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Managerially speaking...

Tell me, which shareholder are we talking about?

by Marcel M. Gingras

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Over the course of my career, I had the opportunity to work directly or indirectly with organizations operating under different ownership structures. I have been associated with government operated agencies, mutual companies, privately held corporations, partnerships and finally, publicly traded companies. I was also very involved in the process of implementing the transformation of a mutual company into a stock company.

To me, stock companies have always represented the ultimate form of ownership. They represent the purest form of capitalism, with easier and potentially unlimited access to capital, open disclosure, potential for lining up interests of management and shareholders, and ultimate accountability to shareholders.

Unfortunately, I believe that many publicly traded companies fail to realize their full potential due to a lack of clarity in identifying which shareholders they are trying to serve. Is management attempting to serve the best interests of the shareholder who bought five years ago and will likely hold the stock for several years to come? Is it trying to serve the interests of the shareholder who bought yesterday and may sell tomorrow if the price is right? Or, is it trying to represent some shareholder in between these two groups?

If asked the question, many executives might answer that they try to serve the best interests of all these groups. To me, this is a 'non answer' as it is nearly impossible to serve the interests of all these shareholders at the same time, especially the shareholders at the extremes, i.e. those who buy and hold and the frequent traders.

What is the issue?

Essentially, this would be a non-issue if management were able to equally serve all groups of shareholders. If this were the case, there would be no need to specify which group of shareholders would take priority. However, I don't believe it is possible to serve all groups of shareholders equally well. In the absence of making specific choices, most executive groups will feel pressured to satisfy the short term demands of shareholders, i.e. the demands of shareholders with a shorter time horizon or the more frequent traders. In this process, I believe that loyal long term horizon investors are likely to be shortchanged in their expectations. They believe they are buying the stock of a company with a long term horizon while they may be investing in a company that has a short term horizon, with varying degrees of consideration given to the long term.

What is the underlying cause?

Simply stated, the cause of all this is quite human. The pressure on management to deliver short term results is enormous. In my view, it is easier for management to attempt to deliver short term results based on somewhat unrealistic expectations than it is to explain a complex long term game plan that may involve peaks and valleys.

There are several reasons why management is under so much pressure to deliver short term results:

1. Many financial analysts tend to be very focused on quarterly results. Management does not look forward to explaining under performance on the quarterly analyst calls. Among the analysts, many of them represent firms whose general focus is on customers who trade as opposed to those who buy and hold. The retail securities market, mutual funds, hedge funds and the short term performance focus in the pension investment area are all elements contributing to the focus on short term results. There is nothing wrong with the way analysts do their job; it is only that their role and the customers they represent need to be kept in mind by company management.

2. The market has come to expect management to 'smooth out' what is happening

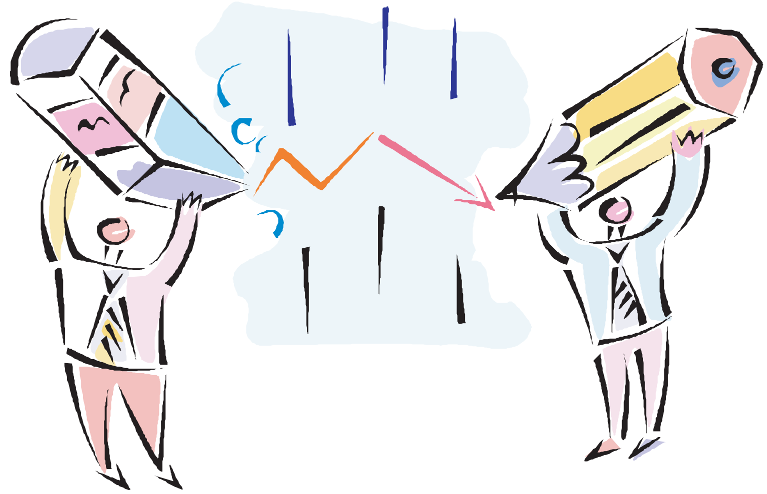
in the economy. As an example, in the financial sector, results are expected to fluctuate, depending on the economy but more importantly, depending on what is happening in the financial markets. Yet, there is some expectation that management will continue to produce steadily increasing results, despite the fact that informed shareholders would expect some fluctuation in the results.

