CUBICASSET MANAGEMENT, LLC

2013 3rd Quarter Stock Market Commentary

TAKING THE HYPOCRITIC OATH

"I won't insult your intelligence by suggesting
that you really believe what you just said."
— William F. Buckley

The early nineteenth century essayist Ralph Waldo Emerson famously quipped that "A foolish consistency is the hobgoblin of little minds..." If true, then America is surely blessed with some of the greatest thinkers of all time, because it would seem that few of our public figures feel constrained by any need for consistency. Consider Al Gore, who light-heartedly refers to himself as the former next President of the United States. Ex-Veep Gore has done as much as anyone to promote environmental activism, primarily by focusing attention on the effect of human activity on climate change. His involvement as an environmental activist has extended over decades. He has delivered a polished monologue on this subject over 1,000 times, most notably in the Academy Award winning documentary *An Inconvenient Truth*, and was the recipient of the 2007 Nobel Peace Prize. His accomplishments and awards on this topic would fill this entire essay.

But while Al Gore undoubtedly does talk-the-talk, he does not always walk-the-walk. According to the Tennessee Center for Policy Research, a review of Gore's utility bills show that his primary residence (a 10,000 square foot 20 room house in Nashville) consumes more than 221,000 kilowatts/year, more than twenty times the average home. His utility bills for gas and electricity run over $30,000/year, just for his primary residence. He has another 4,000 square foot home in Arlington, Virginia, a smaller house in Carthage, Tennessee and he and Tipper bought an apartment in Montecito, California. To promote his movie he flew around the country in a private Gulfstream jet, which uses more fuel in a single cross country trip than a Hummer consumes in a year. And, lest we forget, he recently sold his TV station Current TV to Al Jazeera, owned by the government of Qatar, one of the world's largest exporters of fossil fuels, causing Comedy Central's Jon Stewart to ask "Can mogul Al Gore — who has Current TV and sells it to Qatar, which is an oil-based economy — can mogul Al Gore coexist with activist Al Gore?" I could go on, but I have to go hang my clothes out on the clothes line.

And then there is Congress, which is in a league all its own when it comes to hypocrisy. In 1938, when the Fair Labor Standards Act was passed setting a minimum wage, a forty hour work week and time-and-a-half for overtime, Congress exempted itself from the requirements of the law. It did the same thing in 1964 when it passed the landmark Civil Rights Act, meaning members of Congress were free to discriminate against staffers based upon race or religion, or to sexually harass their employees. (It should be noted that the Congressional Accountability Act of 1995 eliminated these exemptions.) In July Congress voted to exempt itself and its staffers from the cost increases associated with Obamacare by subsidizing their premiums.

But our concern is business and the economy, not politics, and unfortunately there are no shortage of examples of business leaders who say one thing and then do another. As our examples suggest, and the data shows, poor corporate governance is generally a predictor of poor stock performance. Research shows the inverse is true, too: good governance leads to better long-term returns.

Consider Abercrombie & Fitch, the retailer of casual sportswear to young adults. Despite being founded in 1892 by David Abercrombie and Ezra Fitch, the company has managed to remain relevant to its targeted demographic, which in turn has allowed it to charge higher prices than its principal competitors, Aeropostale and American Eagle Outfitters. It has accomplished this through an aggressive marketing campaign often featuring semi-nude young men and women in sexually suggestive poses. The CEO, Mike Jeffries, cultivates the notion of A&F as an aspirational brand by issuing tasteless statements, such as his comment earlier this year, that his brand is suitable only for "the good-looking cool kids." Based upon the theory that all press is good press, the company came under fire for introducing a line of thong panties for ten year old girls and padded bikini tops for seven year olds.

When MTV introduced its reality TV show *Jersey Shore* in 2009, A&F's marketing team spotted another opportunity to push the envelope of good taste. The lead character on the TV series was Mike "the Situation" Sorrentino, a former assistant fitness club manager and underwear model, who admitted himself to rehab for a drug dependency. A&F printed T-shirts emblazoned with the phrase "The Fitchuation." But when the cast of *Jersey Shore* took to wearing A&F clothes on the show, the company offered them a substantial sum to not wear its clothes, stating that "We are deeply concerned that Mr. Sorrentino's association with our brand could cause significant damage to our image." Really?

On April 20, 2010, while the crew of the *Deepwater Horizon* mobile offshore drilling rig was finishing work after drilling the Macondo well, an undetected influx of hydrocarbons escalated to a blowout. Shortly after the blowout, gas liquids that flowed onto the rig floor ignited in two separate explosions. The flowing hydrocarbons fueled a fire on the rig that continued to burn until the rig sank on April 22, 2010. These events claimed eleven lives and multiple injuries. A sea-floor gusher continued to pump oil for months. The total discharge was estimated at nearly 5 million barrels, the largest oil spill in U.S. history. It caused extensive damage to marine and wildlife habitats, and resulted in numerous health problems for Gulf Coast residents. Despite a massive clean-up, tar balls continue to wash up on shore.

Numerous investigations explored the causes of the explosion and record-setting spill. Notably, the U.S. government's September 2011 report pointed to defective cement on the well, faulting several subcontractors, but laying the principal blame on BP. A White House commission likewise blamed BP and its partners for a series of cost-cutting decisions and an insufficient safety system. The company ultimately pleaded guilty to 11 counts of manslaughter, two misdemeanors, and a felony count of lying to Congress. BP also agreed to four years of government monitoring of its safety practices and ethics, and the Environmental Protection Agency announced that BP would be temporarily banned from new contracts with the US government. BP and the Department of Justice agreed to a record-setting $4.525 billion in fines and other payments with legal proceedings not expected to conclude for two more years. As of this writing, criminal and civil settlements and payments to a trust fund had cost the company nearly $45 billion.

