections. When James Kilts took over as CEO in 2001, he quickly dropped the practice of issuing earnings guidance entirely.[25]
- Newell, a global marketer of consumer products: Newell used to state in its annual reports that it aimed for earnings-per-share (EPS) growth of 15 percent a year; however, after Newell acquired Rubbermaid and its earnings fell, this line disappeared from the annual report.
- Unilever, a consumer goods company: As CEO Paul Polman explained, "What mattered far more than goals and targets

was consistent delivery over time. Anything more specific only caused trouble."

If a business does issue guidance, you need to be careful that managers are not managing earnings. Start by comparing the quarterly or annual earnings estimates to the actual earnings per share of the business. Create a chart that shows the guidance given by management, and count how many times they beat their estimates. If management is consistently beating its own estimates, you can classify these management teams as "dedicated guiders." This should serve as a warning signal, and you should closely scrutinize its accounting to understand how the business is consistently beating its guidance.

❒ 42. Is the business managed in a centralized or decentralized way?

It is important for you to determine if top management operates a business using a centralized or decentralized structure. If it is centralized, the business is managed using top-down hierarchies with rigid reporting structures, which create bureaucracies. A centralized management team often tells employees exactly what tasks to do. These businesses also have very narrow decision-making processes, and they mainly get compliance from their employees rather than genuine commitment. This may lead employees to not feel trusted and make them less likely to internalize responsibility. They are afraid to make mistakes and sometimes they will not do the right thing because of that fear.

Bureaucratic businesses also tend to have difficulty recruiting and retaining competent employees because competent employees don't want to just take orders without understanding the reasons behind them. Rules and restrictions cause the most innovative people to run from the business or start their own companies. This means that a business's pipeline of future leadership will often be limited.

In contrast, if a business has a decentralized management structure, those employees who are closest to the customer are empowered to make decisions. These employees often feel as if they are running their own business. An added benefit is that it's much easier for front-line employees to convey valuable information about their customers to top managers. Because it's much easier for information to flow up, managers know more about their customers.

Many of the best-performing stocks in history—that is, those that have compounded at rates greater than 20 percent over 15 years—have used decentralized operating structures; for example, Teledyne, Berkshire Hathaway, Penn National Gaming, Expeditors International, Fastenal, Capital Cities ABC, and Bed Bath & Beyond. One reason for their success is that this type of business attracts independent thought and a diverse workforce, which encourages innovation. The greatest financial benefit is that decentralized businesses have reduced corporate overhead. For example, Penn National Gaming, a regional casino company, has one of the lowest corporate overheads of any publicly traded casino.

Let's take a closer look at Fastenal (another company with a decentralized management structure), whose stock price increased from $0.27 per share on September 1, 1987, to more than $60 per share on December 31, 2010. Fastenal doesn't operate using strict, top-down corporate hierarchies. Instead, this company treats its branch managers more like individual store owners, giving them wide latitude in decision making. Company founder Robert Kierlin always felt that because most customer interaction happens at the store level that it made sense to transfer the decision making to that level. Branch managers know the customer best, so Fastenal's store level managers make decisions about what inventory to carry, and what price to charge for their products. In fact, some managers negotiate directly with corporate suppliers. The compensation structure is also matched to the store level, with branch managers receiving commissions and profit sharing from their stores.

Similarly, Louis Vuitton Moët Hennessy's (LVMH) stock price has increased more than 10 times in value from 1989 to 2010, under the leadership of Chairman and CEO Bernard Arnault. Arnault attributes much of this success to the company's management structure, stating, "One key element of management of a group like this (LVMH has 83,542 employees[26]) is decentralization. You need the right team of inspired managers. I want all of my managers to take charge of their divisions as though they were family enterprises."[27]

How Do You Identify a Business That Is Managed in a Centralized or Decentralized Way?

First, determine who has the responsibility for selecting and hiring employees. Is it the Human Resources (HR) department or the managers who the employees will be working under? If it is the group where the employee will be working, then it is decentralized, but if all hiring is done through HR, then it is bureaucratic. Ideally, the responsibility of selecting employees should rest primarily with those holding authority over the department in which there is an opening. Herb Kelleher, founder of Southwest Airlines, brought model employees into the hiring process. For example, pilots made hiring recommendations for new pilots because they were in the best position to judge the abilities of potential candidates.[28]

Second, speak with the customers of a business. You need to determine how the business solves customer issues. Do employees have to resort to a bureaucratic process to resolve customer issues? Or do they have the authority to solve a customer issue without getting supervisory approval? Think about how frustrating it is when you have to return a product to a store and the manager has to approve the return or you have to fill out lots of paperwork. In contrast, Four Seasons Hotels encourages all of its employees to solve problems themselves, and it rewards employees who go beyond the call of duty in helping a hotel guest.

Third, note what the difference is in compensation among the top five executive officers by viewing the proxy statement. This will help you determine whether the business is run by a top-down CEO or if it is a flat organization. For example, the proxy statement of one business revealed the following:

- CEO received a salary of $2,164,423; the next highest paid executive received $690,577.
- CEO's bonus was $7 million; the next highest was $825,000.
- CEO was also given 590,000 stock options, as compared to 90,000 options for the next-highest-paid executive.

You can clearly see that the CEO had a significantly higher compensation package than the rest of the management team. This indicates that the business is being run by a top-down CEO.

By comparison, the 2009 proxy statement for Expeditors International shows that CEO Pete Rose received total compensation of $4,782,892, and the other 4 top executive officers earned similar amounts. This indicates that it is probably a decentralized operation.

Fourth, talk to salespeople who sell products and services to the business. Salespeople have to determine whether a business is managed in a centralized or decentralized way because they need to identify the primary decision maker in order to make a sale. For example, experienced salespeople will try to determine how important job titles are at a business. If titles are not important, then this is a sign it is decentralized. Salespeople will also look at the environment of the business they are selling to. For example, they look to see if the cubicles or offices of the employees are sterile (centralized) or if they are customized to the tastes of the employees of the business (decentralized).

❒ 43. Does management value its employees?

Most investors view the CEO as the sole person who operates the business, while the employees are viewed as commodities that can be downsized at any point. Nothing is further from the truth. The primary function of a manager is to obtain results through people. If a manager is unable to achieve results through people, he or she is not a good manager. Try to understand if the management team values its employees because the only way it will obtain positive results is through these people.

When employees feel they are partners with their boss in a mutual effort, rather than merely employees of some business run by managers they never see, morale will increase. Furthermore, when a business has good employee relations, it typically has many other good attributes, such as good customer relations and the ability to adapt quickly to changing economic circumstances.

Great Employee Relations Can Translate into High Stock Returns

Great managers know that if they treat their employees well, employees will, in turn, treat their customers well. Some of the highest-performing stocks within the S&P 500 have been run by CEOs who value their employees. One of the top performers is Expeditors International, whose stock price has increased 83-fold (up to July 2010) since CEO Pete Rose took over the freight forwarder in 1988. As Pete Rose once said, "You take care of employees. They take care of customers. And that takes care of Wall Street."[29]

HCL Technologies CEO Vineet Nayar instituted a new way of thinking about employees and customers at his company in 2005. In the book *Employees First and Customers Second: Turning Conventional*

Management Upside Down, Nayar discusses his idea that employees create the most value at a company, because they end up knowing the most about the customer. His company, which provides global IT services, focuses its effort on making sure that employees are able to meet customer's needs. Because employees understand the customer's problems and how to fix them, Nayar makes sure that employees have what they need, and even makes managers accountable to employees. His results are impressive: From 2005 to 2009, revenues have increased by 3.6 times and operating profits by 3.4 times. HCL was one of the few companies that grew during the global recession beginning in 2008, and it also increased revenue by 23.5 percent in 2009.

Read Articles Written about the Business

As you read articles about the business, look for specific situations where the managers demonstrate they care about their employees. Here are a few examples:

- Howard Schultz, founder of Starbucks: Howard Schultz was asked in a 2010 interview about decisions that he had made that turned out to be unpopular with investors. He immediately brought up healthcare: Schultz estimated Starbucks had paid around $300 million in healthcare costs that year. Many investors wanted him to cut that cost, and one institutional investor even called him and suggested he had cover (meaning no one would criticize him) to cut healthcare costs because times were tough. Schultz decided not to cut the healthcare plan, saying he'd rather have the respect of his employees.[30]
- Richard Galanti, CFO of Costco: In an interview during the recession of 2007 to 2009, Galanti was asked whether he considered increasing the amount that employees pay for healthcare from 10 percent to a higher amount in order to save Costco $10 million to $20 million per year. Galanti and the other Costco managers declined to pass the cost along to employees, saying that in tough times they wanted to give their employees as much as they could.[31]
- Herb Kelleher, CEO of Southwest Airlines: When Southwest Airlines was founded, it struggled and was losing a lot of

> money because there was inconsistent ridership. Founder Herb Kelleher faced the dilemma of laying off employees or selling a plane. Kelleher said, "We've always taken the approach that employees come first. Happy and pleased employees take care of the customers. And happy customers take care of shareholders by coming back." So Southwest Airlines sold a 737 plane and instituted a "no layoff" policy.[32] This policy contributed to the success of Southwest Airlines: By 2010, Southwest Airlines was the biggest domestic airline in the country, with a market capitalization greater than *the combined market capitalization of all its domestic competitors.*

In contrast, if you see management taking big bonuses at the same time they are cutting the benefits of the employees, this is an obvious warning signal. No matter how much managers say they value their employees, they will have no credibility.

For example, when American Airlines was on the edge of bankruptcy, it successfully negotiated with unions for concessions in their contracts. Just days after those negotiations, former Chairman and CEO Don Carty made arrangements to protect the pension plans of senior executives. Carty later resigned because he had not disclosed these activities.[33]

Does the Business Have Good or Bad Employee Relations?

There are many questions you can ask to determine if a business has good or bad employee relations:

- Does management treat its employees as assets or liabilities?
- Does management talk about the contributions of their employees?
- Does management believe that retaining employees is critical?
- Does the business promote from within?
- Does management show employees how they can get promoted?
- Does the business invest significant resources in employee training?
- Does the business attract a great number of applicants?
- Are employees avidly recruited from the business?

- Are there large differences between the benefits that the top managers receive versus employees?
- Does management treat employees with respect when they lay them off?
- Does management listen to its employees?
- Does the business have a strong culture?
- Does the business have identifiable, shared values?
- What is the employee-retention rate?

The following sections take a closer look at each of these questions.

Does Management Treat Its Employees as Assets or Liabilities?

To answer this, look for articles and note how the managers refer to their employees. For example, Michael Bloomberg says in his book *Bloomberg by Bloomberg,* "the main asset is not our technology, our databases, our proprietary communications network, or even our clients. It is our employees. Business must recognize employees as assets."

Does Management Talk about the Contributions of Their Employees?

Nucor Corporation, a steel manufacturer, puts the names of all of its employees on the cover of its annual report. This gesture is a good indicator, and another is that Nucor always shows up on *Fortune* magazine's list of "Best 100 Companies to Work For." Good employee relations have likely helped Nucor become one of the best-performing stocks within the steel industry.

Does Management Believe That Retaining Employees Is Critical?

Shipping company UPS learned that it was critical for it to retain its drivers because experienced drivers learned the fastest routes and were more efficient in making deliveries. At one point, UPS management discovered that part of the reason for the high turnover rate for drivers was that loading the trucks was so physically demanding. When it discovered the problem, UPS promptly hired part-time workers to load packages: This way, the drivers could concentrate on their core competence, which was finding the best routes. As a result, the turnover rate of UPS declined. Anytime you see a management team focusing on the well-being of its employees so they can focus their time productively, this is a great sign.[34]

Does the Business Promote from Within?

