Long-term stewardship and our capital markets

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Abstract

Purpose – This paper aims to look at the three areas of corporate governance, intellectual capital and strategic business valuation from the perspective of a long-term value investor.

Design/methodology/approach – The paper begins by briefly laying out the investment tenets of a long-term value investor and then proceeds to align long-term value investing with long-term stewardship of economic resources. The paper is a transcript of a keynote presentation delivered at the 1st McMaster World Congress on Strategic Business Valuation.

Findings – In the area of intellectual capital the paper points out that the concept of intellectual capital falls far short of the fuller and more necessary view on intellectual knowledge which should be replaced or at least augmented with the notion of wisdom.

Practical implications – Any notion of strategic valuation or pricing of assets based on their economic value will be significantly impacted by one's investment principles and time horizon. The paper mentions two examples of inefficiencies in the market due to divergent time horizons. The two examples discussed are income trusts and principal protected notes.

Originality/value – One's investment philosophy or principles which largely determine time horizon will have a significant impact on how one approaches the important areas of corporate governance, intellectual capital and strategic business valuation. The concern of the paper is to the extent that we have become more short-term in our investment principles; this will have serious long-term negative impacts on the capital markets.

Keywords Intellectual capital, Corporate governance, Assets valuation

Paper type Conceptual paper

Introduction

Let me begin with thanking Dr Chris Bart – Program Director of Corporate Governance, Dr Nick Bontis – Program Director of Intellectual Capital, and Dr Patricia Wakefield – Program Director of Strategic Business Valuation for the opportunity to speak with each of you today. I appreciate the tremendous work they are doing at McMaster University with the Directors College and the AIC Institute. I have entitled my keynote presentation today "Long-term stewardship and our capital markets." During the next few moments I want to sketch out what I believe to be some of the major challenges facing our capital markets as a result of a growing preoccupation with short-term results rather than an approach which focuses on long-term stewardship. I will contain my comments largely to the major areas that are under discussion at this conference, namely corporate governance, intellectual capital and strategic valuation.

AIC's investment philosophy – attempting to be long-term stewards

For a point of context, let me briefly lay out the basic tenets of AIC's investment philosophy and principles which I believe align our interests and the interests of our investors with the true long-term objective of the capital markets. That objective is to

Management Decision
Vol. 45 No. 9, 2007
pp. 1387-1396

0025-1747
DOI 10.1108/00251740710828654

maximize wealth creation through the provision of capital to the most efficient users and valuing assets based on their long-term sustainable cash flows commensurate with both market and security risk.

We buy businesses not just pieces of paper
At AIC, we evaluate every investment opportunity as though we are buying the company in its entirety. We believe that too many investors see only a stock price and look at stocks as pieces of paper and not ownership positions in real businesses which comprise the long-term assets of the economy.

We buy businesses we understand and believe in
Investing for us at AIC is all about understanding and ensuring that every time we commit capital to an investment it is only after a thorough and disciplined fundamental analysis by qualified professionals. Some of the core attributes of the businesses we look for include the following: honest and competent management teams, strong franchises (reputations), diversification of revenue (geographically and by product or service), strong market position, top-line growth (preference to organic growth), disciplined use of capital and strong free cash flow.

We buy at attractive valuations
As long-term stewards of capital we spend a great deal of time valuing assets or businesses. In the short-term, the market as Benjamin Graham reminded us all, is a voting machine, but in the long-term the market is a weighing machine. The fundamental strength of our capital markets is that given the large number of participants over time businesses that are efficient and productive with their capital will be valued based on their ability to generate surplus or free cash flow commensurate with the risk of the underlying business. Given the fact that in the short run markets are still dominated by fear and greed, the market will always misprice some assets and allow value investors, such as AIC, to accumulate positions in wonderful businesses below what we believe is their true long-term value.

We measure ourselves by our long-term success not short-term stock prices changes
As a result of our buy-and-hold approach, we do not engage in speculative investment practices such as sector rotation or momentum investing. We do not try to time the markets and hence our investments do not have a predetermined holding period or even selling price. We will hold an investment and provide capital to a company as long as we expect the value of the company to continue to increase at a satisfactory rate. Our real focus is often to use the market as a contrary indicator and buy great companies that have fallen out of favour because of a current mania.

Long-term stewardship versus short-termism
If one were to lay out the two most distinct or differentiated approaches to how one approaches our capital markets, I believe one could distinguish them as either an approach that emphasized long-term stewardship or a view that in the end was much more immediate and short-term in nature. I will refer to the one as long-term stewardship and the other as short-termism. Let me briefly define my terms so that we are all on the same page.

