2015 1st Quarter Stock Market Commentary

THE GOLDEN RULE

"Accept that some days you're the pigeon,
and some days you're the statue."
- Scott Adams

Jerry Rice, who played 20 seasons in the National Football League, is generally considered to be the greatest wide receiver in NFL history. In fact, the NFL Films production, The Top 100: NFL's Greatest Players chose him as the greatest player in NFL history. He is the all-time leader in most major statistical categories for wide receivers, including receptions, touchdown receptions and yards. Rice was selected for the Pro Bowl 13 times and named All-Pro 12 times in his 20 NFL seasons. He won three Super Bowls playing for the San Francisco 49ers and an AFC Championship with the Oakland Raiders after San Francisco let him go. As of 2014, Rice held over 100 NFL records, the most of any player by a wide margin. His nickname in college at Mississippi Valley State was "World," because there was not a ball in the world he couldn't catch. He was fast, strong and possessed superb hand-eye coordination.

Jerry Rice is also an avid golfer, a +1 handicap. For non-golfers, that means he generally shoots one under par for a round of golf. After he retired from the NFL, he received a sponsor's exemption to play in a Nationwide Tour golf tournament. The Nationwide is a notch below the PGA Tour. These are very good golfers striving to make it onto the PGA. In his debut event Rice shot an 83-76, missing the cut. In his second tournament, the BMW Charity Pro-Am, he fired a horrendous 92-82. Even more embarrassing, he was disqualified because his caddy used a yardage scope in the fairway. After these two disappointing outings Rice gave up any hope of playing professional golf.

This story is not anomalous. Michael Jordan is widely considered the greatest basketball player of all time. He led the Chicago Bulls to six NBA Championships, and won an Olympic Gold Medal on the 1992 Dream Team. Jordan was selected as the league MVP five times. In 1999, he was named the greatest North American athlete of the 20th century by ESPN, and was second to Babe Ruth on the list of best athletes of the century prepared by the Associated Press. At the peak of his career, after his third NBA Championship, Jordan retired from basketball to pursue a lifelong dream to play professional baseball. He signed a contract with the Chicago White Sox to play in the teams' minor league system. In 1994 Jordan played for the Double-A Birmingham Barons, batting .202 for the season. This was hardly embarrassing, but not what might have been expected by one of the greatest athletes of the century. In March of 1995 Jordan announced his return to basketball with the Arnold Schwarzenegger-like statement "I'm back."

These musings were prompted by the stunning rise of activist investors in 2014. Firms like Pershing Square Capital Management, Icahn Enterprises, Starboard Value LP, Third Point Management and Elliott Management Corp, to name but a few, have amassed roughly $237 billion in assets, and now can bring pressure to bear on even the largest companies. PepsiCo, Proctor & Gamble, General Motors and DuPont are currently under siege from activists, and even Apple, the company whose $700 billion market cap is the largest ever, was forced to respond to Carl Icahn by raising its dividend and buying in shares. This is the new Golden Rule – He who has the gold rules.

Shareholder activism actually dates back to the 1930s. After the Great Depression, shareholders found that the new laws aimed at reforming businesses were not sufficient to curb abuses. The early shareholder activists in the 1930s and 1940s were rarely effective, as they could not muster enough support to effect change. Most shareholders, instead of trying to reform the company via shareholder activism, simply sold their shares to express their dissatisfaction with the company's governance practices or activities. This became known as "the Wall Street walk," where unhappy shareholders would simply "vote" with their feet.

But in the 1970s three structural changes occurred which made shareholder activism more effective. For one, the Securities and Exchange Commission (SEC) adopted a rule which allows shareholders of a public company to submit proposals that are required to appear on a company's proxy statement (with certain limited exceptions). Frequently these proposals are designed to improve corporate governance and boost the price of the company's shares. These proposals are also often used to address social issues, such as attempting to ban testing on animals or reducing a firm's environmental impact.

The second change was the rise of the institutional investor. Organizations, such as Fidelity, Vanguard, CalPERS and TIAA/CREF grew rapidly and accumulated massive positions in most of the larger publicly traded corporations. With such large stakes, institutional investors were not interested in simply being passive investors, but were also interested in being influential in determining corporate strategy. Jesse Unruh, for example, former California State Treasurer from 1975 to his death in 1987, was in charge of the enormous CalPERS (California Public Employees Retirement System). CalPERS was an investor in oil giant Texaco when it paid a greenmail premium to the Bass brothers to forestall a takeover. Outraged at what was perceived as a misuse of shareholder assets to preserve the jobs of overpaid management, CalPERS adopted a corporate governance policy calling for "independence of board directors, with directors accountable to shareholders, and management accountable to directors; clearly written public accounting information and proxy materials; and a long-term strategic vision that emphasizes sustained shareholder value."

Unruh also spearheaded the creation of the Council of Institutional Investors (CII) to lobby for shareholders' rights. Originally, CII had 20 public and private pension funds. Today, CII's members include more than 140 pension funds that control over $3 trillion dollars in assets, thus wielding enormous power to influence management.

