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What makes a good CEO?

Out of all the jobs on the planet, being CEO is possibly the hardest job to be fired from for poor performance. This sounds counterintuitive, but in reality: 1) the exact specifications on what constitutes good vs bad CEO performance are rarely laid out; 2) the CEO can always blame a subordinate for negative outcomes; and 3) the boss who can fire the CEO (the board of directors) more often than not offers no governance, and instead, simply rubber stamps anything set before it.

Of the CEO's functions, the most important is allocating the business's cash flow. While the subject sounds complex, a CEO can really only allocate cash flow to a few purposes: (1) paying taxes, (2) servicing debt, (3) reinvesting in the business, (4) repurchasing shares, (5) acquiring other businesses, and (6) disbursing cash to equity holders (dividends).

Options 1 and 2 -- taxes and debt -- are fairly straightforward. Equity holders are in partnership with debtholders and the government. Death and taxes are inevitable. Not only does the government always get its cut of the profits, but the government gets to decide how big that cut is. Over the last few decades, the government's cut has been high. Over the next few years, it appears that the government has voluntarily given up some of its cut, which leaves more profits for equity holders. As for debt, the CEO decides how much debt the business should have and how much risk versus opportunity such debt poses to the business. More debt may mean more money for short-term growth, but it also makes the business more susceptibility to bankruptcy during a downturn.

Options 3-6 are the most interesting and the most commonly misunderstood. In the financial media, it is common to hear statements like "a company should pay a dividend" (Option 6) or "repurchasing shares is good" (Option 4). Unfortunately, neither statement is always true (sometimes these might be good choices, and sometimes they might be poor choices), and the truth can not be distilled down to a simple sound bite.

In reality, only one factor determines whether a CEO's decision is a good capital allocation or a poor one, and that factor is the expected return of this choice versus other alternatives. Unfortunately, a CEO may struggle to determine how to allocate capital, because he or she likely ascended to the CEO role from a position that did not require financial literacy. Without the base knowledge of how to determine what is or is not a good capital allocation, how can the CEO make good decisions? Often, CEOs who are financially ignorant rely on management consultants, and management consultants are incentivized to allocate capital in ways that maximize the consultant's fees, rather than in ways that maximize shareholder profits. Additionally, a CEO's compensation plan may be structured such that what is best for the CEO is not what is best for the shareholder. In a recent egregious instance, a new CEO sold a business, which we owned, at a massive discount to its intrinsic value with zero premium to the market price. Shameful! The CEO will receive a multi-million dollar payout for a few months of

“work” while the shareholders get the shaft.

Back to Option 3: When should a CEO reinvest in a business? When the return is higher than other alternatives. Amazon and Berkshire Hathaway are fantastic examples of businesses that have effectively reinvested almost all of their profits over decades. With Amazon, Jeff Bezos has grown sales at greater than 20% per year while establishing multiple monopolies. With Berkshire, Warren Buffett has compounded the business’s book value at greater than 20% per year since 1965. Both Bezos and Buffett have an investment hurdle for any investment. If a project is unlikely to return 20% per annum, they will not fund it.