When I talk about stewardship I am referring to Webster's basic definition, "the administration of responsible care over possessions entrusted to one's care." I am also using the term in its broadest sense which refers not only to one's finances but also to everything we have (own) and are (gifts and abilities). Words such as "entrusted" and "responsibility" take us beyond ourselves to our neighbours, our business associates, culture and to the next generation. Stewardship is a powerful concept that presupposes that all our actions are meaningful in this life, since we are creatures that are significant (impact history), moral and free.

When I use the word stewardship it involves the concepts of purpose, focus, truth or standards, and a long-term intergenerational view. After all, how can one be a good steward without a driving purpose that gives true and lasting meaning to one's life? How can one be a good steward without laying out clear priorities and living a focused life that leaves a lasting imprint on those around you and on those who follow? How can one be a good steward without living up to clear standards and living a life of truth, honesty and integrity? How can one be a good steward without living a life of discipline and considering one's impact on the next generation?

Now, contrast that with the view that I see increasing in our capital markets, that of short-termism. Short-termism in its most general sense is the pursuit of immediate gratification at the expense of long-term thinking. It most typically begins and ends with the question, what's in it for me? Consider the following reports from the business sphere:

- In 2003, the former US Securities and Exchange Commission (SEC) Chairman William H. Donaldson called on business leaders at the Business Roundtable Forum on Corporate Governance "to manage the business for long-term results and to get away from the attitude that you're managing the business out of a straight jacket that has been put upon you to create earnings per share on a regular basis." Expanding on his concern at the 2005 CFA Institute annual conference, Donaldson cited "short-termism" as a critical issue facing the financial industry and the broader capital markets.
- In research conducted by the Business Roundtable Institute for Corporate Ethics, chief executive officers (CEOs) at many of the largest US corporations were asked to identify the most pressing ethical issues facing the business community. "Effective company management in the context of today's short-term investor expectations" was among the most cited concerns.
- In a recent survey of more than 400 financial executives (Graham *et al.*, 2005), 80 percent of the respondents suggested that they would be prepared to reduce discretionary spending on critical long term areas such as research and development, advertising, maintenance, and hiring in order to meet short-term earnings targets. An astounding 50 percent plus said they would delay new projects, even when it meant the long-term sacrificing of value creation.

These results confirm what we already know: that short-termism is a major challenge to corporate integrity and puts our long-term economic prosperity at risk. While management's number one objective should be the creation of long-term shareholder value, it is increasingly obvious that some managers aim only for short-term earning expectations or, worse, for short-term personal gain at the expense of other stakeholders.

When we use the term short-termism, we are referring to what the CFA Institute identifies as (refer to web site www.cfainstitute.org):

> … the *excessive focus* of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to strategy, fundamentals, and conventional approaches to long-term value creation. An excessive short-term focus combined with *insufficient regard for long-term strategy* can tip the balance in value-destructive ways for market participants, undermine the market's credibility, and discourage long-term value creation and investment. Such short-term strategies are often based on accounting-driven metrics that are not fully reflective of the complexities of corporate management and investment.

The bottom line is that the increasing obsession with short-term results by investors, money management firms, and corporate managers can lead to many unintended consequences: reduced long-term value, decreased market efficiency, lowered investment returns, weaker corporate governance, increased risk of corporate malfeasance, and in most cases a permanent transfer of wealth.

Over the past several decades the preoccupation with short-term results over long-term impact seems to have intensified. We can see it in the capital markets and we can see it in other areas of social life as well. Anyone who has followed the debates on family, education, government social and fiscal policy can draw the conclusion that short-termism has seeped into all aspects of our culture.

As we move forward to discuss some of the challenges facing our capital markets it is critical to assess what side of the ledger you are on. Is it long-term stewardship or short-term immediate gratification? Is it "mad money" or "fast money" as CNBC promotes to a declining audience or is it as the old sage Solomon made clear 3,000 years ago when he articulated that, "the plans of the diligent lead to profit as surely as haste leads to poverty?" (Proverbs 21:5)

Long-term stewardship and corporate governance

It is somewhere between amusing and distressing to consider that despite all the literature and lectures on corporate governance we still cannot answer the most basic question of all, what shareholders are the board of directors representing? Is the board there to jump to the whims and fancies of short-term investors (i.e. Hedge funds) or represent the interests of long-term investors?