A business that promotes from within has a better chance of retaining valuable employees because talented employees typically like to work in growing organizations with opportunities for advancement. A business that promotes from within will hire outsiders only when it needs to fill a specialized position. You can obtain this information by interviewing employees and asking them if most positions are filled with internal candidates or if the company actively recruits outsiders. You can also call the HR department and ask if the company has a policy of promoting from within. Most often, when a company promotes from within, it will highlight this in investor presentations found on the company website or on its employment websites.

Does Management Show Employees How They Can Get Promoted?

A manager's job is to help his or her people grow. Great business leaders have sometimes measured their own success by the positive impact they've had on others, especially in helping employees reach their highest potential. In turn, this inspires employees to do great things for the manager and the company.

In the book *First, Break All the Rules: What the World's Greatest Managers Do Differently*, research firm Gallup sought ways to increase employee engagement. The study represents the largest worldwide effort to understand employee engagement, and was based on Gallup's analysis of 10 million workplace interviews. Gallup found there are two employee sentiments that best predict engagement: "my opinion matters—I have a voice" and "somebody here cares about my advancement."[35]

If managers focus on themselves rather than developing their employees, this will cause employees to disengage from the business, and the managers will fail to develop a pipeline of future leadership at the business.

Does the Business Invest Significant Resources in Employee Training?

If managers are committed to employee training, this is a great sign that they have a long-term orientation. In contrast, a short-term oriented manager considers spending money on training employees a waste of money and a discretionary cost that can be eliminated.

Look for examples where the business is investing in its employees through training by reading articles written in trade journals, such as *Training Magazine*.

For example, Kip Tindell, Chairman and CEO of The Container Store, believes that putting employees first is a profitable strategy. He believes that one great employee has the same productivity as three good employees. Great people are hard to find and even harder to keep. So when The Container Store finds them, it pays them well and spends a lot of money training them. In fact, the average amount of time a first-year, full-time employee spends in training is 263 hours versus the retail industry average of 7 hours. This investment in employees contributes to low turnover. The average turnover in the retail industry is 110 percent, whereas at The Container Store it has historically been below 10 percent. This lower turnover decreases costs over time.[36]

Does the Business Attract a Great Number of Applicants?

Many people hear about good places to work and want to work there. *Fortune* magazine and regional magazines such as *Texas Monthly* publish lists of the best places to work. Whenever a business makes the list, it has more job applicants.

Are Employees Avidly Recruited from the Business?

During the 1980s, the most actively recruited managers in banking were at Wells Fargo.[37] Finding a business with this characteristic is a positive sign because it means the business typically has a strong culture focused on execution. This does not mean employees would be successful at another business, but if they are avidly recruited, this is a sign that the business is well respected. Talk to headhunters who work in a particular industry and ask them what businesses they believe are the best places to recruit employees from and why.

Are There Large Differences between the Benefits That the Top Managers Receive versus Employees?

A successful CEO once told me, "If you are constantly reminding people at the bottom that they are not at the top, do you really expect them to be gung ho about the company?"

Does Management Treat Employees with Respect When They Lay Them Off?

One of the most revealing times to observe managers is during layoffs. You will gain a great deal of insight if you watch how they lay off employees. When a company fires employees, does it do so with respect, or do security guards escort employees out? If you learn that security guards escort employees out, this is a warning signal that management really does not care about its employees.

The best-performing managers have always told me that when they have to lay off employees, they treat them with respect. One CEO told me that he would want the former employee to still feel close enough to the company to remain a company advocate and customer. These managers conduct layoffs or firings in an open manner and always disclose the reasons and rationale behind their decisions. They often give furloughed employees assistance in finding a new job. This way, the management team is able to instill a sense of security and confidence in those employees who are left behind, helping to keep more valuable employees from leaving.

In contrast to this approach, you will often see a degree of insincerity by CEOs even as they announce layoffs. For example, one CEO stated, "Loyal and committed employees are critical," yet at the same time, he was laying off thousands. Look for these negative signs when assessing whether a business has good employee relations.

Watch out for those management teams that quickly announce layoffs the moment their business encounters a setback, such as a temporary drop in demand for its goods and services. There are many examples of businesses in the financial-services, retail, or real estate industries that quickly lay off employees when they encounter a downturn, but as soon as things start to pick up, they look to re-hire the same people—often at a higher pay rate. Instead, look for those management teams that attempt to hold on to their employees by taking the following actions:

- eliminating overtime;
- freezing hiring;
- offering voluntary retirement packages;
- reducing hours;
- reducing everyone's salary;
- delaying raises;
- trimming spending on training, travel, or marketing;

- cutting temporary staff;
- delaying capital investments;
- and using less-busy employees to balance workloads elsewhere in the company.

For example, in 2008 before Federal Express resorted to layoffs, it instituted pay cuts and temporarily halted retirement contributions.[38] In 2000, under similarly slowing economic conditions, FedEx Freight also resisted layoffs on a large scale. In 2003, Pat Reed, CEO of FedEx Freight East, said they juggled hours and kept people working. He called the long-term payoff "indescribable," saying it created loyalty and reduced turnover. Another benefit: "It gives you the ability to hire the best of the best."[39]

Does Management Listen to Its Employees?

Managers can learn more by listening to the conversations of a few employees than by spending time setting down strategic visions. Many of the best ideas come from employees who are in the field, so it is critical for management to listen to them and have avenues for employees to channel information to headquarters. For example, the idea for the Post-it note® developed by the 3M Company came from an employee, and the Frappuccino® at Starbucks was invented by a store manager.

Does the Business Have a Strong Culture?

A culture is an organization's shared values and beliefs, and it sets the tone for how employees treat customers. It is found in all businesses and varies from "this is just a job" mentality to "I love my employer." For values and beliefs to be shared, they must be made clear and they must be modeled. A culture is typically built through the example of the top management of a business; employees will watch how top management acts as a cue for how they should act.

An identifiable culture will attract employees most likely to agree with those values and beliefs. It also informs new employees about what is important at the company. For example, Whole Foods Market's culture is so important to the success of the company that management sends existing Whole Foods Market employees to work at new store locations. They do this not just to help set up systems or train, but to help new employees understand which things are most important to Whole Foods Market. They call this transfer *yogurt culture*.

One of the main advantages of a strong company culture is that a business is able to attract great employees and does not need to pay the highest salaries in order to recruit them. Most talented employees will gladly sacrifice pay for the right work environment. Furthermore, when employees feel like they are part of something important, they are more loyal to the business.

In contrast, a business without a strong culture may be one where failures are not tolerated or where there is a lack of trust among management and employees. Businesses with weak or negative cultures may be inwardly focused and often do not possess good customer service. Employees are there to collect a paycheck, and most employees are not looking to develop their careers at the business.

For example, HealthSouth (an owner of rehabilitation centers) had a hard-charging culture and was known for weak employee relations. When CEO Richard Scrushy performed audits of the rehab centers, he often performed a white glove test of the picture frames: After wiping his finger on a hanging picture, he would then wipe his finger on the clothing of the manager of the center. Any dust marks resulted in lower audit scores.[40] Even though HealthSouth was quickly growing and its stock price was increasing, management-employee relations would be suspect based only on this or similar anecdotes. Regardless of short-term growth, a weak or demeaning culture is usually representative of a weak firm, and it should be a warning signal to investors.

As you determine whether or not a business has a strong culture, look for engaged employees, because the happier employees are in their jobs, the more they will typically try to satisfy customers. The company grapevine is the swiftest means of communication, so tapping into it with a few employees can net you valuable information. The best way to determine if a business has a strong, healthy culture is to talk with mid-level and lower-level employees of a business. These are the people who interface with customers most often. It is one thing for management to say something is important, but if the rest of the company doesn't buy it, it isn't part of the culture.

For example, if you could take the staff from, say, Dunkin Donuts, and plunk them down in a Starbucks, do you think you'd receive the same level of service? Not a chance. The Dunkin Donuts employees would not have been selected and trained to provide individualized attention and service: The entire atmosphere would be different. This difference shows up in your customer experience, and is one reason that Starbucks is able to charge a premium for its products.[41]

To learn more about how a culture is built, I interviewed Bob Graham, co-founder of AIM Management Group, one of the nation's largest mutual fund companies. AIM grew from a firm with five employees and no assets in 1976 to a firm with more than $57 billion in assets under management and a valuation of $1.6 billion in 1997 (when it merged with Invesco). One of AIM's greatest strengths as it grew into a top asset manager was its extremely low employee turnover rate, which was (and still is) rare for a business in the investment management industry. The main reason for such low employee turnover was that AIM was well known for having a strong and energized culture. This allowed it to attract talented employees, and more important, to keep them. Graham recalls, "There was a sense of excitement working at AIM. It was known as a people-friendly company, and people wanted to come work there. It was fun and people didn't leave because they had the excitement of building something everybody was proud of."

This was critical to the success of AIM and its growth. In the book *People Are the Product: A History of AIM*, co-founder Ted Bauer observed that, "In the investment business, people are the product. Your inventory goes down the elevator every night and comes back in the morning. If people are happy, they work more productively."[42]

I asked Graham how AIM was able to build such a strong culture when other companies couldn't. Graham says that in at least one way, they modeled their business on friendships. "To build any successful enterprise requires people. You attract good people through the culture. Our philosophy from the beginning was that we wanted the business to operate in the same way our friendships did. The three of us [Bob Graham, Gary Crum, and Ted Bauer] were all friends, and we all got along so well together. In fact, we hired people we wanted to be friends with. If we felt we would not enjoy spending time with them outside of work, then we would not hire them. When you hire these types of people, a big benefit is that whenever you run into inevitable disagreements, they will always be amicably resolved."

As Graham and his co-founders were building the culture, Graham said they wanted to offer a different type of work environment that gave employees a chance to be part of a small family operation. But they also wanted employees to have opportunities.

Graham explains some of the ways that AIM's culture supported its growth. "We offered a more entrepreneurial environment. We wanted people to have a sense that they could control their destinies." Graham credits Ted Bauer with helping to develop employees: "Ted was always willing to give younger people a lot of responsibility. This was a great way to develop people because they really appreciated the responsibility." By constantly promoting and giving more responsibility, Graham says they also avoided becoming stagnant.

In addition to offering entrepreneurial opportunities, AIM attracted employees who appreciated what is now called work-life-balance. Graham says, "We believed that employees should live a balanced life where family was important. We expected employees to have a life outside of work."

I also asked Graham how AIM had managed to avoid the pitfall of an overly competitive culture, which was dominant in most Wall Street firms. In other words, what did they do to foster a cohesive team environment? He told me they weeded out people who were bad apples or who just didn't fit in well with the culture. This made it much easier on those who stayed. These employees made extremely impressive contributions, and they did it together. Graham said, "We wanted to avoid employees who had the attitude that they needed to beat the guy sitting next to them. AIM's culture was not cutthroat. Employees did not worry about who got credit."

AIM's business and cultural growth shows a cycle of benefits that would be hard to reproduce. The results were that AIM was able to attract talented, entrepreneurial employees and keep those same employees happy by giving them a healthy work environment. In turn, these entrepreneurial employees were the engine that helped AIM grow, which then offered more opportunities for others to move up the ranks.

Look for similar elements in businesses you evaluate. When you locate one with the cultural elements that AIM cultivated—that is, talented, happy, energized managers and employees attracting more of the same—you have discovered the foundation of a successful business.

Does the Business Have Identifiable, Shared Values?

The strongest cultures have shared ideas about what is most important; these are *shared values.* For example, senior managers may value the long-term benefits of training over the savings they would have from not training employees. Similarly, a business may value having great service and generous return policies over the benefits of reducing its service staff or reducing its restocking efforts. Managers and leaders play a central role in communicating and demonstrating what is important for the business, and they often are responsible for how well employees understand and adopt these values, which create the foundation for day-to-day decisions regarding the operations of a business.

