

## What Now?...and Steve Bartman and Corporate Governance

We concluded our last Strategy Letter with a minor soliloquy on the relative merits of a prudent investment in cash, which says as much about what we are currently thinking as any number of ensuing paragraphs and is as good a place as any to begin our latest installment, since very little has changed fundamentally.

We continue to believe that a large portion of the equity markets have appreciated wonderfully to levels at which they represent or greatly exceed fair value. This is entirely normal as stocks ALWAYS rally strongly before an upturn in the economy and the economy IS turning upward in nearly every segment but those surveyed by the army of Democratic presidential aspirants. As to the jibes of the “jobless recovery,” it is common sense and a historical and statistical fact that labor growth is a lagging indicator and increasingly so given the spiraling costs of healthcare and pension benefits and the ascendancy of the plaintiffs’ bar into every nook and cranny of our existence.

In a recent op-ed piece in the Wall Street Journal, Professor Allan Meltzer, hailing from Carnegie Mellon University, reaffirmed our strongly held belief that government- collected economic statistics are as reliable as many GAAP income statements. He noted that the Labor department collects data through two surveys: the Establishment Survey, which asks manufacturers and service providers how many employees they have and the Household Survey, which asks a sample of people if they have jobs. Since an economic downturn exacerbates the ordinary dynamics of “the weak die, the strong get stronger and new businesses are formed,” the Establishment survey always understates employment growth coming out of a recession, because it easily picks up jobs lost from established sources, but is slow to pick

up new jobs gained from new firms. The Household survey is currently showing very reasonable job growth, but when was the last time you saw the headline stating: Company X Announces New Hires? This neatly dovetails into the lack of appeal for the U.S. fixed income market, which in our view continues to undervalue the likelihood of a fairly robust 2004 with the attendant higher inflation. We remain short in duration in fixed income portfolios and increasingly wary of the corporate debt market given its spectacular lock-step advance with the equity market.

So while we remain “very busy” in the sense of scouring for ideas and continually revisiting what we currently own, the output has proven sparse of late. Therefore we wait. “Because investors are too impatient not to be fully invested...investors choosing zero duration cash as the lesser of available evils may well be employing a longer time horizon, demonstrated by their investment patience, than those who choose to speculate on long duration stocks and bonds which they intend to trade out of at the first sign of trouble.” So eloquently says one Seth Klarman of the investment firm Baupost whom we quote and paraphrase from a recent Grants Interest Rate Observer.

As any client who has heard our presentation over the years knows, we look for ideas on a truly bottom-up basis and we have not played the closet index game of having to have “one of these and one of those” in order to remain fully invested or at “equal weight” with an index. To do so guarantees performance mediocrity at best and three straight years of double digit declines at worst, a scenario which is an unacceptable outcome to foist upon our clients. Our willingness to reject what has passed for mainstream orthodoxy in the investment management business --- the papers are filled daily with its worst

practices --- has in no small part been responsible for excellent long-term performance on both an absolute and relative basis. We would like to plainly state: we buy value when we see it and from time to time we will run into periods where we don't and it is exactly at these times that we must resist the siren call to participate for the sake of participation.

Klarman continues on: "One of the biggest challenges in investing is that the opportunity set available today is not the complete opportunity set that should be considered. Indeed, for almost any time horizon, the opportunity set of tomorrow, which could be greater, narrower or similar in scope but different in specifics from today, is a legitimate competitor for today's investment dollar. It is hard, perhaps impossible to accurately predict the volume and attractiveness of future opportunities, but it would be foolish to ignore them if they didn't exist." That's smart and FYI his Fund is closed to new business.

Over the last fifteen years at RCB, here have been similar periods where we have appeared "stumped" but they tend to be relatively brief. As a \$2 billion firm that runs relatively concentrated portfolios, we don't need lots of ideas, just a few good ones, and that makes our task conceptually easier. We have also managed to build a fairly diverse group of opinionated and entrepreneurial investment professionals, so there are always ideas coming in from the proverbial left field, some of which flesh out to prove investment worthy. On that note, we welcome Mr. Geoff Stewart, CFA, the latest addition to our analyst pool, who will be covering the odd duo of technology and energy/utilities, the latter of which may prove to be fertile ground for new ideas.