The rise of the institutional money manager

This issue has indeed become much more complex given the rise of the institutional money manager who increasingly controls larger and larger pools of capital. With the aging of the world's population and the need to set aside more and more money in personal savings, institutional managers control more and more of the financial assets. It only follows that their time horizons are becoming the time horizons of the corporate boardrooms. With many of the money managers measured based on their short-term results, more and more pressure is being exerted on management teams and boards to make shorter and shorter term decisions in order to influence the short-term share price of the business and not focus on the kinds of long-term decisions and commitments that will position the business for years to come. This should concern each of us who care at all about our businesses and the overall productivity and strength of our economy. As each of you investigate and come to grips with this important area of corporate governance, where does the notion of long-term stewardship factor in? With institutional money managers more focused on 2 percent and 20 percent we need to have both executives and boards of directors with the moral conviction and backbone to truly protect the interests of long-term investors and the broader interests of society.

Excess liquidity and private equity

One example I will mention briefly is the area of private equity and the abuses that are taking place at the hands of these smart, but too often greedy (short-term) firms. In the past, private equity funds improved the companies they took over by increasing the operating efficiencies, lowering the cost of capital, strategically repositioning the businesses into new markets, in general reinvigorating the businesses, truly adding value for all the stakeholders. Typically, this meant a six to eight year time horizon or hold in which the money made by the private equity firms resulted from selling their position over time to new shareholders. Fast forward to today where literally hundreds of billions of dollars have poured into leveraged buyout funds and where over 2,700 funds globally have raised more than half a trillion dollars in cash to invest. This will bankroll these funds with at least $2.5 trillion in deals, given their fondness for putting $4 (or more) of debt leverage atop every deal they put up.

Now, there would be no reason to resent the financiers and their take if they were building businesses and creating jobs. But, these folks don't make their money building businesses and creating jobs. They do not make their money discovering new drugs, writing new software programs, creating retail chains or developing new energy sources. No, they are making their money simply trading existing assets and raping and pillaging the balance sheets of companies with outrageous fees. The same companies that, in many cases, they had just purchased! Many of these firms are burdening these target companies with piles of debt raised solely to pay them out their cash and immediately generate a return in order to protect their capital. As an article in Forbes stated, "it is akin to letting the Sopranos come in and gut your business to cover your gambling debts." The new term created by these folks probably because raping and pillaging does not sound that pleasant at the country club is the term "dividend recapitalization." In 2005, companies reported that they paid out more than $18 billion in instant short-term gratification to new owners (Weinberg and Vardi, 2006).

Some of the stories of abuse that are emerging are nothing short of shocking. An article entitled, "Gluttons at the gate – private equity firms are using slick new tricks to gorge on corporate assets. A story of excess" which appeared in *Business Week* (Thornton, 2006) details some of the most outrageous abuses. Most of you have no doubt read about some of these antics.

The question I have is where is the board of directors when these gluttons take a run at a company? Whose interest are they looking out for? Or back to my first question, what shareholders is the board of directors representing? If we cannot answer this most basic and fundamental question, what is corporate governance all about except to provide cover from our legal system? What about long-term wealth creation? What about efficient use of capital? What about stewardship and responsibility to the broader society and the next generation? Or as in the case of these private equity firms, are we simply reduced to a state of short-termism where the cleverest folks can legally redistribute wealth through financial calisthenics?

Long-term stewardship and intellectual capital

The importance of the metaphysical

Economics is really a metaphysical science rather than a mathematical one in which the spiritual values and attitudes are more important than physical assets and the morality and virtue of the populace as foundational as the money supply. Products, after all, are the assembly of qualities and their value derives directly from the innate character and ideals of those who create them and the workmanship of those who produce them. Things are, in their final analysis, the expression of thoughts. Quality products derive from quality thoughts, shoddy products from shoddy thoughts (Brookes, 1982).

If this is true, an economy, like an individual business or a specific product or service is the sum of the spiritual and mental qualities of its people, and the economic output will only be as strong as the values of the society. Without the refining influence of moral standards, such as honesty, trust, integrity and loyalty the marketplace will quickly deteriorate. A society, particularly a free market society that does not have strong values will end up producing less and less of value; a nation whose values are in decline will eventually witness a decline in their economy (Brookes, 1982). This highlights for me the importance of the whole discussion on intellectual capital. But, does the concept intellectual capital go far enough?

