CUBIC ASSET MANAGEMENT, LLC

2014 3rd Quarter Stock Market Commentary

THE ROLLING STONES AS MANAGEMENT GURUS

"If you want more of something, subsidize it;
if you want less of something, tax it."
- Ronald Reagan

The most hated industry in America is banking. But the airlines are doing their best to give them a run for the money. Fares are soaring and seats are getting smaller even as passengers are getting larger. And then there are all those fees. Want to sit on the aisle or in a bulkhead row? Pay up. Want to book a trip using frequent flyer miles? Despite the fact that it is not possible to do it online at most airlines, there's a fee for making a telephone reservation. Quantas even charges a fee just to join their frequent flyer program. If you've lost your boarding pass, or don't have access to a computer before your flight, Spirit Airlines will print one for you for $10. And then, of course, there are the ubiquitous fees for checked baggage.

The airlines no doubt figured that checked bag fees would be a huge success for them, and initially they were right. First, they limited the size and number of bags you can carry on. Then they installed a fee for checked bags, providing a sorely needed revenue source in an industry which has historically had trouble making a profit. Secondarily, by forcing passengers to check bags they reasoned they would speed up the boarding process, cutting aircraft turnaround time.

But things are not working out exactly as planned. In May the U.S. Department of Transportation released data showing that checked bag fees were $3.35 billion in 2013, down 4% from the prior year. Apparently more passengers are attempting to bypass the fees by bringing their luggage on board. According to the flight attendant blog site *The Flying Pinto* some passengers have also brought on a bathroom sink, car tires, a Toyota Celica fender and a miniature horse in a carry-all designed for dogs. And if there happens not to be enough space in the overhead bins, no problem, because the cabin attendants will check your items for you. Interestingly there is no fee for luggage checked in this manner. Further, because so many passengers are trying to bypass the extra fees, the time taken to board has been steadily rising. As the opening Ronald Reagan quote points out, if you "tax" checked luggage, you get less of it.

The point of this is that carrots and sticks can be used to motivate behavior, but unless the incentives are very well thought out they often result in behavior that is different, or even opposite to, that which is intended.

In a November, 2009 paper entitled "Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008", co-authors Lucian Bebchuk, Alma Cohen and Holger Spamann of the Harvard Law School examined the compensation of the top five executives of both Lehman Brothers and Bear Stearns during the period 2000-2008. They found that these teams were able to cash out of $1 billion and $1.4 billion, respectively, of bonus compensation that was not clawed back when the firms collapsed, a stark contrast to the fate of shareholders. They suggested that flawed compensation models led to excessive risk-taking, which increased the severity of the crisis.

A subsequent paper by Sanjai Bhagat of the University of Colorado and Brian Bolton at Portland State University, " Misaligned Bank Executive Incentive Compensation," examined this theme in much greater depth. The authors looked at the compensation structure at 14 of the largest financial institutions in the same 2000-2008 period and compared it to the structure at 37 other banks which neither sought nor accepted TARP. They found that the banks in the first group had significantly lower Z-scores - the number of standard deviations below the mean bank profit that the profit would have to fall to wipe out the entire shareholders' equity. In simple terms, since large-bank executives shared disproportionately in bank profits, while bank losses were borne by shareholders (and ultimately taxpayers), there was a perverse incentive to roll the dice.

Over the years we have written many times about the justification for the quantitative criteria we use in our investment process - why we focus on stocks with low P/E ratios, for example, or high returns-on-equity. Rarely, though, have we written about our qualitative criteria. The most important of these we refer to as "management integrity, a broad concept which includes the requirement that each company should align the financial interests of executives and shareholders. Far too many companies pay lip service to this principle, but utilize pay practices which violate its spirit.

Consider the company Helen of Troy, an El Paso, Texas based designer, producer and marketer of hair dryers, curling irons, combs and brushes, under such licensed brand names as Vidal Sassoon, Revlon and Dr. Scholl's. The company started as a wig store in 1968. Founder Gerald J. Rubin transformed the company in the late 1970s when he convinced Vidal Sassoon to allow Helen of Troy to market its products under the Sassoon brand.

Rubin's compensation formula for his positions of Chairman, CEO and President was unusual, to say the least. He had a base salary of $600,000, modest for a company Helen of Troy's size. But in addition, he received a bonus based upon "adjusted EBITDA." EBITDA, or earnings before interest, taxes, depreciation and amortization, is a non-GAAP measure of profitability which ignores the cash required to fund capital expenditures or working capital. In Rubin's case, the higher the EBITDA, the greater the percentage he was entitled to. Thus if EBITDA was in the range of $50-$75 million, he was entitled to 2% of it, from $75-$100 million he was entitled to 3.5%, and so on, up to a phenomenal 8.5% above $175 million.

Not surprisingly, since Rubin's bonus ignored capital deployed to buy or license brands, he went on an acquisition binge. Over the next three decades the company grew into a $1.3 billion company through a series of additional licensing deals, product acquisitions and company takeovers. The result was that Rubin was paid in excess of $10 million per year until the directors were forced by shareholder pressure to buy out his contract. The buyout resulted in further payments of a whopping $41.6 million in 2013, and another $31.3 million in 2014. Ordinarily, the departure of a charismatic chairman and founder causes long term shareholders to dump a stock; in this case, the company had its biggest one day rise ever when new management announced the termination of Rubin's employment agreement.