We would also note that the fourth quarter has generally proven to be an excellent time for us to buy stocks. A good chunk of the world has discovered the secret that being up 15% after tax is better than 15% before tax, so there tends to be a lot of tax-related selling in already beaten down stocks that has historically created some interesting values and we are looking closely.

We will close this part of our Strategy Letter with another quote, except as you may soon realize, we are taking the other side. The Financial Times in October did a piece with the headline "Market Veterans Believe Established Investment Theories are Breaking Down." They go on to quote one Laszlo Birinyi, who has made himself a career out of studying and selling research (not

to us) on the "money flows" in and out of stocks. "We are witnessing the death of long-term investing...the explosion of hedge funds is a symptom of that" says Mr. Birinyi. "Long-term thinking and long-term investment strategies are less useful and not being rewarded by the market...learn to use stocks like hedge funds do, as pieces of paper that can be traded and be willing to be an active trader yourself."

If this sounds as particularly silly to you as it did to us, we invite you to contact our client service professionals Daryl Ann Weber and Michael Smith to discuss how this dwindling crew of long-term investors can work together.

## And On To Baseball Clichés and Corporate Governance

For those of you who have had the pleasure of not associating with Chicago Cubs fans recently, Mr. Bartman is the Cub fan who couldn't leave well enough alone and interfered with play at a crucial moment in a recent play-off game, setting in motion the falling dominos that resulted in the Cubs moving their record from 0 and 94 to 0 and 95 for being crowned World Series Champions.

It's the "leaving well enough alone" that sets up our parable on the role of the institutional investor in corporate governance. Since we are both institutional investors and registered voters in California, we think we know a little something about what constitutes appropriate governance. (And a lot more about what doesn't.)

Our analysis here will reference our direct experience and common sense, as well as SEC proposals **Disclosure Regarding Nominating Committee Functions and Communications between Security Holders and Boards of Directors** (<http://www.sec.gov/rules/proposed/34-48301.htm>) and **Security Holder Director Nominations** (<http://www.sec.gov/rules/proposed/34-48626.htm>).

A variety of audacious criminal and ethical breaches that have been publicly exposed over the past few years clearly and correctly suggest that the tri-part, checks-and-balances relationship between the operating management of a public company, the shareholder/

owners, and the Board of Directors has been dysfunctional for years if not decades in many companies.

In our opinion, the fault lies everywhere. Speaking very generally and prefacing these statements with “many, not all,” management (as perfectly exemplified by Dick Grasso) took what was offered and then some; Directors never took their oversight role seriously if at all; and shareholders went along nearly silently for the ride while egregious behavior was right in front of their noses. As is almost always the case, it wasn’t until people started losing money that the suing and whining started.

The problem we are facing today is: “what exactly is the fix?” Under normal circumstances, “the market” tends to correct things brought to the light of day, with the help of, or in spite of, a variety of hastily drawn-up, politically expedient regulatory pronouncements or laws. To a large degree, in the case of many corporate governance issues with the exception of executive pay, this is happening. Companies that are adding independent directors and putting them in charge of crucial committees, changing compensation structures for management to be risk-based, and re-committing themselves to honest and open accounting disclosure are getting marked higher and those that aren’t are getting pressure. It would be fair to say with the NASDAQ up 70% from its lows of a year ago and margin debt up 300% in the same time frame that the well meaning but clueless folks on the Los Angeles Times editorial board and many others are missing this point as they call out that “U.S. securities regulators should be developing and advocating reforms aimed at restoring the trust of investors.”

That said, the historical fact is that the weak link in the system has really been shareholders who never pay attention and the resultant lack of independent representation on the Board. Much of this was simple laziness and sloth and much of it is due to the huge asset growth in passive investment products, where nobody cares what is going on in the 500 stocks we own as long as we perform in line with the 500 stock index. Haven’t generations of MBAs and CFAs been taught about the brutal efficiency of the market and the obvious attraction of indexing? If hundreds of billions of dollars of pension and fiduciary assets are indexed and by definition then not being remotely involved in the oversight of the investment, is anyone surprised at how the mice have

played?

The cat now has the attention of the SEC and the two proposals noted above concern themselves with how Directors are added to a Board and the ability of shareholders to nominate their own Directors. If you go to the website and read the proposals and the dozens of responses to the proposals, two things become clear. First off, the SEC proposal is terribly weak and full of disclosure language that rings of legal and consultant fees and not much else. It puts very little additional bite into the ability of shareholders to directly nominate their own directors and make a legitimate go of it versus the consensus slate. It is fiendishly difficult and expensive to attempt to unseat incumbent directors and we do not see the SEC proposals as much additional help.