Intellectual capital versus wisdom

Intellectual capital has become all the rage in the last few decades. This is seen in the fact that more and more *Fortune* 500 companies have created a position called the Chief Knowledge Officer (CKO). Interestingly enough, when you read much of the literature it is as if we just discovered the importance of intellectual capital in the last few decades which I find somewhat condescending given the importance the mind is given within many historical texts and particularly within the Biblical text of which I am very familiar.

Many see intellectual capital as a combination of four factors: your genetic inheritance, education, experience; and attitudes about life and business (Bontis, 1998). Some define it as the intellectual material – knowledge, information, intellectual property, experience – that can be put to use to create wealth (Stewart, 1997).

I find these definitions interesting and helpful, but inadequate since they do not take the concept of intellectual capital and place it into community which is much more than just structural capital. What good is it to have the smartest people if they cannot integrate into the society and act ethically and morally? What about Enron? Enron was known in the business world as having the "smartest guys in the room." Or what about the intellectual capital of the 87 or 88 Duke University professors who would rank high on the intellectual capacity scale but allow their own prejudices to convict a number of their own students with little to no evidence; and even today when the case has crumbled, they do not have the humility to say they made a mistake. I think you get my point.

Intellectual capital outside of a true worldview is not only impotent it can be very dangerous. Warren Buffett looks for three things in his managers: hard working, smart and honest. The first two without the third is disastrous!

Today's concept of intellectual capital falls far short of the fuller and more necessary view on intellectual knowledge which should be replaced or augmented with the notion of wisdom.

Wisdom in the Bible refers to "masterful understanding," "skill," and "expertise." The possession of wisdom enables humans to cope with the ups and downs of life and to achieve what would otherwise be impossible. It is far reaching in terms of its importance and impact! Wisdom is also inseparable from knowledge. In the Book of Proverbs, the term denotes mastery over experience through the use of both the mind and heart.

Wisdom entails knowledge, insight, prudence, cunning, discretion, learning, and guidance. It includes counsel, understanding or competence and resourcefulness and heroic strength. All these virtues are packaged with the concept of wisdom! Wisdom equips one to rule, to show broad leadership, enables one to acquire wealth and subsequently manage it wisely. Most importantly the concept of wisdom presupposes that all these capacities are exercised in the realms of righteousness, justice, and equity which gives wisdom a moral dimension to be exercised in the public square at all levels of society/culture (Waltke, 2004).

The Bible does something that has been largely lost in our culture and that is it transforms the word wisdom into character and hence action! The mind and the heart are to act together and knowledge or intellectual capital should never be abstracted from actions, practice or conduct. When we look for new employees at AIC we want people with the highest of intellectual capacities, but they must also possess a passion for doing that which is right; they must be people of true character who seek wisdom and therefore, appreciate the long-term view and will do what is right in the short-run to accomplish what will be truly amazing in the long-term. Intellectual capital is important, wisdom is indispensable and in short supply.

Long-term stewardship and strategic business valuation

The importance of pricing assets based on their economic value within our capital markets is essential and foundational to ensuring the efficacy of our markets over the long-term. Prices must represent and be tied closely to returns on invested capital and returns on equity if we are to reward efficient users of capital and make sure capital is not wasted. It is also important that sophisticated investors do not take advantage of the less sophisticated and that the capital markets are not used as a mechanism to redistribute wealth, but rather as a vehicle to reward enterprise, entrepreneurship and create long-term sustainable wealth in the economy.

What happens in a world of "experts" and "innocence" in the creating and structuring of investment products when there are few moral checkmarks? What happens in a short-term driven environment when people are more ingenious, or might I say, intellectually bright, but lack wisdom and become less than helpful to their fellow citizens? What happens when fiduciary responsibility means little?

May I introduce the topic of business trusts and principal protected notes to you as two cases in point?

Income trusts (business)

In 2006 income trusts accounted for a third of the country's record $28.1 billion of equity offerings after sales had grown by almost eightfold since 2001. For firms, such as CIBC, trusts represented 62 percent of their underwritings in 2006 with TD at 49 percent and

RBC at 43 percent. Big business for our friendly investment bankers indeed as they reached to meet the seemingly insatiable demand for income oriented investments.

What's the problem? The problem is that significant capital market participants facilitated a massive misallocation/reallocation of capital placing low quality and overpriced assets in the hands of either short-term retail investors, or unsuspecting retail investors, or perhaps a bit of both.

Business trusts, as a group, are low quality equities with as many as 75 percent of the largest 50 business trusts paying out cash distributions exceeding their accounting income. In fact, according to Accountability Research, the average cash distribution at the peak was running at 158 percent of their reported net income.