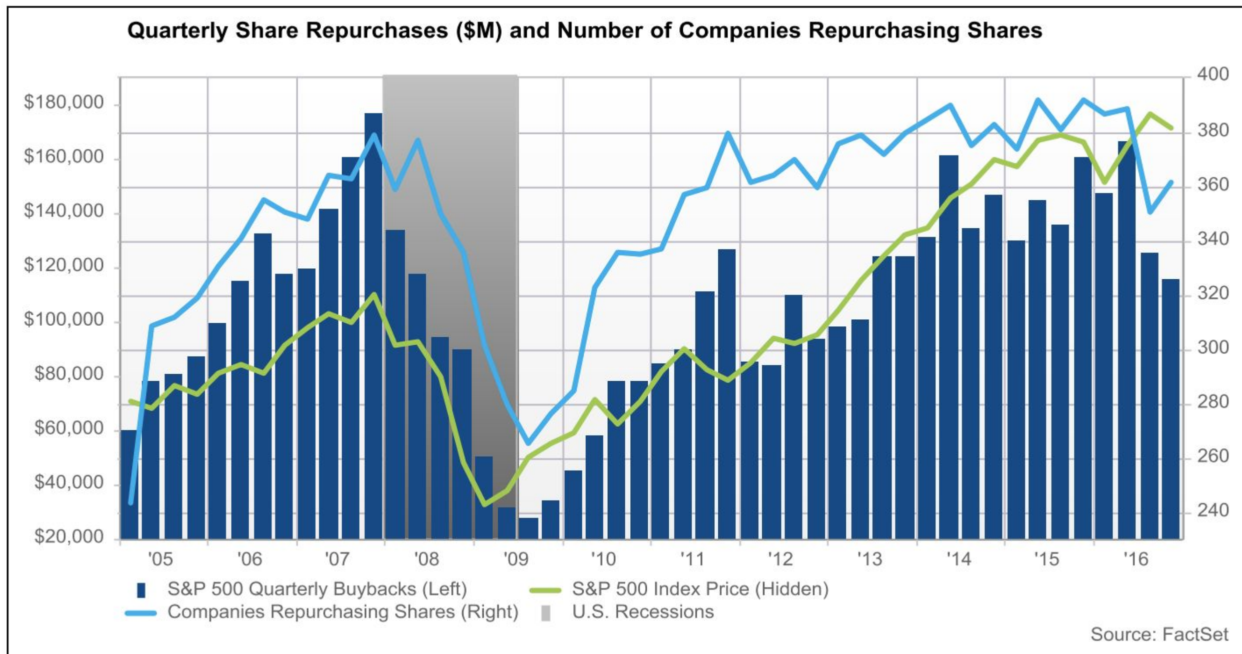
By contrast, more ordinary CEOs do not have such investment hurdles, and as a result, they succumb to two common problems. The first problem happens when a CEO increases earnings simply by increasing the amount of capital used to generate the earnings. These new earnings are produced with a very poor return on capital. Buffett described the situation like this:

> *When returns on capital are ordinary, an earn-more-by-putting-up-more record is no great managerial achievement. You can get the same result personally while operating from your rocking chair. Just quadruple the capital you commit to a savings account and you will quadruple your earnings. You would hardly expect hosannas for that particular accomplishment. Yet, retirement announcements regularly sing the praises of CEOs who have, say, quadrupled earnings of their widget company during their reign — with no one examining whether this gain was attributable simply to many years of retained earnings and the workings of compound interest.*

The second problem happens when a CEO reinvests in a slowly dying business with high capital requirements. Imagine a manufacturing business that is trying to compete against a cheaper foreign competitor. In this scenario, the rational path forward is to limit reinvestment and to return as much capital as possible to investors. Unfortunately, in most circumstances, the CEO continues buying the latest gadgets, with hopes that such gadgets will somehow permanently fend off the cheaper competitors. They almost never do.

Option 4: When should a CEO repurchase shares? When they are cheap! A quality CEO should have a very good idea what his business is worth. When the business trades significantly below that value, it is a good time to purchase shares. When the business trades significantly above that value, it is a bad time to purchase shares. For instance, Buffett has indicated that Berkshire will consider repurchasing shares if they ever fall to 120% of book value. Any price above this does not clear Buffett’s investment hurdle for Berkshire to repurchase shares. John Malone of Liberty Media takes this option one step further. Malone not only repurchases (buys) shares when they are cheap, but he issues (sells) new shares when they are expensive. He then uses the proceeds to buy back shares when the price finally falls. What a brilliant insight! Using this strategy, Malone has returned in excess of 20% per year since 1973.