To learn how to identify a business that has strongly held and clearly defined values, I interviewed Lee Valkenaar, Co-Chairman of the Board for Whole Planet Foundation.[43] Valkenaar has been at Whole Foods Market since 1987 in various capacities, including executive vice president (EVP) of Global Support (from 2004 to 2008) and president of the Mid-Atlantic Region (from 2001 to 2004). He helped build the culture that Whole Foods Market is so well known for today. In Valkenaar's opinion:

> When you are explicit about your company's values, it gives employees an opportunity to identify with those values because they identify those values within themselves. When employees see things that resonate within themselves, they can align themselves with those values. One of the main advantages of a business that has values is that it creates buy-in from employees by giving them a form of ownership in the business, which increases the chances of successful execution.
>
> Many companies have values that are expressed through a vision and mission. You need to determine if these values are baked into the policies and procedures of the business or if [they are] just a statement that shows up on the wall. If they are incorporated into the culture—into the policies, procedures, and practices—that is when execution happens. People can and should be held accountable for knowing and adhering to these 'shared value policies' the same as they would an attendance policy.

For example, although you may see it in a mission statement, most businesses do not think employee empowerment is critical. Empowered employees can be intimidating to some senior managers, and empowerment also requires a substantial investment in time and energy to make decisions with more voices. When a business truly considers it important to empower employees, it encourages them to speak up. Whole Foods Market has team meetings every month where employees are solicited for their honest feedback. According to Valkenaar, some of these meetings can be intense, and sometimes employees have personal agendas or just want to vent their personal frustrations. For some senior managers, it is not easy to hear that the employee does not like the policies that have been implemented, but it is critical for senior management to listen.

To identify whether a business really has shared values, you need to ask the following questions:

- How do values show up in the organization? At Whole Foods Market, one shared value is that there should be more equitable levels of pay across the organization. To implement this, managers established salary caps for the top executive officers, which limit the amount they can make, compared to a full-time employee. According to the 2010 proxy statement, the compensation was limited to 19 times the annual wage for a full-time team member.
- Are the values identifiable and explicit? Are they found on the company website? Start by looking at the website of the business in the about us tab. If there is nothing there that mentions values or mission, then they are not a central part of the organization.
- Does management continually state them? Reinforcement and public recognition by managers send a message about what's important. Do the employees even know what the company values are? If you were to walk up to any employee at the business and ask what the values are, would that employee be able to answer this question? If not, then it is highly likely the company has not done a good job of expressing what its values are.
- Does the company hold its employees accountable for knowing and incorporating the values? If a supervisor or employee violates the core values, is this behavior tolerated? If a business is serious about communicating, teaching, and operating by using shared definitions of what's important, it won't look away if an employee ignores a shared principle.

Let's say a company, on paper, makes a commitment to an environment of mutual respect, but employees don't buy in. Then that's not a shared value. Many companies have values on paper that say it's important to treat people well, but as Valkenaar notes, "If a business is not proactive in managing assholes, then it is probably not acting in accordance with the values of the organization."

- Are there costs associated with the values? At Starbucks, healthcare costs represent a large portion of costs, but offering great benefits is valued at the company, because that's how it attracts and retains the kinds of employees who keep customers happy. Observing direct investment in something is often the only way to discern its importance to a company.

Finally, Valkenaar gives an example of a business that has not baked those values into its culture. He related a publicized story about a company that encountered a problem because it manufactured a product that said, "Made in the U.S.A." on the outside of the product, but inside, the label stated "Made in China." Visualize the path this product must have taken: As the brainchild of a creative merchandiser, it wound its way from production to the retail stores. Imagine what message is implicitly sent when you brand a product made in the United States and manufacture it in China.

Could that even happen in a company that completely believed in domestic sourcing? Also, if the company were truly committed to open communication, someone likely would have voiced concern even after the item was produced. Finally, if the company thought that customers deserved to know exactly what they were buying, the company would likely have stopped stocking the product completely.

Any company can say it wants open communication with employees, the trust of its customers or that it buys American, but this example shows why saying it isn't the same as doing it. Valkenaar sees a clear disconnect between employees and leadership that allowed this to happen. If the company had really incorporated its values into its business, the snafu would likely have never happened, or at the very least the problem would have been solved long before the product ever hit the shelves.

What Is the Employee-Retention Rate?

If a business has an especially good employee-retention rate, it will often mention this on its website, annual report, or a plaque. For example, Baldor Electric, an electric-motor manufacturer, has a plaque at its headquarters showing the names of its employees who have been with the company for more than 10 years and the date each joined the company. Most of the employees on the plaque have been at the business for 15 years or more. There are many advantages to a high employee-retention rate, including reduced hiring costs, better customer relations, and higher profitability than competitors.

For example, even though Costco pays its employees 40 percent more (on average) than Sam's Club (which is owned by Wal-Mart) and gives its employees better benefits, Costco's profit per employee is much greater than its competitor Sam's Club. Low employee turnover is one of the reasons for this. Whereas Sam's Club turnover is 21 percent in the employees' first year, Costco's is only 6 percent. "Paying your employees well is not only the right thing to do, but it makes for good business," says Costco CEO Jim Sinegal. He further states that if Costco paid rock-bottom wages, it would get what it paid for. "It doesn't pay the right dividends. It doesn't keep employees happy. It keeps them looking for other jobs. Plus, managers spend all their time hiring replacements rather than running your business."[44]

❐ 44. Does the management team know how to hire well?

There are few management decisions more important than those involved in hiring and promoting employees. The number-one job of a manager is to pick the right people and then put them in the right positions. In essence, management is the art of getting things done through other people. Jack Welch, former CEO of General Electric, said, "My job is not to know everything about each business. It is to pick the people who will run the business and to decide how much money Business A versus Business B or C gets—and how to transfer people, dollars, and ideas across those businesses. I don't get into the how."[45]

If the management team has good people it can trust and count on, then executing the plans of the business becomes easier. In turn, talented employees hire other talented employees, who strengthen the entire organization. Therefore, if management is able to hire well, this is a great indication of competence.

You need to determine the caliber and tenure not only of top managers, but also those managers in important operational roles. Begin by identifying all of the key managers at the business by position. You may want to construct a management-timeline report, similar to the one shown in Table 8.1 for regional gaming business Penn National Gaming.

To construct this timeline, use the historical proxy statements to identify the top managers of the business. To identify other managers not shown on the proxy statement, screen for all of the Form 3, 4, and 5s, which you can find on the SEC website. These forms must be filed promptly, and they describe the holdings and transactions of officers, directors, and beneficial owners.

An added benefit of creating a management timeline report is that you will be able to note if there is a lot of manager turnover at the business, which is a negative sign. I have learned that one of the best indicators of a business that is deteriorating is when the most competent top managers of a business begin to look for other jobs or leave the business. You can use your timeline to monitor management turnover to alert you of any potential problems within the business.

After you have finished constructing a timeline report, research the backgrounds of each manager by searching for press releases and historical articles found in news aggregation sites, such as *Dow Jones Factiva* or *LexisNexis.* You will often find a press release issued by the company describing the background of the new management hire. You can then search for other articles by combining the name of the manager with previous employers. As you read through the articles and the press releases, determine whether the managers hired have the experience and knowledge necessary to do the job. Pay particular attention to whether they have dealt with a similar customer base in the past. If the top managers are hiring other managers with a lot of experience with the customer base, then this is a positive sign; however, if they are hiring their former colleagues or other managers who have limited experience with the customer base, this should serve as a warning signal.

For example, at IMS Health, a pharmaceutical information and consulting company, CEO David Thomas hired managers who had worked at his previous employer, IBM. These new hires did not have

Table 8.1 Penn National Gaming—Management Tenure from 2001 to 2010

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
CEO	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino	Peter Carlino
Pres/COO	Kevin DeSanctis (02/01)	Kevin DeSanctis	Kevin DeSanctis	Kevin DeSanctis	Kevin DeSanctis	Kevin DeSanctis (10/06)	x	Tim Wilmott (02/08)	Tim Wilmott	Tim Wilmott
EVP of Operations	x	x	Len DeAngelo (07/03)	Len DeAngelo	Len DeAngelo	Len DeAngelo	Len DeAngelo	Len DeAngelo (08/08)	x	x
CFO	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford	Bill Clifford
SVP/Regional	x	x	x	x	x	x	x	Thomas Burke*	Thomas Burke	Thomas Burke
SVP/Regional	x	John Finamore	John Finamore	John Finamore	John Finamore	John Finamore	John Finamore	John Finamore	John Finamore	John Finamore
VP/Secy/Tr	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito	Robert Ippolito
Corp Development	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder	Steven Snyder

*Burke with PENN since 2002, previously General Manager Argosy Riverside and Bullwhackers

Note: x denotes position not filled

pharmaceutical knowledge or experience with the customer base. A sweep of press releases and news stories would have alerted you to the fact that many other IBMers ended up at IMS Health, among them:

- John Schultz, IMS' SVP of European Sales (after 20 years at IBM);
- Bruce Boggs, SVP of IMS' U.S. Sales (after 26 years at IBM);
- Adeh Al-Saleh, President of IMS EMEA, (after 19 years at IBM); and
- David Carlucci, President/COO (after 25 years at IBM). Carlucci later became CEO of IMS Health.

The warning signal to our firm was that it appeared that the CEO was hiring his former colleagues rather than hiring managers who were more qualified or who had experience in the pharmaceutical industry. As one indicator of the success of using this hiring method, note that the stock price when Thomas was appointed in 2000 was around $25 per share. It remained in the $25 to $26 per share range as Carlucci took over as CEO in 2006, and it then dropped to $22 per share when the company was taken private in 2009.[46] In other words, over a nine-year period, the managers at IMS Health failed to create any market value for shareholders.

In contrast, Casey Hoffman, founder of supportkids® (a child-support-services company), mainly hired single parents. These managers understood what it was like to be in their customers' shoes and lived their lives understanding many of the same frustrations and difficulties as their customers. This allowed them to execute more effectively than those who did not understand the customer base. As a result, supportkids grew its revenues at an annual rate of 28 percent during Hoffman's tenure as CEO.[47]

How Do You Determine if the Manager Knows How to Pick Good Employees?

A business will put the odds of succeeding in its favor if it recruits and retains employees who truly want to work there. Employees who are thoroughly engaged are more likely to stay longer. On the other hand, if a business does not hire well, then most of its employees will rotate in and out of critical roles, reducing productivity for the long term. Managers who know how to hire well are disciplined, hiring only those employees that fit their criteria, instead of just hiring the best candidates who are available at the time. Therefore, watch for those businesses that take their time as they hire employees.

Next, determine if the employees are coming from businesses with similar cultures. For example, if an employee has spent 20 years working at bureaucratic British Airways (BA) and has been hired at a decentralized business such as Penn National Gaming, then it is less likely to be a good cultural fit for both the company and that employee. If most company hiring is from businesses with similar cultures, then the odds are better that it will be a good fit.

Managers who hire well typically hire for a certain character trait, such as integrity or attitude, rather than skills. Issadore Sharp, founder of Four Seasons Hotels, said he hired employees for attitude first and then trained for the rest. "I can teach anyone to be a waiter," he said, in the book *Four Seasons: The Story of a Business Philosophy*. "But you can't change an ingrained poor attitude. We look for people who say, 'I'd be proud to be a doorman.'" Herb Kelleher, founder of Southwest Airlines, echoed this sentiment when he said, "You don't have the time, techniques, or enough drugs to change attitudes."[48]

How Well Is the Business Able to Articulate the Values and Attributes of the Firm to Attract the Right Employees?

It is critical for a business to attract the right employees. Businesses attract employees to a degree because of the culture they offer. Employees who enjoy and excel in collaborative environments pick those types of companies, whereas other employees may choose to work in more structured environments. The type of employee a business attracts depends on the type of business. For example, in retail, you must have a strong customer-service culture. If you visit retail stores and find that the employees are not customer oriented, then this is a clear indicator that they are not hiring well.

