

True shareholder democracy is the 'holy grail'

BY WILLIAM H. MILLER III

Ed. Note: There is probably no one wise to the ways of investing who does not know of Bill Miller's phenomenal record. The Legg Mason Value Trust mutual fund that he manages is the only mutual fund that has beaten the S&P 500 in each of the past 15 calendar years. His reputation as a savvy money manager was already well established when we approached him in 1991 (purely coincidentally at the start of his record run) for his views on shareholder-oriented management. The result, "What I Look For in Corporate Performance," became one of our enduring classics. We included it in *The Art of Corporate Governance*, a "best of D&B" compendium published in book form in 2004. Today Miller is chairman and chief investment officer of Legg Mason Capital Management Inc., leading a team that manages (as of earlier this year) \$64 billion of assets.

for management and concomitant dilution for shareholders.

Many companies have replaced options with restricted stock, which we believe to be a superior vehicle for alignment of shareholders and management. Most option schemes were not incentive plans in any meaningful sense, but rather accounting- and tax-favored compensation mechanisms. As compensation, restricted stock is superior because its accounting is honest, the value of what is being delivered is known, the dilution is much less for owners given equivalent value delivered, and there is no incentive to eschew dividends and to hoard capital as there is with stock options.

I think the most sensible way to compensate people is 100 percent cash. If the board or management believes equity ownership is desirable in order to properly align incentives, then they can require that a portion of the cash be used to buy shares in the open market and for those shares to be held long-term. This eliminates all, or almost all, of the opacity and the disincentives and misalignment of the current system. It is clear, fair, and understandable, and would be a big improvement on current practice.

At the conclusion of the 1991 article, I predicted that managements that did not allocate capital rationally or treat their owners fairly "will face increasingly difficult relations with their owners." Since



A LOT HAS CHANGED in the past 15 years, including my hairline, but in my judgment, the principles laid out in that article remain sound, and as appropriate today as they were then. Sound principles, after all, should not be subject to the vagaries of fashion that afflict both managements and investors far too often.

A couple of points made back then deserve some added amplification now. One relates to management compensation and especially to stock options; the other to the proper role of shareholders in the area of governance generally.

Stock options were singled

out for particular scrutiny, even though their use in the early 1990s was insignificant compared to what we were to experience by the end of that decade. The pernicious practice of repricing has mostly disappeared owing to shareholder pressure and, more important, changes in accounting conventions, which is all to the good. The deleterious effect of options, however, continues today, with the latest scandal involving backdating of option grants or especially favorable timing of grants, so as to ensure (or nearly so) substantial gains



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That was then...
...Managements seem to assume that if they sincerely serve the corporation's best interests, they are also serving shareholders well. For this to be so, owners and management would have to have identical interests. They do not.
Management's principal interest is in the health, continuity, and growth of the enterprise. The shareholder's main concern

is an adequate return on his or her investment relative to risk assumed and to their investment alternatives. Management's future is much more closely tied to a single enterprise than that of

stockholders. The shareholder's capital is mobile, and the rational shareholder will not invest or keep capital invested suboptimally. This is the source of the frequently heard, though often misplaced, complaint about the short-term orientation of institutional investors. They are free to pursue investment alternatives in ways that the typical management is not.

Companies that invest capi-

tal in projects that do not earn the cost of capital breed inefficiency, waste resources, destroy value for their owners, and depress their stock prices. Managements should not be surprised when shareholders rush to sell the stocks of companies that invest below cost; it would be irrational not to, and such sales would occur irrespective of whether one had a long- or short-term horizon....

then, shareholders have become much more active in voicing their concerns and protecting their interests.

Corporate governance in general is a far more visible topic and area of interest than it was 15 years ago, and rightly so. The shareholders own the company and should determine its fate. The pendulum has begun to swing away from imperial managements or boards who take a paternalistic attitude toward their owners, and that is a trend that should continue and be encouraged.

The holy grail of good governance would be true shareholder democracy. If more than 50 percent of the voting shares are cast for abolishing a poison pill, or de-staggering a board, or having shareholders approve executive compensation plans, then those proposals should be implemented by the board or management. Why should a single owner of 51 percent of the shares of a business be able to effect any change desired, while multiple owners aggregating to 51 percent can have their desires ig-

nored by the board?

The argument that allowing true shareholder democracy could be disruptive or could allow special interests undue influence is as specious when applied to companies as it is when applied to our country. If 50 percent (or even fewer) of our citizens want a change, we transfer the nuclear codes and totally change the government, despite the disruptions. It has worked well for us, and would work just as well in Corporate America. ■