An Open Letter to Company CEOs from a Value Investor

Dear CEO,

I write to explore some beliefs, practices and misconceptions which may have led to the lacuna in understanding between company managers and shareholders and to suggest a future more linked and successful.

I understand that the role of CEO is a complex and difficult one. You are required to manage a huge workforce who range in attitude from de-motivated to overly ambitious. Keeping all on board and contributing productively is a mammoth task. You are simultaneously required to steer the company through economic seas rougher than Antarctica's Drake Passage, all this while making operational choices and decisions on strategic direction. I also appreciate you must have worked very hard to get to the position of CEO. Now that you have arrived your reward is to work 80 hours per week and spend more nights away from home than Ernest Shakleton.

Frankly I believe that you are the arbiter of your precarious situation. You have chosen to take advice from investment bankers and stockbrokers. These vultures' interests are neither aligned with your own nor those of your shareholders. You would not ask a horse trader if his horse was the best in the fair!

Of course anyone can make mistakes and I understand it is hard to be right all the time, especially when you are under so much pressure. Maybe you would benefit from a few words of advice from a value investor. You have probably met many investors during your time in management, but value investors are different. In an era when the average holding period for stocks on the New York Stock Exchange is less than 6 months, value investors (who fully expect to hold a stock for more than 5 years and have a focus on company ownership rather than trading securities) are unusual.

Warren Buffet once said *"earnings can be as pliable as putty when a charlatan heads the company reporting them"*. Wall Street analysts' intense focus on quarterly earnings has blurred your focus. This is somewhat understandable since Jack Welch, formerly chairman and CEO of GE, one of the most lauded and 'successful' managers off all time, appears to have achieved a lot of his success by an intense focus on 'guiding for' and then 'meeting' quarterly numbers. He would do whatever it took to meet those numbers, and even refused to talk to any analyst who questioned him. (Market expectations of GE earnings in 2010 are at the same level as when Jack left in 2001).

Subsequent events at companies such as Worldcom, Enron, Parmelat, Tyco and Vivendi should teach us all that an unhealthy obsession with the earnings race eventually catches up

with you. Why pander to this short-term focus? Be courageous and admit the truth; you don't know what will happen in the next 3, 6 or even 12 months. If you focus on making investment and strategic decisions that shall, in your professional opinion, deliver benefits in the long term then investors will eventually learn that you are acting in their interests. This is very difficult, but ask yourself – do you want the type of shareholder who has a heart attack if one random day of light sales means you miss your guidance? On Wall Street people who attempt to predict near term results might be termed investors, but we value investors call them speculators.

Many reputable companies have rejected the Wall Street way. Expeditors, a highly successful California-based freight forwarding company, has gone to extremes in resisting the disease of a short-term focus. They accept only analyst and fund manager questions via email and publish all answers monthly in an SEC 8-K filing. Expeditors refuses to provide short-term guidance but reinforces market understanding of company strategy so that there can be no ambiguity regarding their focus. Trading on a multiple of 28 times 2010 expected earnings this strategy does not seem to have done them any harm.

Remember your balance sheet is your fortress! Do not compromise it. I understand that it is sometimes necessary to take risks. When you have opportunities, organic or otherwise, turn to your shareholders. If the opportunity presented is as good as you believe and has a reasonable chance of delivering a return ahead of your cost of capital, then we will provide more equity. In the event that things don't work out quite as well as planned, then hopefully this extra capital will protect and see the company through.

Buying a company for whatever reason, whether it's for products, attractive geographical exposure or maybe customer relationships, often appears attractive to company managements. Maybe, again, this is because fee junkies advise managements. Value investors do not want you to make acquisitions, except in exceptional circumstances. While this may surprise you, the fact that most 'merger and acquisition' activity does not deliver value for acquiring shareholders should help you understand.

A KPMG survey found that "83% of mergers were unsuccessful in producing any business benefits regarding shareholder value" (KPMG 1999). A major McKinsey & Company study was slightly less damning, finding that 61% of all acquisition programs were failures because the acquisition strategies did not earn a sufficient return on the funds invested (Sirower 1997). If your company has too much cash on the balance sheet and has not got internal investment opportunities that you believe will deliver value, return the cash to your shareholders via dividends or, when the stock is cheap, share buybacks. While some acquisitions do add value they are few and far between, with the chances of success vastly improved by investing within franchise in related business areas.

Management incentives should be aligned with shareholder interests. While instruments such as stock options, deferred bonuses and restricted stock should in theory improve shareholders' confidence that management are in their corner, evidence from the past couple of decades doesn't bear this out. The asymmetric nature of payoffs must be addressed so that management is remunerated commensurate with their success in delivering long-term shareholder return.

Don't tell us your stock is cheap – show us. A value investor believes that value does not equal price. You are in the best position to appraise the value. You will be aware of private market resources held in your books at historic cost. Depending on your personal financial circumstances (and of course with due regard for insider trading legislation), you could make personal purchases of stock, assuming you really believe your stock is good value. Better still, organise and execute a management buy out. Be sure to offer us a fair price – we too know the value of our company.

You should realise that managements who claim that anti-takeover 'poison pills' protect shareholder interests do not fool value investors. Having performed our due diligence we will immediately identify that these instruments are in place to serve management only. The current negotiations (July 2010) between common stock investors and Frank Stronach, CEO and Chairman of Canadian auto parts company Magna International, is proof whose interests these repellents serve, if any is needed. Frank wants over $1 billion to forego his super-voting B shares; under the current structure Frank controls 66% of the voting rights of Magna while owning only 1% of the equity. I have no doubt Frank will get a sizable proportion of the amount he is seeking. When Frank gets this money, who will suffer? If you introduce any of these measures you are doing the exact opposite of what shareholders employ you to do (to maximize shareholder value). As a direct result the stock in the company you manage will trade at a discount to reflect this.

We do not demand too much from management. A value investor expects integrity, diligence and an unwavering focus on long-term value as key qualities. Having instilled these principles throughout the organisation and, guided by them when making difficult decisions, your management team will have a reasonable shot at long-term success. Remember, as CEO you are merely a guardian of the company for long-term shareholders.

Yours truly,

The Value Investment Institute, July 2010