The second issue brings up the issue of corporate governance versus corporate democracy, the latter of which seems to be the leaning of a number of misinformed “players.” Corporate governance refers to the need and ability of stakeholders to ethically and legally ensure their investment is being run in a fiduciary fashion and designed for maximization of return. We are all in favor of intelligent changes that enable more shareholder activism to level the playing field against what may be called “the incumbency.” Corporate democracy, or the idea that the many should have a direct say in how a legal corporation is run, is a very different ball of wax, but you would not know it judging from the SEC website.

We hereby call on Dean Emeritus at George Mason School of Law Henry Manne, as published in a recent Wall Street Journal Op-ed piece for some perspective. “The idea of corporate democracy is ludicrous,” he begins on a modest note. Unlike the State of California, a corporation has no control over its shareholders, “some” of whom have actually entered into a reasonably well-understood risk/reward assumption, part of which includes an implied judgment on people, governance and management. You can exit as you wish.

He goes on to say “The SEC report pays great deference to the 690 commentators who accepted the commission invitation to ruminate on this idea. The vast majority of the recognizable respondents are clearly special pleaders with no real stake in a properly functioning corporate system and few have any demonstrable sophistication about corporate economics. The SEC could probably get

this many affirmative response to a proposal to abolish the NYSE.” (Astutely written pre-Grasso.)

And lastly, “Modern activists do not want the responsibility of running large corporations. If they did, they would turn their efforts to amassing control blocks of stock. They really want to interfere with the property and contractual rights of others in order to achieve their own ends without paying the market price.”

In other words and as far as we are concerned, very little in the new SEC proposals will be truly helpful to the investor since it lacks real reform that would enable activist investors (defined as those with real ownership and a desire to assist in the process of shareholder value creation.) It does raise the specter of turning annual elections of directors into a bizarre circus of special interests who have no meaningful skin in the game and whose interests and motives are not accountable in many cases to their own fiduciary responsibilities – a veritable ocean of Steve Bartmans. Would you give out your personal email address as the lead director of a Fortune 500 company? (This is actually in the proposal.)

There are actually some facts in the matter as opposed to the headline desire of some to cling to the belief that new laws and regulation will “fix” issues of human greed, temptation and laziness. In the March 2003 Journal of Corporate Finance piece entitled “An Analysis of The Effect of Management Participation in Director Selection on the Long-Term Performance of the Firm,” the authors conclude that “large numbers of outside directors and the existence of a nominating committee have negative effects on company performance,” and “removing management from participation in the selection of the board of directors is harmful to companies’ market performance.”

Why does this make some counter-consensus sense? Use two extremes: Board number “one” has five insiders handpicked by Warren Buffett and Board number “two” has five complete strangers with no initial contact at all with the CEO. The history of mankind shows that five people with common interests working in a collegial fashion with few organizational hang-ups will produce superior results versus a completely artificial committee construct obsessed with a rigid legal/rule based system of command and control supervision. Obviously, these are extreme examples, but when Warren Buffet is told that Berkshire

Hathaway’s board does not meet acceptable levels of what now constitutes proper corporate governance, one cannot help but wonder where the train stops in the other direction. This harkens back to an earlier point: if you are just buying pieces of paper and give little thought as to who is running your investment, then you are part of the problem, not the solution.

Our personal corporate governance wish list is simple:

- Separate the job of CEO and Chairman of the Board. The former runs the company, the latter runs the Board.
- Triple the pay of board directors and as a result attract real and qualified business and finance professionals who will provide serious oversight. We would rather have “honest, tough, and smart” than a regulatory definition of “independent.”
- Fire the current compensation consultant and seriously review management compensation and change it to a real risk based system. It does NOT matter how you “ACCOUNT” for it, what matters is that there is symmetrical reward and risk for success and failure. To suggest restricted stock cures the problems associated with excessive option issuance is missing the point entirely.
- Eliminate Staggered Voting, and allow material (5%+) shareholders to directly nominate candidates and have their costs paid pari passu with those nominated by the current board.
- Subject management compensation packages to an annual shareholder vote.

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*The opinions expressed herein are those of Reed, Conner & Birdwell and are subject to change without notice.*