3. The media puts a lot of pressure on producing steady results, again meaning that management must try to minimize natural fluctuations. The media tends to jump on the opportunity to portray management in a bad light whenever it 'fails' to produce expected results; hence, the temptation to smooth out results. A difficult issue for management is the fact that the public in general may confuse stock performance with the financial stability of the organization, which may lead to a negative impact on the company brand and sales.

4. The board of directors will also put pressure on management to perform. This is their role. There is nothing wrong in the board putting some heat on management as long as it understands what it is asking for and what it is really getting. Good short term results do not always lead to good long term results. A strong board is able to balance the two.

5. The average tenure of C.E.O.s has been shortening for a variety of reasons. No point taking a 20-year horizon if the average stay is going to be around 5 years or sometimes shorter based on figures quoted by the media.

6. Finally, management is remunerated both on short term and long term performance, which seems to be fine until one looks a little bit more closely. On the short term side, annual bonuses tend to be determined on a 12-month performance where the financial component is typically most important. Lack of performance will affect everyone on a bonus scheme including middle management. Low bonuses become a morale issue, a retention issue and a recruiting issue. On the long term side, options have been the favoured instrument for rewarding management. However, options are not quite a perfect match as far as aligning the interests of management with those of long term horizon shareholders. This topic has been well documented lately. As a result, several boards have been taking a proactive approach as far as modifying long term incentive plans. Restricted share units, performance share units and deferred share units are all likely to become part of the new arrangements, and they are likely to be accompanied by performance measures and restrictions on the ability of executives to exercise these incentives.



Impact on company operations

In general, operations have a difficult time adapting to a management style that focuses on short term results. In some industries, due to the cyclical nature of the business, operations are structured in a way such that they react quickly to a changing economy. However, there are several companies operating through very long cycles. Again, using the financial sector as an example, companies typically have very long term relationships with clients, loans transacted are repayable over long periods, they make long term investments and selling products create liabilities to be met several decades later.

Generally, short term focus on results is reflected through one or several of the following actions:

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1. Staff reduction or hiring freeze, even though this may be at the expense of client service.

2. Freeze on training programs, even though it may be at the expense of longer term productivity.

3. Postponement of technology investments, even though these may be justified for the long term success of the enterprise.

The long term impact of these measures is real but might not be reflected in the company's performance, for quite some time. However, you can expect one or more of the following to happen:

1. Confusion among employees who can't understand whether management has a plan and whether they believe in it and stick to it.

2. Disappointment among clients who may fail to see the long term commitment of their supplier towards their business.

3. Short term savings tend to have a ripple effect. The idea is that these budget cuts should be temporary and they will be made up in the following period. However, this tends not to happen. For example, let's assume that an organization has an information technology (IT) budget of $10 million and decides to reduce it by 10 percent for the current year, i.e. to $9 million. The following year, going back to the same level as that budgeted for the current year will result in an increase of $1 million or 11.1 percent. If the organization wishes to catch up on the work postponed, then it is looking at $11 million in spending as compared to $9 million or a 22.2 percent increase. Most organizations will balk at this type of increase, even though it may have been just to get back on the original plan.

4. Operational divisions have a difficult time planning, as budget cuts may not be related to the financial health of specific divisions or units.

5. Support divisions, such as Human Resources, become an easy target for quick savings and typically they never get to deliver on their promises or meet expectations from operating divisions, and they quickly acquire a reputation for being unreliable partners.

So, what is the solution?

This is a tough question. It is much easier to criticize the situation than it is to be creative and come up with solutions. Here are a few ideas:

1. Companies spend a lot of time producing mission and vision statements which sometimes turn out to be meaningless to a good portion of their employees, either because employees don't understand what is meant or because management acts in a way that does not support the statements. I suggest that time should be invested to increase clarity on the nature of the shareholders who will be best-served by investing in company XYZ. A commitment to take action for the sole benefit of long term shareholders, for example, would help to focus on meeting this objective and provide real substance to the mission and vision statements.

2. Better alignment of bonuses and long-term incentives with the interests of shareholders who have been identified as the target shareholder group

3. To the extent possible, better communication with the financial market with respect to the shareholder group being best-served by an investment in this company and reinforcement of actions being taken to be true to the commitment, even though it might mean more volatility in short term results. Some companies have followed this approach in the past with some success.

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