The only way a business can hire employees who will be enthusiastic about their work and loyal to the business is by clearly communicating the values and attributes of the business to potential employees. This way, employees can self-select into the business if they believe that their values and preferences fit with the business. Some businesses excel at expressing what makes them unique. For example, at Whole Foods Market, potential employees are told that they will have a four-week trial period of working in a team; after that trial period, two-thirds of the team must accept the employee in order for him or her to join the company permanently. Potential employees who do not like team environments will most likely not want to go further in the interview process. Therefore, potential hires at Whole Foods Market self-select into the business.

Employees who thrive in clear-cut, well-defined work environments do not want to work in uncertain environments where there are no hierarchies or predetermined channels of communication. For example, Exxon Mobil does a good job of explaining to employees that it has a highly structured environment and that it will take a long time in order for an employee to be promoted. It expects its hires to remain at the company for long periods of time. Employees who become frustrated with their progress may leave, but those who remain are more likely to make their careers at the company.

One type of employee isn't necessarily better than another, but the business does need to do a good job of communicating what type of firm it is. If you note that the business has high turnover or disengaged and unproductive employees, then this is a sign it is not clearly communicating its values to potential hires.[49]

Do They Hire Managers or Employees Who Are Candid?

You want to determine if the manager hires employees who are candid or those who are not afraid to challenge the top management team. Candid employees will speak up when they think the manager is pursuing a flawed strategy, whereas an employee with a different personality or outlook may just assume the manager knows more than the employees.

Candor is, in essence, the willingness of employees to express their real opinions. Perhaps you have been in a formal meeting where another manager is making a presentation that you know will not work, but you wait for the boss's response before proceeding to question the plan. If the boss approves, it is highly likely you will not speak up. An open CEO encourages others to be open and not agree to things that they have no intention of acting on, or consider poor ideas. Formality thus suppresses candor, whereas informality encourages it. One way to learn if a business hires candid employees is to learn about the type of workplace it has. Ask the employees if the meetings they attend are full of presentations that are prepackaged, well-orchestrated, or stiff. If the meetings are instead open, employees will probably be more comfortable providing valuable feedback.

For example, at DaVita, which operates dialysis treatment centers, CEO Kent Thiry encourages employees to bring him bad news. Thiry regularly surveys employees, and he makes it a point to act quickly on the feedback he receives. He uses the information to avoid mistakes.[50]

Similarly, Motorola was recognized as a great business in the 1980s when it was run by CEO Robert Galvin. During that period, the only way managers got ahead was by challenging existing assumptions and not supporting the status quo. Galvin encouraged his employees to tell him the truth and to challenge him. A story often told is that a young middle manager once approached Galvin and said, "Bob, I heard that point you made this morning, and I think you're dead wrong. I'm going to prove it: I'm going to shoot you down." Galvin's response to a companion was proud: "That's how we've overcome Texas Instruments' lead in semiconductors!"[51]

However, as Motorola's top management changed, these employees no longer felt comfortable being candid. As a result, Motorola developed fewer innovations, and its stock price (even after accounting for spin-offs) increased only marginally over the last 20 years, from 1990 to the end of 2010.[52]

If the top managers are hiring employees who are not encouraged to speak their minds, it is likely the business will encounter problems down the road, making it a bad investment.

What Type of Board Members Does the CEO Choose?

Typically, the CEO plays an important part in bringing board members in, especially if the CEO has been running the business for a long period of time. Is the CEO bringing in cronies, board members with prestige, political figures, friends, consultants, or lawyers? If they are bringing in, say, politicians, many will lack business experience, and this could be an indicator that the CEO is bringing in people because they are loyal to him or her. Viewing the types of board members that have come to the business during the CEO's tenure will alert you to whether the CEO is using the business as a personal vehicle to benefit him- or herself, or if the CEO is running the business with shareholder interests in mind.

Most of the largest frauds in corporate history involved board members whose interests were more clearly aligned with management than shareholders and the business.[53] For example:

- Enron's board was known for rubber stamping the company's deals. Board members didn't often challenge management on the financial reports or any other matters. And why would they? A board member doing so would be risking as much as $380,000 received as an annual board retainer.
- WorldCom, the telecom business embroiled in accounting fraud, had a board almost entirely aligned with CEO Bernard Ebbers: Most were insiders, and even those who were outsiders had strong personal and financial ties to Ebbers.
- At cable business Adelphia Communications Corporation, family members made up the majority of the board. The founders of Adelphia were charged with securities violations.
- Insiders dominated conglomerate Tyco's board. CEO Dennis Kozlowski's board filled 8 of 12 positions with Tyco employees. Kozlowski was convicted of grand larceny related to unauthorized compensation.

Look out for conflicts of interests between directors and the CEO found in the Related Party section of the proxy statement. For example, here's what you would have found in HealthSouth's proxy statement (HealthSouth's CEO was involved in a corporate accounting scandal):

- A director earning $250,000 annually for seven years as part of a HealthSouth consulting contract.
- A director with a $395,000 joint property investment with HealthSouth CEO Scrushy.
- A director whose company received a $5.6 million glass installation contract at a new HealthSouth hospital.
- A company owned by HealthSouth employees (Scrushy, six directors, and the wife of a director) that also did business with HealthSouth. The company, MedCenterDirect, was a hospital-supply company that operated online.

Watch also for donations to charities made by the company on behalf of certain directors as this often serves as a red flag. For example, at Enron:

- Dr. John Mendelsohn was a board member and member of the audit committee: He received substantial donations for the cancer research center he directed from both Enron and Ken and Linda Lay.
- Lord John Wakeham, another audit committee member, was paid $72,000 each year over many years as an Enron consultant.
- Wendy Gramm (another audit committee member) received a $50,000 Enron donation for the program she directed at George Mason University, the Mercatus Center Regulatory Studies Program.

These are potential conflicts of interest, and they serve as clear warning signals.

❒ 45. Does the management team focus on cutting unnecessary costs?

I used to believe that a frugal manager was a good manager. Over time, I learned that although managers who are habitually thrifty will be able to recognize opportunities to lower costs, they may not invest in important projects. Frugality is bad when the company does not spend money for the benefit of customers.

On the other hand, reducing unnecessary costs while continuing to invest in the core business is good. For example, if you visited the headquarters of retailer 99 Cent Only Stores, you would see stained carpeting, broken file cabinets, folding tables used as credenzas, and front pages of newspapers displayed as art. Clearly, founders Dave and Sherry Gold have chosen not to spend money on the headquarters because customers don't care what corporate offices look like. As Dave Gold says, "I don't mind spending money. I just don't like to waste it." Instead, 99 Cent Only Stores invests in the things that benefit the customer, spending money on the stores, and making sure its buyers (who find the best products for customers) are well compensated: In fact, the company pays its buyers *double* what they would make anywhere else.[54]

Another CEO who believes in investing in his business is David Zaslav, CEO of television company Discovery Communications. Zaslav puts creative leaders rather than a business leader in charge of each channel and prioritizes brand building, audience building, and great content. His thinking is that quality content is always going to be in demand. Zaslav sees the company as two halves: "On the right half is better content, better shows, better characters: *Deadliest Catch* and *Oprah*. The left side is everything else. If we can take $2 out of the left side and invest $1 or $1.50 more in our content and brands, that gives the trajectory of our growth a push."[55]

Watch also for the *type* of costs a business cuts. When Starbucks CEO Howard Schultz cut costs during 2009 and 2010, he avoided cuts that would directly affect the customer. Instead, he reduced costs by eliminating supply chain inefficiencies, waste, and certain parts of the support structure. Starbucks also reduced expenses, but at the same time, it kept investing in the things that mattered most: For example, maintaining employee benefits and committing more resources to employee training. During 2010, Schultz said that his customer-satisfaction scores actually rose, reaching their highest levels ever because, "We reinvested in our people, we reinvested in innovation, and we reinvested in the values of the company."[56]

Also, think about this: If the management team is continually announcing cost-cutting programs, this is a sign that they are not focused on continually cutting unnecessary costs. These types of businesses are often serial restructurers as well. For example, during his Hewlett-Packard tenure (2005 to 2010), CEO Mark Hurd took $3.2 billion in restructuring charges and $3.3 billion in write-downs for amortization of intangible assets related to acquisitions. This buy-and-restructure strategy helped HP deliver annual revenue growth of 7.5 percent and 22 percent growth in earnings per share during Hurd's tenure. However, Hurd was constantly restructuring the workforce by increasing the use of contract manufacturing and other cost-cutting measures. He also acquired companies (such as Electronic Data Systems, 3Com, and Palm) to grow markets in services, networking, and mobile devices—acquisitions that, combined with ongoing restructurings, made "one-time charges" recurring. The problem is that once these large costs have been taken so quickly, it becomes more difficult for the business to cut costs further without the quality of the product declining.[57]

❒ 46. Are the CEO and CFO disciplined in making capital allocation decisions?

Capital allocation is the manner in which the management team invests the excess free-cash flows that the business generates.

Management decides when and where these excess free-cash flows should be invested or distributed. There are five actions management can take with excess free-cash flow:

1. Reinvest the capital back in the business in new projects.
2. Hold cash on the balance sheet.
3. Pay dividends.
4. Buy back stock.
5. Make acquisitions.

It is difficult to find CEOs who are both good at operating the business and at allocating capital. The main reason for this is that operating a business and allocating capital are two completely different skill sets; being proficient at one of these functions has no correlation to being competent with the other. As a group, CEOs possess varying degrees of competence when it comes to capital allocation.

The best capital allocators are those who are removed from the day-to-day operations of a business—for example, Warren Buffett, CEO of Berkshire Hathaway; Peter Carlino, CEO of Penn National Gaming; and Bruce Flatt, CEO of Brookfield Asset Management. The best capital allocators delegate the day-to-day operations to other managers within the business; for example, Carlino delegates the day-to-day operations to COO Tim Wilmott. This allows these CEOs to see the big picture and not get bogged down in the details.

One of the best capital allocators in corporate history was Henry Singleton, longtime CEO of Teledyne, who cofounded the business in 1960 and served as CEO until 1986. In John Train's book *The Money Masters*, Warren Buffett reported that he believes "Henry Singleton has the best operating and capital-deployment record in American business." When Teledyne's stock was trading at extremely high prices in the 1960s, Singleton used the high-priced stock as currency to make acquisitions. Singleton made more than 130 acquisitions of small, high-margin manufacturing and technology businesses that operated in defensible niches managed by strong management. When the price-to-earnings ratio of Teledyne fell sharply starting in the 1970s, he repurchased stock. Between 1972 and 1984, he reduced the share count by more than 90 percent. He repurchased stock for as low as $6 per share in 1972, which by 1987 traded at more than $400 per share.[58]

The best way to determine if managers are good at allocating capital is to review their historical decisions, whether they are buying back stock or making new investments. You can identify a good capital allocator by looking for examples where they are disciplined.

For example, in a fourth quarter 2008 conference call, Penn National Gaming CEO Peter Carlino discussed why the company did not build a hotel next to its successful casino site in Hobbs, New Mexico. A hotel would help the casino generate more cash flow as it would encourage visitors to stay overnight. Carlino said that preliminary estimates to construct the hotel came in at $30 million, yet he felt that it would not make sense to build the hotel until the construction costs came in closer to $20 million. This $10 million difference is not a large amount, considering Penn National Gaming generated more than $300 million in distributable free-cash flow in 2009.[59] Even though a hotel would add to cash flows, Carlino demonstrated that he is disciplined in waiting for the right deal before proceeding with any capital investments.

In contrast, the majority of CEOs would probably build the hotel and hope that the extra cash flows from overnight visitors would make up the $10 million difference. But Carlino's capital discipline has helped Penn National Gaming become one of the greatest compounding stocks in the last 15 years, compounding at more than 27 percent from its May 1994 initial public offering (IPO) to its stock price at the end of 2010 of more than $27 per share.[60]

❒ 47. Do the CEO and CFO buy back stock opportunistically?