Just for yuks, I visited the BP website to look at its corporate mission statement. A portion of it is reproduced below.

> **Health, Safety, and Environment**
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> **Health and safety:** to ensure that there are no accidents, no harm to people and that no

> one is subject to unnecessary risk while working for the group.
>
> **Environmentally sound operations:** to conduct the group’s activities in a manner that, consistent with the board goals, is environmentally responsible with the aspiration of ‘no damage to the environment’. The group will seek to drive down the environmental impact of its operations by reducing waste, emissions and discharges, and by using energy efficiently.
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> ‘**Transcending the environmental trade-off’:** to contribute to human progress by applying the group’s resources in such a way that the perceived trade-off between global access to heat, light and mobility and the protection and improvement of the natural environment may be overcome.

The cognitive dissonance is stunning, reminiscent of what New Life Church members must have experienced when tapes revealed their evangelical pastor Ted Haggard was buying crystal meth from his masseur and lover, Mike Jones.

Enron was founded by Kenneth Lay in 1985 when he merged pipeline division of the Houston Natural Gas Company with that of InterNorth. In the early 1990s Congress passed a law permitting the purchase and sale of electricity followed by similar legislation authorizing the sale of natural gas. Enron quickly became the largest energy trader in the country. Its stock rose some 311% from 1990 through 1998, when traders took notice of the explosive growth in its energy business. It soared 56% in 1999 and rocketed another 87% in 2000. It was voted the most innovative large company in America in *Fortune* magazine's list of Most Admired Companies, with interests in pulp and paper production, water treatment and broadband, in addition to energy trading and transmission.

In October, 2001, a huge accounting scandal was revealed at Enron Corp. It turned out that for several years the firm had used a variety of accounting gimmicks to manipulate financial statements for the purpose of inflating reported income and cash flow while concealing billions of dollars in debt by placing it in off-balance sheet special purpose entities. The company filed bankruptcy on December 2, 2001, in what was at the time the largest bankruptcy in U.S. history (later to be surpassed by WorldCom). Millions of shareholders were wiped out, and thousands of employees lost their jobs. The company's auditor, Arthur Anderson (one of the five largest accounting firms in the world at the time, was ultimately dissolved as a consequence of its failure to reveal the extent of the fraud. The architects of the fraud, Ken Lay, Jeffrey Skilling and Andrew Fastow were all sent to prison. The entire scandal is wonderfully documented in a book called *Enron: The Smartest Guys in the Room* by *Fortune* magazine reporters Bethany McLean and Peter Elkind.

Once again, it is worth examining Enron's public pronouncements about its corporate culture. It's motto was "Respect, Integrity, Communication and Excellence." It's "Vision and Values" mission statement included the following. "We treat others as we would like to be treated ourselves....We do not tolerate abusive or disrespectful treatment. Ruthlessness, callousness and arrogance don't belong here." You can't even make this stuff up.

Hypocrisy is often defined in social psychology using catchy phrases, such as not “practicing what you preach,” or “saying one thing and doing another.” It involves publicly upholding moral norms, especially for others to follow, but personally violating them. It is probably the single most studied topic by social psychologists, who are correctly skeptical of people's self-described motives. In fact, many people are unaware of the reasons that they do what they do.

In a landmark study in 1959, psychologists Leon Festinger and James Carlsmith had dozens of students perform boring, repetitive physical tasks, such as turning pegs around in their holes. At the end of the task, half the students were asked to enthuse about what they had done to the next group of students. Those who had to describe the peg turning as exciting were more likely to later report that they had genuinely enjoyed their pointless labor. This experiment was an early example of the theory of cognitive dissonance, in which people feel discomfort when their beliefs conflict too much with their actions. One would hope that the result would be to change one's actions, but too often we simply change what we think, rather than modify our actions. This seems to be a result of two basic features of human behavior. First, most people care deeply about making a good impression on others. Second, most want to hold positive views of themselves, leading them to claim purer moral intentions than they actually have.

But as investors, should we care if a corporate CEO's conduct does not synch with his/her pronouncements? The answer is a resounding yes! In a research study commissioned by Institutional Shareholder Services (ISS) and published in 2004, Lawrence D. Brown and Marcus L. Caylor of Georgia State University examined the question of whether firms with weaker corporate governance perform worse than those with strong corporate governance. The quality of governance was determined by the score achieved on ISS' proprietary rating system called the CGQ (Corporate Governance Quotient). Performance was determined by looking at a large variety of standard measures, including one, three, five and ten-year stock market returns, as well as several profitability measures including return on assets and return on equity.

In general, the study found that higher CGQ scores were associated with better performance with regard to shareholder returns, profitability, risk (as measured by volatility) and dividend yields. Specifically, the study found a direct link between good corporate governance and superior three-year, five-year and ten-year returns. The principal factors which result in a high CGQ score are a board of directors which demands that management be accountable to shareholders, and aligns managers' financial interests closely with those of shareholders. It is not a coincidence that one of the seven criteria we utilize for stock selection, which we call "management integrity", is a combination of conservative accounting and alignment of shareholder and management interests. Companies like EMC Corp, Xerox, Sherwin Williams and Abbott Labs, have long been recognized for exceptional governance. They insist upon maintaining independent audit and compensation committees, having an outside majority on the board, not having many directors serving on more than four boards, not employing poison pills as defenses against takeovers, and giving shareholders the right to call special meetings.

Good governance usually leads to good stock returns.