The third structural change was the passing of the Employee Retirement Income Security Act of 1974 (ERISA). While the focus of ERISA concerns mismanagement of employee benefit funds, the law has been interpreted to be more expansive. For example, the Department of Labor has interpreted the law to say that it is the fiduciary duty of the pension funds to vote by proxy, rather than delegate such rights to their external managers. The Department of Labor has encouraged pension plans to actively monitor, engage with, and communicate with the corporations in their portfolio to improve corporate governance.

In recent years numerous hedge funds have sprung up which all utilize a similar strategy. First accumulate a large position in a target company. Next urge management to take one or all of the following actions.

1) Boost the dividend, as Carl Icahn urged Apple to do.

2) Buy back shares, as Elliott Management has advocated at network infrastructure maker Juniper Networks.

3) Slash costs, as Nelson Peltz' Trian Fund Management insisted at Bank of New York Mellon after winning a board seat.

4) Sell or spin-off an underperforming or non-core divisions, as Paul Singer's Elliott Management is urging EMC to do with subsidiary VMWare.

5) Sell the company, as Starboard Value's Chief Executive Jeff Smith has recommended to Yahoo CEO Marissa Mayer.

In 2014, activists were more successful than ever. They won a board seat in 73% of all proxy fights, up from the previous record of 63% in 2013. In the case of restaurant chain Darden, operator of several restaurant chains, Starboard Value successfully ousted all twelve directors after the company sold its Red Lobster division without giving shareholders a vote.

For the most part, activists have been reasonably successful at unlocking value over the short term, earning respect even from their harshest critics. The strategies enumerated above which have produced their profits all revolve around correcting misallocations of capital. Even corporate lawyer Martin Lipton, who devised the "poison pill" to deter takeovers, has grudgingly acknowledged that there are some activists he respects (although he adds that there are none that he likes). But when we say they have been successful over the short term, we do mean short term. According to FactSet, 84% of activists hold their positions less than two years.

While shareholder activists have forced many complacent managements to acknowledge their obligation to shareholders, the true owners of the companies, there is a dark side. Many hedge fund managers have moved beyond financial engineering to exert influence over day-to-day operations. For the most part, they have been quite unsuccessful.

Consider, for example, Bill Ackman's $900 million stake in retailer J.C. Penney Co. (JCP) in 2010. After seeking and gaining board seats he pushed the 111-year-old department-store chain to radically reinvent itself. Ackman urged his fellow board members to oust well respected retailer Mike Ullman as CEO and replace him with Ron Johnson, the architect of Apple's Genius Bar and glitzy retail stores.

But Johnson's leadership was an unmitigated disaster. In slightly over a year, the company's sales had fallen by more than 25 percent, its stock had plunged nearly 50 percent, and 19,000 employees had lost their jobs. The board, Ackman included, fired Johnson and rehired Ullman. Then, within four months, Ackman was publicly calling for Ullman to be fired again. Ackman finally dumped his position in JCP in late 2013 at a huge loss.

Eddie Lampert, who runs ESL Investments out of Greenwich, Connecticut, is another activist who thought he could improve another troubled retailer. Lampert first accumulated a 53% stake in Kmart, then took a significant 48.5% position in Sears, combined the two companies into Sears Holdings, and named himself as chairman of the combined entity. Over the next decade he has proceeded to run the company into the ground. He has closed hundreds of stores and fired thousands of employees. He has been forced to sell off Sears Canada at a distressed price, closed down divisions, such as The Great Indoors, and spun off others, most recently Lands' End. The company has posted 32 consecutive quarters of declining sales and its credit rating is now CC, meaning default is imminent with little hope of recovery.

We opened our essay by looking at two athletic superstars, Jerry Rice and Michael Jordan, who were unable to successfully transfer their skills to other sports. It is a pity that many activists have not taken those case histories to heart. These money managers are all able to identify undervalued companies, and to identify issues responsible for the undervaluation: excessive cash hoards, owning too many unrelated businesses, shunning the use of debt, and empire building by aggressive CEOs. It is relatively easy to identify generic solutions for such problems, such as returning cash to shareholders, or implementing performance metrics which tie executive pay to measures which drive shareholder returns.

But the hubris associated with being a successful investor has led too many money managers to assume that they would make successful CEOs, despite having little or no operational expertise and despite lacking depth of company or industry specific knowledge. Admittedly, there are isolated individuals or organizations that that have excelled in multiple arenas. Bo Jackson was named to the All Star team in both the National Football League and Major League Baseball, but he was the only athlete ever to be named to the All Star Teams of two professional sports. And Nelson Peltz' Trian Fund has been able to effect significant improvement in the operations of target companies. But these cases are the exception. Money managers should stick to what they do best. Even Warren Buffett, the greatest investor of all time, lets the CEOs of his various companies establish their own strategies and be responsible for day-to-day operations, while he focuses on what he knows best, the allocation of capital.