Earnings per share is the most important measure in determining what a share of stock in the business is worth. Because stock repurchases decrease the number of shares outstanding, they have the effect of increasing earnings per share. If the stock is undervalued, these stock repurchases can add materially to the value of the business. The timing of buybacks will depend on the value of the stock, on how much cash the business has, and how much cash it needs. Management may decide to buy back stock as a one-time act, or you may see management lay out predetermined amounts each year that it plans to use for buybacks.

There are a couple of common motivations behind stock repurchases:

- Management may believe the stock is undervalued, so it takes advantage of the opportunity to potentially add value.

- Management may want to offset dilution from issuing stock options.

Let's review the two reasons for buybacks in more detail.

Adding Value By Buying Back Stock Opportunistically

By making buybacks when the stock is undervalued, management can materially add to the value of the business. For example, if a business is worth $50 per share and management buys 10 percent of the stock at $25 per share, then management has automatically increased the value of the business to $52.50 per share ($25 per share multiplied by 10 percent equals $2.50 per share plus $50 per share). If it instead pays $100 per share, then it is reducing shareholder value. The lower the price it pays for the stock, the more value management will create for shareholders.

The best way to determine if the management team is opportunistic in its stock repurchases is to examine its history. Western Union, for example, generates a lot of excess free-cash flow, so stock buybacks make sense. When Western Union was spun off from First Data Corporation in 2006, management announced it would invest $1 billion per year in stock buybacks. In 2008, when the stock was trading at more than $23 per share, Western Union repurchased $1.3 billion in stock. However, as the stock price *declined* to below $14 per share in 2009, management pulled back, saying the recession had limited its ability to repurchase shares, and that it would only repurchase $400 million in stock. With stable cash flows and a strong balance sheet, Western Union had more than enough cash to buy the stock. Instead, as the stock price *increased,* Western Union began repurchasing stock, announcing it was reinstating its plan to buy back $1 billion in stock each year. Although conserving cash is important, in this case, it was unwarranted given the strong cash flows, and clearly illustrated that Western Union's management team was not opportunistic in its stock repurchases.[61]

An example of a business whose management team has made many opportunistic purchases in the past is AutoZone, an automotive-parts retailer. AutoZone's earnings per share (EPS) grew at a rate of 15.7 percent from August 2002 to August 2010, while its net income grew at a rate of 6.23 percent over the same period. The main reason for the difference was due to the share repurchases that AutoZone made, which reduced the number of shares outstanding from 104.4 million shares to 48.5 million, or by 53 percent.[62] The share repurchases have clearly added value: EPS grew 15.7 percent during the eight-year period. Had AutoZone not bought back any stock, then the EPS would have grown only 6.23 percent, which would have resulted in a lower stock price.

Table 8.2 examines further how AutoZone's stock repurchases have added value over eight years (with August as year end).

You can use a similar table when you are assessing whether a management team has added value through stock repurchases. The amount and number of shares repurchased are found in the 10-K in a separate section titled Stock Repurchases.

Similarly, when a business issues new shares (e.g., stock options), it destroys value. For example, General Motors reported a 4.82 percent growth rate in net income from 1985 to 1995. However, its EPS over the same period grew at an annual rate of only 2.68 percent because GM increased the number of shares outstanding during that time.[63]

Offsetting Options Dilution

When determining whether the stock repurchases add value, disregard those repurchases made to offset options dilution. Most investors don't think of repurchasing issued options as capital allocation, but this is an area that management controls, and it

Table 8.2 AutoZone Stock's Repurchasing History, from 2002 to 2010

Year	Outstanding (in millions)	Repurchased (in millions)	Avg. Price Paid per Share	Amount Paid (in millions)	EPS with Share Repurchases	EPS without Share Repurchases
2002	104.4	12.6	$55.47	$699.00	$4.10	$4.00
2003	94.9	12.3	$72.44	$891.00	$5.45	$4.84
2004	85	10.2	$83.14	$848.00	$6.66	$5.29
2005	78.5	4.8	$88.96	$427.00	$7.27	$5.33
2006	75.2	6.2	$93.23	$578.00	$7.57	$5.31
2007	69.1	6.0	$127.00	$762.00	$8.62	$5.56
2008	63.3	6.8	$125.00	$849.00	$10.14	$6.00
2009	55.3	9.3	$140.00	$1,300.00	$11.89	$6.13
2010	48.5	6.4	$175.63	$1,124.00	$15.23	$6.89

Source: AutoZone 10K 2002 to 2010 August 25 year end, Basic EPS data is Capital IQ

Table 8.3 Microsoft Option Issuance and Buybacks

	2010	2009	2008
Stock buyback (No. of shares, millions)	380	318	402
Options Issuance (No. of shares, millions)*	101	90	68
Percentage of stock buyback used to offset option dilution	27%	28%	17%

*Includes Stock Awards and Shared Performance Stock Awards: Shared performance stock awards (SPSAs) are a form of Stock Award in which the number of shares ultimately received depends on Microsoft's performance against specified performance targets.[64]

is another form of capital allocation. You can create a table that includes the number of stock options issued in a given year compared to the number of shares bought back in order to understand what percentage of stock buybacks are used to offset options dilution. In the 10-K, there is a section titled Stock Plans, where you can find the total number of options that are issued by the business. Table 8.3 is an example for Microsoft.

As you can see from Table 8.3, the amount of stock buybacks to offset options dilution averages 25 percent, leaving 75 percent of repurchases to potentially add value. When evaluating how effectively management is using buybacks, use this percentage rather than all the repurchases.

Key Points to Keep in Mind

- The best-performing businesses over the long term, as measured by shareholder returns, are managed by CEOs who have a purpose greater than solely generating profits.
- Most successful businesses are built on hundreds of small decisions, instead of on one well-formulated strategic plan.
- Good management teams work on proving a concept before investing a lot of capital. They are not likely to put a lot of money in all at once hoping for a big payoff.
- The strategic plans that are most prone to failure are those that have an overly narrow focus, such as those that set a financial target (e.g. guidance).
- Businesses that are decentralized attract independent thought and a diverse workforce, which encourages innovation.

(continued)

- Many of the best-performing stocks in history—that is, those that have compounded at rates greater than 20 percent over 15 years—have used decentralized operating structures.
- When a business has good employee relations, it typically has many other good attributes, such as good customer relations and the ability to adapt quickly to changing economic circumstances.
- If managers are committed to employee training, this is a great sign that they have a long-term orientation.
- Avoid investing in those management teams that quickly announce layoffs the moment their business encounters a setback.
- If a business culture is admired and respected, the business is able to attract great employees.
- Few management decisions are as important as selecting the right people for the right positions. Good hiring indicates sound judgment.
- The best capital allocators are those who are removed from the day-to-day operations of a business.

CHAPTER 9

Assessing the Quality of Management—Positive and Negative Traits

In Chapter 8, we looked at how management operates the business; this chapter shows you how to evaluate the positive and negative traits of the managers themselves. Many investors rely on the personality, education, and technical knowledge of a management team to assess whether they are capable of leading a business. These are important qualities, but there are far more important qualities. If you are going to invest for the long term with a management team, you'd also better think about the character and values of the people on that team. For example:

- Is management passionate about operating the business?
- Does the manager have integrity?
- Would managers fudge accounting numbers to meet guidance?
- Do managers have enough humility to acknowledge when they have made a mistake?

As you begin to evaluate the character of a manager, look for a pattern of behavior that can help you forecast future behavior. When it comes to people, the best predictor of future behavior is past behavior. You want to get an overall sense of what the manager is like. In order to do this, look at what the managers have accomplished in the past and more important, how he or she accomplished them. Published interviews are among the best sources for real insight, as are in-depth articles written about the manager. As you are reading and forming an opinion of a manager, make sure you're getting more than just quick quotes or a few annotated quotes. If the majority of answers are captured, it's a much stronger piece of evidence, and it reduces the likelihood that certain comments were taken out of context.

A manager's habits and values are among the most important factors that determine whether he or she will be a success or a failure in the long term. The questions in this chapter will help you to identify the traits that are common to the best-performing managers, so that you can invest with them for the long term.

❒ 48. Does the CEO love the money or the business?

Most investors spend too much time trying to determine whether management has the right financial-incentive structure to create shareholder value rather than examining if the manager has passion for the business. External incentives, such as a large compensation package, will never be as powerful as internal motivation. Passion motivates more than money. Warren Buffett, chief executive officer (CEO) of Berkshire Hathaway, firmly believes this: When he was asked how he determines which managers to partner with, he said, ". . . the biggest question I ask myself is 'Do they love the money or do they love the business?'"[1]

Why Is Passion Important?

Passion is a necessary ingredient for long-term success in business or any profession. If you have ever asked the advice of successful businesspeople on how to become successful, the most common advice you probably received was that you needed to find something you love to do and then do it. By doing what you love and getting very good at it, you'll be happier, society will likely reward you, and the money will eventually follow. They probably counseled you to not go after a job for the money, and in fact, most people who have made a lot of money didn't make that their primary goal. For example, when entrepreneurs create a business, they are usually following some passion. They do not say to themselves, "I want to be an entrepreneur" and then look for a business to start or acquire.

The same rule of success applies to public company CEOs and other managers: If they are not passionate about the business they are managing, they will likely do a poor job managing the business over the long term. Steve Jobs, founder of Apple, said it plainly in a commencement address to Stanford University students in 2005, "The only way to do great work is to love what you do. If you haven't found it yet, keep looking. Don't settle."

The act of building a business over a number of years is slow and can be boring at times. How can CEOs be effective if they are not genuinely interested in what they are doing? CEOs and other managers who are passionate about their businesses throw themselves into their work, constantly learn from their mistakes, and they find opportunities and solutions to problems that others do not see. Passion turns into tenacity, which is a necessary ingredient for success because the rewards are often far into the future.

How Do You Identify Passion?

You can identify passion by answering the following questions:

- Is the business a career or just a job for the manager?
- Would the CEO refuse to sell the business, no matter what the price?
- Is the manager interested in money or motivated by money?
- Does the manager focus on appearances instead of the business?
- What type of philanthropic endeavors is the manager involved in?
- Are the managers lifelong learners who focus on continuous improvement?

Is the Business a Career or Just a Job for the Manager?

Start by asking whether the business is a career or a job for the manager. When you review the backgrounds of managers (which you can find in the proxy statement or articles written about the managers), determine whether they have remained in the same industry for a long period of time or if they jump from industry to industry. If they have remained in the same industry for a long period of time, then the odds are they enjoy their work. Look at previous positions to understand if there is consistency or a pattern in what they do.

For example, the founders of child-care provider Bright Horizons have always been passionate about helping children have the best start possible to their lives. They figured that millions of U.S. parents wanted and needed to work but could not afford high-quality child care. They decided to fill this need with Bright Horizons. A quick check of the founders' backgrounds tells you that this husband-and-wife team also served as co-country directors in Sudan for Save the Children before founding the company. Because their background was previously in helping children, it was obvious that they were pursuing their passions.[2]

Would the CEO Refuse to Sell the Business, No Matter What the Price?

If someone else offered to buy the business from the CEO, how would that CEO respond? A truly passionate CEO would say the business is not for sale and would decline these overtures. In contrast, most CEOs would sell if the price was right. What if you were offered $1 billion for a business generating an estimated $50 million in revenues? Would you sell it because it was an extremely high offer?