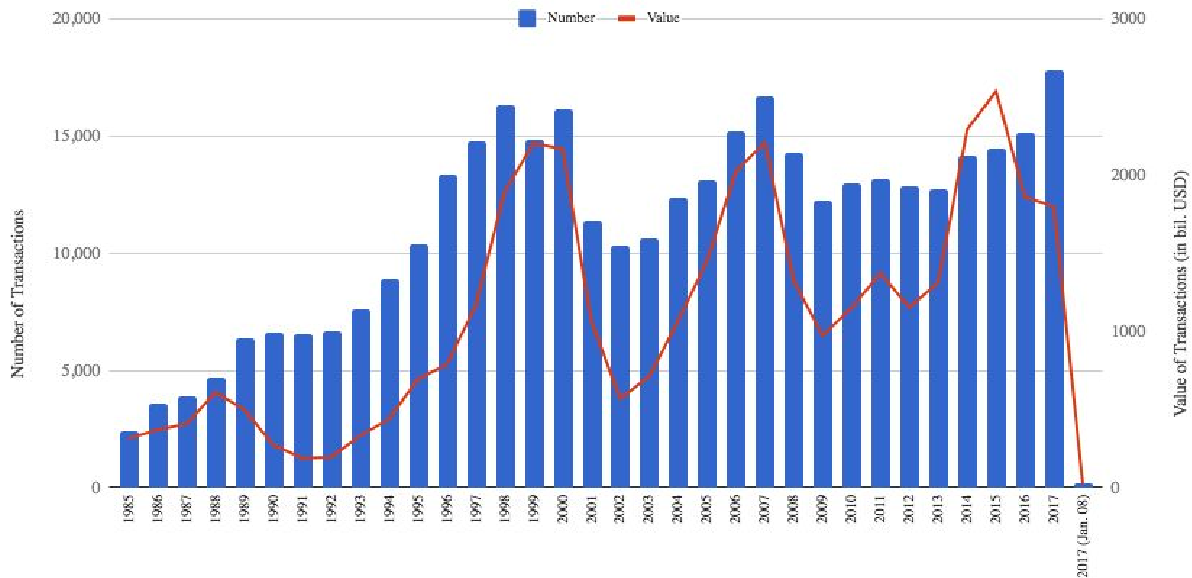
Unfortunately, most CEOs have no idea what their business is worth. Instead, like most investors, they choose to buy high and to sell low. The figure below clearly demonstrates the problem. The higher the market (green line), the higher the amount of share repurchases (dark blue bars). If a CEO were rational and understood what his business was worth, then he would do the opposite: purchase large numbers of shares when the market is down and taper off buying as the market goes up. So much for rationality.



Share repurchases can also mask how executives pillage a company. Many executive compensation plans pay out an outrageous fraction of a company's earnings to executives. These payouts typically happen via stock options. To mask the dilution caused by such stock grants, many companies purchase offsetting amounts of stock, at any price -- but many investors fail to notice this sleight of hand.

Option 5: When should a CEO purchase another business? When it is cheap! Such a transaction should only happen when the CEO can acquire -- at a very good price -- the future cash flows or assets of the purchased business. (Note that combining the businesses may reduce some overhead, leading to cash flows greater than the separate businesses.)

Unfortunately, the average CEO shows the same skill at acquiring other businesses as he does at repurchasing his own company's shares. The chart below shows merger and acquisition activity over time. You can see large activity peaks in 2000, 2007, and 2015, with troughs in 1991, 2002, and 2009. Peak buying coincides with market tops (2000 & 2007), and inactivity coincides with market bottoms (2002 & 2009). Once again, so much for buying low and selling high.



Buffett summarized the situation this way:

> *The sad fact is that most major acquisitions display an egregious imbalance: They are a bonanza for the shareholders of the acquiree; they increase the income and status of the acquirer's management; and they are a honey pot for the investment bankers and other professionals on both sides. But, alas, they usually reduce the wealth of the acquirer's shareholders, often to a substantial extent. That happens because the acquirer typically gives up more intrinsic value than it receives. Do that enough, says John Medlin, the retired head of Wachovia Corp., and "you are running a chain letter in reverse." ... The acquisition problem is often compounded by a biological bias: Many CEOs attain their position in part because they possess an abundance of animal spirits and ego.*

Option 6: When should a CEO pay a dividend to shareholders? The answer depends on what other opportunities are available. A dividend should not be paid if reinvesting in the business, repurchasing shares, or purchasing other businesses can be done with returns higher than an investor is likely to get with cash. On the other hand, if the business is in a long-term decline, if the stock price is high, and if there are no cheap businesses to purchase, then paying a dividend may make sense. However, there is a catch. Uncle Sam has decided to take two cuts out of the dividend pie. The first cut is via the corporate tax, and the second cut is via the individual income tax. Up until recently, this could mean a 35% corporate tax followed by a 35% dividend tax, so only 42% of the business profit may make it to the shareholder. This double taxation makes dividends very tax inefficient, and it skews the optimal strategy towards other avenues for capital deployment.

As an investor, why should you care what makes a good CEO versus a poor one? You should care because, over time, a CEO's capital deployment decisions either increase or decrease the intrinsic value of a business. Good decisions can lead to rapid, exponential increases in value, while bad decisions are the equivalent of setting fire to millions of dollars. Unfortunately, most CEOs do not make good capital allocation decisions, yet they try to sell their decisions to investors as if they were wise choices. Frequently, the only way to tell a CEO, "You're fired," is by cutting his business from your portfolio.

Cordially,

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