Many companies tie executive bonuses to specific corporate events, such as the completion of a merger. Yaniv Grinstein and Paul Hribar of the Johnson Graduate School of Management at Cornell University examined mergers and acquisitions at companies which promised to reward the CEO for completion and found, not surprisingly, that such companies did complete a higher percentage of deals than other companies without this bonus feature. Unfortunately, though, the executives received their bonuses for the effort they expended, which turned out to be unrelated to the outcomes for shareholders. Over the subsequent years the stocks of the acquiring companies lagged the returns of other companies in the same industry. The group of firms for which this was true included Exxon, Travelers Group, HealthSouth and Banker's Trust.

Other firms tie bonuses to the achievement of specific margin targets. Consider, for example, Valeant Pharmaceuticals, an obscure drug manufacturer until it merged with Biovail in 2010. It grew explosively over the next four years through a series of acquisitions. Its proxy statement shows that a significant portion of executive bonuses are determined by achieving certain gross and operating margin targets. The easiest way to achieve the desired results is to slash head count and skimp on research. This has led to a culture of aggressive cost cutting, which increases profits in the short term. But a lean business model may harm prospects over the long-term.

In 2011 the company purchased the rights to the drug Sculptra, which builds up collagen and is injected for cosmetic touch-ups. Valeant had purchased the drug from Sanofi in 2011. Sculptra was initially approved only for HIV positive patients but Valeant wanted to expand the market opportunity. The FDA requested an additional study, but the company's cost conscious culture caused them to resist the FDA's request. After two years of obstructionism, Valeant is selling the rights to Sculptra to a division of Nestlé, which will inherit the responsibility for conducting the study that Valeant never started.

Operating lean has other downsides. There are frequent layoffs and high turnover. One new Valeant product was Jublia, a drug to treat toenail fungus, with an estimated market opportunity of $800 million a year. Jublia ran into manufacturing problems. Again, Valeant took an aggressive stance with the FDA, who ultimately declined to approve the treatment. Some executives stated they believe that if the company had not been so thinly staffed, they would have been able to find a solution to the problem more quickly and fix it before the FDA turned down the application.

Earlier this year Valeant became embroiled in a bitter hostile takeover bid for Allergan, the manufacturer of Botox. Despite offering a substantial premium to shareholders, Allergan's board rejected the offer, primarily because Valeant indicated it would slash Allergan's research and development budget by 69%, which the latter argued is the lifeblood of a pharmaceutical company.

The goal of a bonus system should be to motivate management to run the business in a way which maximizes long-term shareholder value, rather than to take actions that result in a large bonus this year but which reduces long-term value. Consider the bonus schemes in place at the Walt Disney Company and Valero Energy. Both companies, like almost company within the Standard & Poor's index, have an investor relations department which meets with Wall Street analysts and helps guide them in constructing an earnings estimate for what the company will probably earn in the coming year. In the case of the above two firms, though, the internal earnings target to achieve the maximum bonus is 2.6% below the earnings to which the companies guided analysts. Rather than promoting shareholder value, this is a prescription for getting management to coast. Executives do not have to meet Wall Street expectations to get paid, although an earnings miss will certainly cost shareholders money. Nearly 20% of the S&P consistently sets bonus targets below Wall Street expectations for earnings.

This is not as egregious as the system in place at casino operator Wynn Resorts where maximum bonuses are earned for earnings which are below the prior year.

We have discussed a few examples of bonus plans which result in the destruction, rather than the creation, of shareholder value. Some provide incentives to shift earning into a different time period, some cause executives to understate organizational capabilities, others promote the assumption of excessive risk while others ignore the cost of capital. Even well-thought out plans frequently focus too much on the short-term. How can the financial interests of shareholders and management be truly aligned?

First, bonuses should be based upon performance measures associated with driving shareholder returns, like earnings per share (EPS) or return-on-invested-capital (ROIC). Second, there should be a truly independent board. Third, measures used should be fairly static over time, not reset lower following a bad year. Fourth, executives should be encouraged to think long-term by having a significant portion of the bonus tied to cumulative measures. Fifth, do not limit bonuses, since this will only encourage managers to defer additional profits once they have achieved their maximum target bonus. Last, allow for claw-backs of compensation if evidence of fraud, or excessive risk taking, etc., is discovered from prior periods.

In an ideal world, it would not be necessary to have tightly proscribed programs. Warren Buffett's longtime partner, Charlie Munger, has written that "The right culture, the highest and best culture, is a seamless web of deserved trust. A trust-based system allows individuals to operate without extensive control procedures and therefore avoid the time and cost of having their own actions monitored and having to monitor the actions of others. As such, a trust-based system can be more efficient than a compliance-based system, but *only if* self-interested behavior among employees and executives is low." He went on to state "One would want managers to see themselves as fiduciaries for shareholders, and act accordingly." Unfortunately, there is only one Warren Buffett and too many executives allow their best judgment to be clouded by self interest, necessitating a more elaborate set of principles. To quote Mick Jagger:

You can't always get what you want
But if you try sometime you find
You get what you need.