This was the situation faced by Mark Zuckerberg, founder of online social network Facebook, in 2006 when he was courted by managers from Viacom, Yahoo, and others to buy his company. Zuckerberg continually resisted their offers and realized that he did not want to sell the business. He said he was not growing Facebook solely for the money and that no amount of money would buy his business.[3] What is most interesting is not whether Zuckerberg made a good decision or not but rather that such a young person (who was only in his early 20s) was so passionate about his business that he would not sell it for $1 billion, or $10 billion for that matter.[4] Zuckerberg prefers to have tight creative and financial control of the business and wants to play the game his way. The money is secondary. Zuckerberg has been quoted as saying, "We are engaged in something greater than getting rich." This is true passion. Fast forward to 2011 and Facebook is valued between $60 billion and $75 billion.[5]

Is the Manager Interested In Money or Motivated By Money?

How do you determine if a manager is interested in money rather than motivated by money? You simply look at their spending habits and how they live. Passionate leaders make little time for other activities or hobbies, and have few outward signs of wealth. They are narrowly focused on the business at hand. In contrast, some managers seek social approval by having big homes and nice belongings. The difference between the two is that one manager is interested in money and the other type is generally motivated by money. People who are interested in money tend to be conservative in their spending habits, whereas managers who are motivated by money tend to have liberal spending habits.

For example, Warren Buffett's personal spending habits have remained the same, while his net worth has increased enormously through the years. Similarly, Dave and Sherry Gold, founders of dollar store retailer 99 Cent Only Stores, have lived in the same home since 1963 and Dave drives an older Toyota Prius. When I asked Sherry Gold why, she answered, "We had everything we wanted that was achievable through money."[6] Money serves as a score, and it does not significantly change their personal lifestyles.

While spending and lifestyle can be an indicator of motivation, it isn't always definitive. Some high-performing CEOs live in big mansions, such as Leslie Wexner, founder of retailer the Limited (owner of Victoria's Secret). He may have liberal spending habits, but his motivation for running the business is more than just making money. Study the managers in-depth to understand the source of their motivation.

To begin studying a CEO's lifestyle, start by compiling a set of articles that focus on the CEO, using a news-archiving service such as *Dow Jones Factiva.* For example, there were many articles written about Stephen Hilbert, CEO of insurance firm Conseco, and his larger-than-life lifestyle. Articles about Hilbert reported lavish parties in his 23,000-square-foot mansion in Carmel, Indiana. His home included a full-size replica of Indiana University's Assembly Hall, and he and his friends wore Hoosier uniforms when they played basketball. Most investors ignored his personal lifestyle because the stock price rose 46 percent a year, compounded, from 1988 to 1998. However, these aspects of Hilbert's personal lifestyle should have been warning signals because they indicated he was *motivated* by money rather than just interested in money.[7]

What happened to the company? On December 17, 2002, Conseco filed for bankruptcy, and the high returns investors had previously earned were wiped out completely.

If you cannot find articles written about the lifestyle of a manager, you can look up the value of their homes, which will give you a glimpse into how they live. Ownership of certain assets such as residential real estate is generally fairly transparent. You can check for residential real estate at the county level where the manager lives. For example, in Austin, Texas, you can search www.traviscad.org, which is the website for the local taxing jurisdiction. You can usually search for properties by the name of the person. First, find out which city the manager lives in and then determine the name of the county and the taxing jurisdiction. In most cases, the county will list the ownership of properties online and you can see the tax value of the home as well as its size.

For example, suppose you're interested in learning more about Warren Buffett's lifestyle. A simple online search will tell you that the tax assessor for Omaha is in Douglas County. You then go to the Douglas County tax assessor website, and enter "Warren E. Buffett." On the site, it lists that Warren Buffett owns a 1921 home sitting on three quarters of an acre of land, with 5,830 square feet with five bedrooms, and a handball court, valued at $660,200 in 2010.

If you want to try a more comprehensive real estate search, there are public records companies that have combined many of the local public records into national databases, allowing you to search for holdings across different counties and states. This would yield information on second homes, vacation homes, and so on. Keep in mind that these properties may be held in the CEO's name or in the name of a spouse or business entity.

Does the Manager Focus on Appearances Instead of the Business?

Managers who are truly passionate about their business have less time for outside social engagements. Steve Jobs, founder of Apple, did not spend his money lavishly when he was one of the richest people in the world, and he claimed to have little time for a social life. He was on a mission to make computers as common as kitchen appliances, which at the time, was dismissed as hype.

It is important to look for distractions managers have outside of the business. The biography found in the proxy statement is a great starting point because it lists the other activities of the top five executives, such as sitting on the boards of other public companies and non-profit affiliations. You want to gain a basic understanding as to whether they are devoting a large amount of their time to other activities. Do they sit on socially prestigious boards in their community? If so, how much involvement does the organization require? Try to gain insight into what motivated the manager to join the board: Was it for social prestige, or was it because he or she is truly interested in the mission of the non-profit? And keep in mind that just because a manager is dedicated to great causes, such as the community, diversity, or other socially responsible goals, this does not necessarily translate into good ethics. For example:

- Ken Lay, who was then the Chairman of Enron, donated $1.1 million in 1999 to endow the Kenneth L. Lay Chair in Economics at the University of Missouri-Columbia. Lay was later convicted of conspiracy and fraud after Enron failed.
- Alfred Taubman gave significant gifts to the University of Michigan in Ann Arbor, and buildings named for him include the Taubman Medical Library and Taubman Health Care Center. There is even a school within the university named for him, the Taubman College of Architecture & Urban Planning. Yet he spent a year in jail after being convicted in 2001 for price fixing at auction house Sotheby's.
- Dennis Kozlowski, the former CEO of conglomerate Tyco International, donated millions to Seton Hall University, and its Stillman School of Business was housed in an academic building named for Kozlowski. Yet he was convicted of looting Tyco of $600 million.[8]

Many times, you can infer the motivation of managers by the number of large social or charity events they attend. For example, when I searched for information about the CEO at a large Texas oil business, all the articles written about him related to his attendance at high-profile social events. I could not understand how he made time for the actual business! I later interviewed him and asked him why he had so much available time to attend all of these social functions, and he answered that he had capable people running the organization. Although this seems like a rational answer, his absence hurt the business, the stock price fell, and he was eventually fired by his board of directors.

What Type of Philanthropic Endeavors Is the Manager Involved In?

Philanthropy can be a great window into the character of a manager. There is a considerable amount of public disclosure in philanthropy. You want to determine what managers care about. Are they seeking social acceptance in their community? Or are they genuinely passionate about the charities they give to? In the case of philanthropy, it is a warning signal if the manager is overly involved in social scene philanthropy—that is, the kind that's more about the social recognition than the charity itself. This indicates that the manager is externally motivated and tends to seek acceptance of those who are in high social standing. Many times, these managers will direct corporate assets to support their social climbing. When you see a business contributing money to the most elite social functions, then it is likely that the manager is using the corporation to improve his or her social standing in the community. These types of donations typically do not pertain to the company but are instead used for social leverage.

To counter a common assumption that philanthropists always have the greater good at heart, consider a few examples:

- All of Enron's key officers were active philanthropists, with a great number of nonprofit organizations in the Houston area benefiting from their contributions.
- WorldCom and Bernie Ebbers were well known as donors to charities and universities in Mississippi, and were respected in the community.
- Adelphia, once one of the biggest cable television companies in the United States, used to sponsor Christmas pageants and flew cancer patients to health facilities for treatment.

Yet all of these businesses are now defunct and many of their executive officers have served jail time.

What can you really tell by studying a manager's charitable giving or philanthropic patterns? Where can you find how and how much a business or person donates? Look for articles about gifts in some of the news stories you read about your company or management. Most corporate and personal giving is direct and isn't reported in any uniform way, though some giving may be through a foundation. If the manager or company has created a foundation, you should be able to scan the foundation's tax return because it is a public record. You can request it from the IRS or just check an online provider, such as *GuideStar*. Look for Form 990, which will detail which groups received gifts, the location and the amount of the gifts, future gift commitments the foundation has made, and contributor names and amounts. Companies will publicize some of this on their websites, but not all of it. Look at more than a year or two, and you can see what the general pattern and focus of their giving is.

Some other ways to turn up additional information include checking websites and regional newspapers by adding the CEO's spouse to your search. You can also check publications and websites of non-profits where you know the CEO serves on the board or giving lists or honor rolls of their alma mater or universities with which they are affiliated. There are also companies that collect and cumulate donation records that have been made public at one time or another. All these can offer a glimpse into the social priorities of the manager you are evaluating.

Are the Managers Lifelong Learners Who Focus on Continuous Improvement?

Lifelong learners are managers who are never satisfied and continually find ways to improve the way they run a business. This drive comes from their passion for the business. It is extremely important for management to constantly improve, especially if a business has been successful for a long period of time. Look for managers who regard success as a base from which they continue to grow, rather than as a final accomplishment.

For example, Michael Bloomberg, eponymous founder of the financial information and media company, wrote, "We've got to improve just to stay even. Each of us at Bloomberg has to enhance his or her skills. Every element of all our products must be improved. . .Most companies never upgrade until they are forced."[9]

The opposite of those who improve are those who are complacent. Complacent managers tend to think everything is okay and often lack passion for the business. They are satisfied, sometimes indifferent, and usually fall into mediocrity as a result. They often remain invested in the way they have done business in the past, such as when Eastman Kodak refused to acknowledge the threat to its film business from digital photography in the 1990s.

Another example is mobile phone manufacturer Nokia, which was one of the most successful European companies: In fact, in 1998, it was the world's biggest mobile phone manufacturer. Nokia was able to get to the top of the industry quickly, but once there, it became complacent. Nokia CEO Olli-Pekka Kallasvuo tended to focus on hanging onto market share instead of creating new products. He ignored the trend of mobile phones merging with computing when Apple introduced the iPhone in January 2007, and he continued to focus on making cellphones that were about calling people instead of about checking e-mail, getting directions, or checking the weather. After the introduction of the iPhone, Nokia's stock price fell 49 percent, and Kallasvuo was eventually replaced as CEO.[10]

❒ 49. Can you identify a moment of integrity for the manager?

Basically, if CEOs have integrity, they are honest. They don't say something to a group of people just because that's what the group wants to hear. When you ask a question, they tell you what they really think. In contrast, if a CEO often says, "We'll go in this direction," but acts differently, be cautious. If the CEO sets certain standards of behavior or expectations of performance, yet violates them personally, then you should perceive that the manager lacks integrity.

How can you learn if the CEO has integrity? One indicator is consistency between what they say and what they do. For example, Warren Buffett, CEO of Berkshire Hathaway, says the same things over and over again, and he follows through in his actions. In contrast, politicians are typically not consistent in what they say or do, which is why so many people are suspicious of them. They often say one thing in order to get elected and then do another.

Another way to observe consistency in behavior is to see how people act under different circumstances. You never truly know someone's character until you have seen it tested by stress, adversity, or a crisis, because a crisis produces extremes in behavior. A billionaire Chinese entrepreneur once told me that he would not do business with a person unless he had seen them encounter a moment of integrity, which he explained as "how you act when you are confronted with a crisis or an ethical situation." He then said that if it took him 20 years to wait for a person to encounter this moment of integrity, he was more than willing to wait in order to do business with them. He had a hard-and-fast rule that has served him well, and he was rarely disappointed by his business partners.

One of the best ways to determine whether a manager has integrity is to identify a moment where he or she faced a difficult situation and see what action he or she took. If you are unable to identify a moment of demonstrated integrity, then you are taking the risk that you do not know how that person will act when faced with a difficult situation. You may want to wait to increase the amount you invest until after you have seen management encounter such a moment.

There are many examples (many already covered in this book) of CEOs who have presented false results through accounting fraud. These CEOs are often concerned with losing access to new capital, defaulting on loan covenants, or they may be worried about how Wall Street views them. Such CEOs typically fail to consider the broader implications of their actions. You want to know if the manager you are evaluating will follow the right path when faced with adverse scenarios.