As businesses sold off less desirable assets and private companies went public at inflated prices, the question that should have been asked is why would the public literally overpay (based on core financial metrics) up to twice as much for a business that is weak and generally of low quality rather than simply buying one of our large chartered banks or globally positioned life insurance companies?

The answer from my perspective is simple: lack of knowledge on the part of the purchasers, huge demand for perceived income with no counterbalance on the risk side of the equation, aggressive accounting and financial reporting which distorted the long-term sustainable distributions making the trusts appear more attractive than they are, and investment bankers pushing these products and collecting significant fees (approximately $2 billion in fees since the beginning of 2001). The business trusts, as a group, facilitated a significant transfer of wealth at the end of the game from the less sophisticated to the sophisticated!

Where was the strategic valuation on these companies? Anyone who simply did "back of the envelope" calculations knew this was and still will be a sector full of much pain and adversity for investors. How could so many pensioners even begin to think they were investing in high quality assets when even a superficial analysis demonstrates that many of the business trusts will get themselves into serious trouble over time and in particular when the economy weakens? What the pensioners probably do not realize is that the system has made them participants in the raiding of many balance sheets in Canada. This is due to the fact that as much as one third of the distributions from business trusts represent a return of capital (Rosen, 2005).

If we had more professionals demonstrating true wisdom and acting as long-term stewards of our capital markets the magnitude of the business trust abuse would have been much smaller! Don't blame Jim Flaherty for this!

Principal protected notes

Let's take a few moments to talk about another investment that should never see the light of day and yet has become exceptionally popular, that is Principal Protected Notes. The existence of these products again highlight for us that the capital markets are not efficient at pricing assets and that the intellectual capital on Bay Street needs a good dose of wisdom as it uses its knowledge and marketing power to sell inefficient and overpriced securities.

A couple of quick points about Principal Protected Notes:

- $13.8 billion plus in this category as at June 30, 2006.
- New issues are being launched at a rapid rate. As at August 31, 2006, there were 657 notes outstanding, beating the 461 notes outstanding at the 2005 year-end

and 291 notes in 2004. For the eight months ended August 31, 2006, there were 210 new issues, with the pace continuing in the latter part of the year.

- These products are very expensive with Management Expense Ratios of between 2.5 percent and 3.0 percent, even though in many cases the vast majority of the investment is in a passive investment (example: a strip bond).
- Liquidity is compromised.
- Transparency is lower.
- Tax efficiency is often compromised.
- These investments in reality forgo substantial upside. A cursory look at the performance of these products shows how much they typically under perform the asset they are attempting to replicate.
- They violate rule number one in investing, buy low and sell high. They turn this on its head by having to sell down the active portion of the investment if the market weakens substantially.

Why are they sold? The answer is multifaceted. The commissions are generous, the story is easy to represent (people overpay for a linear world) and the professionals that structure the investments make a lot of money. For example, the banks who provide the guarantee could not ask for a better deal. The banks receive a deposit, they have to put no capital at risk and therefore, there is no call on their tier one capital and yet they can charge wonderful fees. Returns on capital are essentially infinite!

What's the problem? Is this long-term stewardship of our capital markets? Is this the most efficient use of capital or a mechanism to earn exceptional fees off market participants while truncating their returns? Where's the moral compass? Where's the moral benchmark? Where's the strategic valuation of these investments? De-bundling, transparency and getting the fees down is better for everyone over time as more capital would then be committed to higher return opportunities and provide better economic returns to the owners of the capital.

Closing remarks

I have just touched the surface when it comes to several very large topics. My objective is to challenge each of you to ask the very simple question, how am I approaching the capital markets? Am I approaching the capital markets as a trust to be handed down to the next generation or as a short-term vehicle to redistribute as much money into my hands, or the hands of my firm, with little concern over market pricing and capital market efficiency? Is it long-term stewardship or short-termism? We all need to be part of the solution in helping people see themselves as long-term investors and not as consumers of financial products.

Solutions: the way forward

- We need principled long-term oriented corporate governance that focuses on the interests of the long-term investor and capital market efficiency.
- We need to think about how our intellectual capital is translated into a moral and ethical framework which is better described as the pursuit of wisdom. This

wisdom should be used to create high quality products that add true value for all investors.

- We must strive to value all assets based on their long-term fundamentals and minimize manias and marketing hype that can lead to misallocations/redistributions of capital.
- We must strive to increase the financial literacy of investors. To this end, I was pleased to see that Dean Paul Bates of the DeGroote School of Business has endowed a chair in this vital area.

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