For example, I once attended an annual meeting of a bank in Texas. The morning before the meeting began, the bank put out a news release announcing it had finalized a deal with a Texas billionaire, whereby he would give them a large capital infusion that diluted existing stockholders. Our firm believed this deal was detrimental to existing stockholders, but I wanted to verify this with company management at the meeting. The annual meeting lasted half an hour, and when it came time for the CEO to take questions from the audience, I raised my hand. Within moments, the CEO stepped down from the podium and declared that the meeting had ended. Surprised, I walked over to the CEO and again tried to ask him a question, but he said that he had to attend the board meeting. I recognized most of the board members, who were still socializing in the room. In that moment, the CEO had failed to demonstrate integrity. In other circumstances, I had had a more favorable assessment of this CEO because he was typically straightforward with information, but in this small act, he demonstrated a lack of integrity. This particular bank eventually went bankrupt due to aggressive lending.

In contrast, when I was researching the background of Dave Gold, co-founder of retailer 99 Cent Only Stores, I was searching for articles that would give me insight into his character. I ran across an article that described how Gold had admitted to making a mistake in purchasing a business for 99 Cent Only Stores. Instead of writing off this investment (as most other CEOs would have), Gold acquired it back from the company *with his personal funds*—in the amount of $34 million, no less!—which was twice what his company had paid for it previously. I had never heard of a CEO buying back a mistake in order to benefit shareholders, especially at two times the price. I felt I had a deep insight into Gold and knew this was the type of CEO I wanted to partner with, and I made an investment in the business when the stock price fell.[11]

The most difficult time to assess a manager is during normal times. You gain more insight into management when conditions are adverse than you do when circumstances are ideal. As you read historical articles written about the business or SEC filings, begin to identify those periods when the business encountered a difficult situation, such as an economic downturn, product recall, negative media coverage that was inaccurate or overblown, or a lawsuit. Read articles, press releases, and transcripts of quarterly conference calls that were written during this time, and note how the management team responded to these difficult situations. If you are assessing a manager with limited tenure at the business, review articles and conference call transcripts at the prior business. Did the manager disclose more information to shareholders, or did the manager clam up?

For example, during the recession that began in 2007, some managers disclosed more information so their shareholders could better understand the operations of the business and what the management team was doing to cope with the difficult economic situation, whereas others did not want to disclose information, citing a lack of visibility as the reason. This was a weak excuse, however, because managers do not need to forecast the future, but they do need to disclose how they are reacting to a difficult situation. You need to determine how a manager responds to a difficult situation and then evaluate the action they took. Were they calm and intentional in dealing with a negative situation, or were they reactive instead? Ideally, you should seek to partner with those managers who solve problems for the long term.

There are a few ways that management typically responds to difficult situations; identifying which actions these managers take will help you decide whether they are an ideal partner or not.

- Some managers allow current adversity to overwhelm them completely. In this type of situation, management is trying to evade the problem rather than confront it. For example, when Bear Stearns was nearing bankruptcy, then-CEO James Cayne could be found playing golf or playing in bridge tournaments. He ignored the risks the firm was facing.[12]
- Some managers attempt to blame the problems on others or on events beyond their control. In this scenario, you will typically see heavily lawyered press releases or releases carefully crafted by public relations firms. The managers will make statements that they are assessing, reviewing, or analyzing a problem. These are indicators that senior managers are not *acting*—which is what they *should* be doing.
- Some managers strike back quickly without thinking things through and often end up going in the wrong direction. These are the managers who announce layoffs in order to quickly cut costs the moment their business faces distress.
- Some managers are determined to get over their setbacks but do not solve the problem; instead, they apply a quick remedy, which only solves the problem in the short run. For example, a retailer I was analyzing discovered that the reason some of its sales had dropped was that it did not have enough shopping carts in the stores. The management team quickly sent in new shopping carts but then failed to follow up later when the supply was depleted again, so of course the retailer found itself in the same situation a few months later.
- The best managers are those who quickly and openly communicate how they are thinking about the problem and outline how they are going to solve it. Again, you are looking for those stories where managers acted with integrity. For example, Robert Silberman, CEO of Strayer Education, disclosed that new-student enrollments had dropped 20 percent in the 2010 winter term, the largest drop that Silberman had seen in his 10-year tenure as CEO. Even though Silberman did not know the exact reasons for the drop, he reported this negative news to shareholders the moment he had the information, and then he held a special conference call first thing the next morning to answer shareholder questions. He gave shareholders as much information as he could, and he explained how he was reacting to it.

- Similarly, on the day of the 2001 terrorist attacks on the World Trade Center, Bruce Flatt, then-CEO of Brookfield Properties, had to deal with several kinds of problems. The media was circulating false reports that Brookfield's four office buildings next to the World Trade Center were not stable and about to collapse, even though engineers had already concluded they were structurally sound. Flatt hired a car to take him from Brookfield's headquarters in Toronto to Manhattan (because no planes were flying that day after the attacks), and he surveyed the four office towers Brookfield owned. After seeing the buildings himself and confirming with engineers that they were sound, Flatt was better able to make corrections with the media and give good information to tenants. He immediately had truckloads of plywood sent in, and he was the first landlord to start repairs in Lower Manhattan. He then promised tenants they could return in eight weeks.[13] Flatt said, "We felt it was important to return to the premises as soon as possible. It was a calculated risk, but we needed to evaluate the situation, make decisions, and help our tenants." Flatt delivered on his promise, and within eight weeks, the tenants were able to return to their offices.[14]

❒ 50. Are managers clear and consistent in their communications and actions with stakeholders?

The best management teams are clear and consistent in their communications with customers, employees, suppliers, and shareholders. They communicate things as they are and do not attempt to manipulate the information.

You will find that the more transparent management is about the business, the more accountable they are. In contrast, whenever managers make something complex, they may be concealing risk taking or bad judgment. Incomplete disclosure also makes it difficult for you to assess the competence of the managers. Although this may be good for the manager, reducing his or her chances of being replaced, it obviously makes your evaluation of the business more difficult.

The following sections describe a few ways you can (and should!) determine whether management is clear and consistent in its communications.

Read the Company's Annual Report Shareholder Letter

You can start learning how a CEO communicates with shareholders by reading shareholder letters written by the CEO. By reading them sequentially, rather than reading only one shareholder letter, you will gain greater insights into the CEO and the business. You are looking for letters where the CEO communicates clearly about how the business is performing; these letters should describe and explain:

- What is important at their business.
- What is driving their decisions.
- The issues they have encountered.
- The metrics that are important to monitor the health of the business.
- How the CEO plans to resolve issues faced by the business: This is one of the most important pieces of information to look for.

If, instead, the shareholder letter looks like it has been written by a public relations firm or is a carbon copy of the information disclosed in the Management, Discussion, and Analysis section (MD&A) found in the 10-K, then it is likely the CEO is not interested in giving investors insight into how he or she is thinking.

For example, if you read a shareholder letter written by Warren Buffett, CEO of Berkshire Hathaway, you might note how easy it is to understand what he writes and how authentic he is in his communications. When Buffett writes, he says exactly what he means.

In contrast, in The Coca-Cola Company's 2003 annual shareholder letter report, former CEO Douglas Daft wrote, "I am pleased to report that our Company earned a record $1.77 per share in 2003." This good news was coming just after the company had announced a $197 million charge, with the stock down 20 percent since Daft had been named CEO. Daft then went on to explain that this was a "particularly challenging business environment"—in other words, blaming the outside environment for the results. Daft retired from The Coca-Cola Company shortly thereafter.

Read Conference Call Transcripts

Once you feel you have a good understanding of the business, read transcripts from the most recent as well as historical conference calls.

These are a great information source because if you do not have access to the management team, this is the best place to see how they communicate. You can obtain clear insight into how management thinks and acts by reading these conference call transcripts.

Watch how managers address business issues in the conference call. There is almost always a recent issue the business has encountered, and most questions are directed toward such recent issues. Are the managers open and honest in their communications? Or do they attempt to avoid the issue? Monitor how many questions go unanswered. Note if the managers use excuses, such as saying that the information is proprietary. Many management teams will use the excuse that they cannot share information with shareholders for competitive reasons. This is an extremely useful indicator: I have found that if the strategy of the business is based more on hiding information from competitors rather than outperforming competitors, it is far less likely that the business will have long-term success. If the unanswered questions have to do with specific financial guidance, this is okay. You instead want to monitor how many unanswered questions there are about things that are specific to the business, such as marketing, historical mergers or acquisitions, personnel, or legal issues. Most of the time, this is not proprietary information, and the manager should be able to answer these questions or at least tell you how they are thinking about the issues.

For example, during a conference call on November 4, 2004, with a diversified media company that owns radio stations, an institutional analyst asked if management had near-term plans for format changes at its radio stations. Management responded by saying, ". . .we don't disclose any format changes that we might employ in our radio division. I'm sure you understand." In fact, this is not proprietary and is one of the most important components of a radio company. If management does not want to answer questions about the most important part of its business, investors should view management's actions as a warning signal.

In many cases, you will find that the managers *respond* to questions, rather than *answer* them. In other words, they will respond to the question with a statement that has nothing to do with the question, but it makes the manager look as if he or she is answering the question.

For example, one CEO was asked why the margins of the business had dropped, and he went into a long discussion on how the world was quickly changing around him and said that the economy was uncertain. The CEO could have at least explained that margins dropped because the cost of materials had increased, which was the real reason for the drop.

The first part of the call is usually filled with the CEO or CFO reading from a script that has been prepared in advance. A lot of time on the conference call is spent on this part, and I sometimes think that management does this in order to limit the question-and-answer period.

For that reason, I prefer to invest in businesses such as Penn National Gaming, which skips the script and jumps straight into questions with a few prepared remarks. Peter Carlino, CEO of Penn National Gaming, says "I find most of my shareholders can read, so I believe it is best to spend more time answering questions than reading a script that is found on the company website." Over the years, managers have started to remove these scripted sessions from their conference calls to allow more time for shareholders to ask questions. This is an extremely positive sign because it indicates that managers want to address shareholder questions or concerns. They understand that shareholders receive the most valuable insights during the unscripted format.

For example, in an August 2010 conference call, clothing retailer Urban Outfitters announced that it would release a detailed management commentary so that its earnings call could be more focused. Similarly, in July 2010, disk drive manufacturer Seagate and biopharmaceutical company Gilead Sciences both announced that they would start reducing the time spent with prepared remarks on conference calls, instead posting those a couple of hours before the call so investors would have time to absorb the information and formulate questions. These are all positive signals that management is open with shareholders.

The following sections discuss some questions you can ask to better understand how managers communicate with stockholders, customers, employees, and suppliers: How do the managers communicate when confronted with adversity? And does management only emphasize good news in their communications?

How Do the Managers Communicate When Confronted with Adversity?

The best managers to invest in do not make excuses as to why they cannot communicate with customers, shareholders, employees, or suppliers when they are confronted with adversity. Instead, they communicate openly when the economy is in disarray or competitive pressures are high. In contrast, the worst managers to partner with are those who engage in face-saving behavior when confronted with problems. They usually turn to heavily lawyered news releases that do not address the issues, and they dance around the information instead of being forthcoming.

When Howard Schultz, founder of Starbucks, returned to the company in January 2008, he found that problems both inside and outside the company were causing sales to decline. Upon returning, Schultz promptly stood up to his 180,000 employees and their families and admitted that he had failed them. He told them, "Your leadership has failed you, and even though I wasn't CEO, I have been around as Chairman. I should have known more. I am responsible." Schultz said that once he did this, it was a powerful turning point for his company because the burden was off his shoulders, and he could now move forward. In an interview, he said, "You have to be honest and authentic and not hide. I think the leader today has to demonstrate both transparency and vulnerability, and with that comes truthfulness and humility and obviously the ability to instill confidence in people, and not through some top-down hierarchical approach."[15]

Does Management Only Emphasize Good News in Their Communications?

You need to determine what information management emphasizes. For example, in the 10-K, there is a section titled "Selected Financial Data." This is a pro-forma statement that condenses the income statement and balance sheet. This is where management highlights certain financial items it finds important, such as earnings before interest, taxes, depreciation, and amortization (EBITDA) adjusted for some type of charge. This section may give you some insight into management regarding what it reports and doesn't report.

For example, Internet company InfoSpace, one of the few profitable dot-coms (according to its pro-forma statement) during 2000, reported that it had earned $46 million in pro-forma profits during that year. Naveen Jain, then CEO, was touting the stock on CNN's financial network in late 2000, proclaiming, "Our wireless business is on fire!" The truth was that by GAAP standards (instead of pro-forma), InfoSpace lost $282 million in 2000. But the CEO was emphasizing pro-forma targets, which did not realistically represent the true earnings of the business. Eventually, InfoSpace's stock cratered, and a dollar invested at its peak price was worth only three cents by 2005.[16]

The following sections discuss some questions to ask yourself as you either listen to or read what a manager says:

- Is the manager easy to listen to?
- Do you learn from the manager?
- Does the manager use corporate speak?
- Does the manager use double speak?

Is the Manager Easy to Listen to?

Chris Lozano, who was an intern at my firm, attended a lecture at the University of Texas at Austin with talks given by two entrepreneurs. One was the founding partner of a venture capital firm and the other was the founder of Southwest Airlines, Herb Kelleher. It was an interesting contrast according to Lozano, who said the venture capitalist was talking to the audience, whereas Kelleher was engaged in a conversation with the audience. Lozano said, "When I listened to the venture capitalist, I felt like I was having a boxing match with him." If you find it difficult to listen to managers or read what they write, then it is likely a warning signal.

Do you Learn from the Manager?

After you've read or listened to what managers say, ask yourself if you are learning more effective ways to run a business from them. For example, when I was analyzing retailer 99 Cent Only Stores, I learned a lot about the retail business through both Dave and Sherry Gold, the founders. Their teachings enhanced my understanding of the fundamentals of running a successful retail business. On the other hand, if you find yourself wanting to teach a management team how to run its business, this is probably a signal that you have run into an incompetent management team.

Does the Manager Use Corporate Speak?

Many managers use corporate speak or make generic statements. You may often find yourself running two conversations in your head as you try to discern what they mean. Ask yourself, "Do they use a lot of corporate jargon such as the word strategic or thought leadership"?[17] This may indicate that these managers do not truly understand their business and are more concerned with showing others how smart they are. When managers use corporate jargon, it may be that they are more interested in self-promotion than in clearly explaining to shareholders how the business is operating.

Does the Manager Use Double Speak?

Double speak is when someone says contradictory things, such as "We don't time the market, but we will continue to hold cash until after the middle of the year, when things might get better."

For example, the CEO of Reuters, Tom Glocer, once said this in a statement to the company: "Above all else, we acknowledged things would be tough in 2005, but we confidently set a budget that shows Reuters growing our revenues for the first time in four years." Reuters then added that it was not issuing revenue guidance in the memo, which had been released to staff earlier that week. The statement said, "This statement is not meant to imply that revenues will be positive for 2005 as a whole. The 2005 budget is not yet complete, and no revenue guidance has been issued for 2005."[18]

Here's another example: Griffin Mining, a zinc miner, disclosed on February 21, 2006, that "operating costs were higher than envisaged due to inevitable initial teething problems in commissioning the plant."[19] The key question you should ask is, if the teething problems were inevitable, why weren't they in the budget?

And another example: At a conference on October 3, 2001, Joseph Nacchio, CEO of Qwest Communications, stated that instead of trying to convince the audience that Qwest was doing well, he would "just let the numbers speak for themselves on October 31." When October 31 came, the company missed expectations, and Nacchio stated, "Some of you will recall that at a recent conference I said the results will speak for themselves. The reality is, they do not speak clearly for themselves without some interpretation, given the current economic conditions and the effects of merger and other one-time charges." Nacchio quit in June 2002 amid an SEC probe into alleged accounting manipulation.[20]

❒ 51. Does management think independently and remain unswayed by what others in their industry are doing?

One of the toughest challenges a manager faces is to look at all of the profits that competitors are earning and not be tempted to copy that success. Sometimes these profits may be earned from unsustainable sources.

For example, Jamie Dimon, CEO of J.P. Morgan, did not follow his reckless competitors as they chased poor-quality mortgage-backed securities in search of higher fees. At the time, most of J.P. Morgan's shareholders complained that Dimon was being too conservative and that he was passing up the chance to make millions of dollars in profits. However, when the financial crisis of 2009 put some of his competitors out of business, Dimon was one of few CEOs who managed to both weather the storm and strengthen his business during this time of distress.

Shareholders will often attempt to influence managers to maximize short-term profits. The best managers always maintain a long-term focus, which means that they are often building for years before they see concrete results. For example, in 2009, Jeff Bezos, founder of online retailer Amazon.com, talked about the way that some investors congratulate Amazon.com on success in a single reporting period. "I always tell people, if we have a good quarter, it's because of the work we did three, four, and five years ago. It's not because we did a good job this quarter."[21]

Another example of long-term thinking is how Howard Schultz runs Starbucks. For many years, investors have said that Starbucks should undo its company-owned stores and franchise them instead, because this would significantly increase the amount of free-cash flow that Starbucks could generate and would improve the return on capital. Although it is a good argument economically, Schultz has continually refused to franchise Starbuck's stores. He believes that this act would fracture the customer-service culture of the company, which is central to Starbuck's success. He is therefore managing the business for its long-term interests and has demonstrated the ability to think independently.[22]

Another way to determine if managers think independently is to see if they continually benchmark themselves against their competitors or if they try to copy the past success of competitors. It is difficult to copy someone else's success, and when a business tries to copy what it believes makes a competitor successful, it may be a sign that the management team does not have a sound plan for the business.

For example, during the tech boom of 1998 to 2000, I remember people trying to come up with tech-based concepts that would make them rich. Most of these people did not think about meeting customer needs; instead, they were trying to copy the success of others. More recently, investors have started hedge funds in hopes of hitting it big. What they fail to realize is that many of the billionaire hedge fund managers today did not explicitly set out to create large funds. It was an unintended consequence of being at the right place at the right time, which is something that cannot be fabricated.

Similarly, when a Las Vegas casino had a great degree of success luring Japanese gamblers to its baccarat room, competitors tried to copy what they thought was the reason for the success: They spent millions of dollars building larger and more elaborate baccarat rooms and offered more services to lure these Japanese gamblers. For a short while, the Japanese gamblers visited the rival casinos, but they always came back to the original casino. The competitors became even more frustrated and continued to invest millions more, without any success. The reason that particular casino was successful is that the manager took the time to learn the language and culture of these Japanese gamblers. He was in the best position to understand how they thought and what they wanted. The rival casino businesses could not duplicate this because they had only copied what they could see. This should have served as a warning signal that the rival casinos did not have a sound plan of their own focusing on what they did best. Therefore, look out for those businesses that are announcing similar products or services just because their competitors have been successful.

❒ 52. Is the CEO self-promoting?

You need to be careful about investing in businesses run by CEOs who are self-promoting or those with larger-than-life personalities. These are CEOs who are often popularized in the media and consistently show up on business magazine covers because they are announcing headline-grabbing growth projections or transformational news. These CEOs make themselves the brand rather than the business.

You can identify these CEOs easily because they brag about their accomplishments and are often well-rehearsed, articulate, and enthusiastic. In other words, they focus on a great pitch. They also are usually:

- Flamboyant.
- Have lots of charisma.
- Engage in aggressive salesmanship.
- Tend to command the center of attention.
- Take over discussions.
- Have an attitude that they are smarter than everybody else.

Most of the time, these traits mask underlying issues.

Most corporate boards choose these strong-willed, egotistical CEOs because they believe that this type of CEO will be able to meet difficult challenges. However, although these CEOs are good at selling themselves, they often bring many problems to a business because they spend an inordinate amount of time managing to Wall Street's expectations, at the expense of the company's day-to-day business.

Another way to identify these types of CEOs is to monitor how much time they spend attending investor conferences that are sponsored by Wall Street sell-side research firms to promote their businesses. Look on the website of the business in the investor relations section, and identify how many Wall Street events the CEO, chief financial officer (CFO), or other managers are attending. If they are present more than two to four times per month, then you are likely dealing with a promotional CEO who is trying to increase the company's stock price.

As always, there are exceptions for CEOs promoting the business. If the business is dependent on Wall Street to finance its expansion, then it is necessary to generate investor interest. Many businesses issue debt or equity to expand their business or for acquisitions. For example, if they are attending high-yield conferences to generate investor interest in a debt offering, then this is a necessary function for the management team. Instead, watch out for those CEOs that are touting the stock and who do not need Wall Street to finance their businesses.

Other ways CEOs can promote their stock is by spending a lot of time talking with TV outlets and other press. If you see CEOs who are constantly in the financial press, then it is highly likely they are just there to bring attention to their companies' stock. Be cautious of CEOs who focus solely on the stock price. Most investors believe this is a good sign, but it is not.

For example, in telecommunications company WorldCom's 1998 annual report, CEO Bernard Ebbers bragged about a 132 percent increase in income and a 137 percent increase in stock price, and he promised to continue both trends. In 1997, Ebbers told a reporter, "Our goal is not to capture market share or be global. Our goal is to be the No. 1 stock on Wall Street."[23] This statement alone should have caused you to sell your stock. Ebbers was using his company's high stock price to make multiple acquisitions, such as telecommunications company MCI; in fact, he made more than 75 acquisitions. How prominent did WorldCom become? WorldCom eventually (and famously) went bankrupt, and Ebbers was convicted of fraud and conspiracy related to accounting fraud.

Some of the Best-Performing CEOs Are Unknown and Do Not Promote

Some of the best CEOs are collegial, team oriented, and soft spoken, and they are able to gain the confidence of their employees. In fact, many CEOs who have compiled the greatest long-term records of creating wealth are relatively unknown and don't self-promote, such as Yun Jong-Yong, who was CEO of South Korea's Samsung Electronics from 1996 to 2008. Yun transformed Samsung from a maker of commoditized memory chips and other commoditized products to a company that designed innovative digital products, such as cutting-edge cell phones. The opposite of the self-promoter, Yun refused many interviews. Instead, he let the results speak for themselves as Samsung Electronics gained $127 billion in market value under his tenure.[24]

The management teams of some of the best-compounding stocks from 2000 to 2010 spend very little time meeting with Wall Street—for example, Four Seasons Hotels, Strayer Education, Whole Foods Market, Morningstar, and Expeditors International. Instead of simply meeting with analysts each quarter, the management teams at Expeditors International and Morningstar ask shareholders to email or write their questions, and then they answer these questions in a publicly released form 8-K so all the shareholders can read their responses. Issadore Sharp, founder of

Four Seasons Hotels, did not typically meet with analysts and was not available on the quarterly conference call. I once tracked him down at a hotel and asked him why he did not meet with analysts, and he said that he would rather spend time with his employees. He said, "I can spend an hour with you and you might own my stock for a year and then sell it, or I can use that time with the housekeeping staff who could potentially stay at this business for more than 20 years."

Key Points to Keep in Mind

- When it comes to people, the best predictor of future behavior is past behavior.
- Passion motivates more than money.
- You gain more insight into management when conditions are adverse than you do when circumstances are ideal.
- The best managers to invest with are those who quickly and openly communicate how they are thinking about problems and outline how they are going to solve them. They communicate things as they are and do not attempt to manipulate information.
- The more transparent management is about the business, the more accountable they are. In contrast, whenever managers make something complex, they may be concealing risk taking or bad judgment.
- CEOs that focus on their stock price aren't focused on their business.
- Some of the best CEOs are collegial, team oriented, and soft spoken.