

## WHAT'S THE NEXT BIG THING ON THE CORPORATE GOVERNANCE FRONT?

### HOLDING DIRECTORS' FEET TO THE FIRE OVER THE COST OF CAPITAL – AND ESPECIALLY OVER THEIR STEWARDSHIP OF THE COMPANY'S STASH OF SHAREHOLDERS' CASH: FINALLY...A GOVERNANCE REFORM WORTH MAKING WE SAY

*Get ready: The OPTIMIZER has been pretty good at looking ahead, and around the corner, to scope out the big new trends in corporate governance...and do remember you saw it here first:*

*Smart investors will begin to use the shareholder proposal process, we predict, to hold Directors feet to the fire on the way shareowners' money is doled out... Here's why we say so...and also say that such actions are way overdue:*

**U.S. public companies are currently sitting on \$1.24 trillion in cash as we write this...a record-breaking and truly staggering amount of cash... that legally belongs to shareholders...So what have companies been doing with it?**

Over the past decade – and now, once again, as the economy slowly recovers – many of our biggest and best-known companies have been earmarking the lion's share of free cash to stock buyback programs. And these programs, please note, have had *historically horrible results*: A recent **Morgan Stanley** study of buybacks at 26 industrial companies since 2007 found that more than half had zero or negative return on stock repurchases.

Turn for a second of the tens of billions U.S. *banks* spent to buy back shares between 2000 and 2007: All of this cash could, in theory at least, have gone directly to shareowners – but all of it went up in smoke instead – never to be seen again – in the financial crash. And now, big banks are once again allocating the lion's share of their free cash to buybacks rather than to dividends: **JP Morgan Chase**, for example, recently announced it would increase the annual dividend by \$3.1 billion - and buyback \$8 billion in stock. At **Wells Fargo**, the company authorized a \$1.5 billion dividend increase...and a buyback program that could go as

high as \$6.4 billion. How did they come up with these ratios? And what is the expected return to shareowners on these “investments” of *their cash*? If one is a long-term investor, one oughta' be asking questions like this...and demanding answers we say.

Other serial buyback practitioners – who hoped that buybacks would prop up the stock price – or at the very least, increase earnings per share - like **Cisco** and **Home Depot** - haven't done any better than financial or industrial companies...and have had the same knack for buying big at the highs and waiting on the sidelines during stock price lows: In the last quarter of 2007, Home Depot spent more than \$10 billion buying stock at an average price of \$37 a share. Early this year, they sat the bench while the stock was at \$18...and now, with the stock at \$34.93 as we write, they're set to plunge in again. **Microsoft**, another big buyer-back of its own stock – which currently has \$41 billion of cash on hand - generated total returns to shareholders of *negative 0.2%* over the past decade.

***We have two other major problems with stock buyback programs – both in need of serious fixing:*** The biggest issue, we say, is the common corporate-speak that describes buyback programs as “returning money to investors.” This is a perversion of the English language – and of the facts – that comes mighty close to being fraudulent language in our book. Yes, one might argue that buy-back programs tend to hype the stock price when first announced, allowing short-term oriented shareholders to maybe make a few bucks by selling quickly...But look at the long-term results cited above...where the true effect was to fritter the cash that really belongs to long-term investors completely away! And hello...we stockholders can get our investment “returned” any day we want by simply calling our broker, or going on E-Trade. Our second big gripe is the fact that many of the biggest

buyers-back use the shares to “offset” the issuance of *new shares* to employees...and frankly, it appears to us, to hide the dilution from investors. In any event, “returning cash to investors” *may* arise from buybacks - IF they increase earnings per share and the long-term ROI going forward - but NOT if new shares totally cancel-out the effect...or worse, end in *negative returns to investors*.

***Bad as all this seems, there’s worse news yet when it comes to corporate use of their free cash: When companies have used free cash to make acquisitions, roughly 70% of them failed to meet owners’ and shareholders’ expectations for return on investment*** - as an article from **McKinsey & Company** - “Perspectives on Merger Integration” - pointed out in June.

***In fact, when one drills down deeper, the numbers are even worse: Somewhere between 53% and 61% of mergers actually destroy shareholder value...and all but 17% of the remainder are basically costly distractions that end as an economic “wash” for shareholders in terms of stock price appreciation...but with the shareowners’ cash - which they could have invested safely in T-bills, for example - gone, irretrievably, down the drain.***

How’s this for a recent horror story to emphasize the point in spades: **Bank of America** spent \$4.5 billion to acquire **Countrywide Financial** in 2008...and by mid-year 2011 it has racked up losses on the purchase of \$30 billion...from write-offs, penalties and legal fees.

***At the other end of the spectrum, even a conservative company like Apple – which has generated mega-returns to investors – but which is sitting on \$70 billion or so in cash as we write – does not seem to be doing what a fiduciary is supposed to be doing – to manage shareholders’ cash as a “prudent person” would:*** The current rate of return on their huge cash-stash and other investments fell to 0.79% in 2010, a May 23 WSJ article noted...with total return, after unrealized gains, estimated as a mere 1%: Far less than the rate of inflation...and less than even a novice investor could safely make elsewhere! Hey Apple...this is supposed to be the *stockholders’ money*...not yours!

***Here are three “straws in the wind” that add to our belief that corporate use of cash – and the company’s overall cost of capital too – will draw increasing attention from activist investors going forward:***

***Let’s start with Ralph Nader...who’s currently mounting a challenge to Cisco Systems and demanding a \$1 per share special dividend from their big stash of cash - \$43 billion, or nearly 50% of Cisco’s market cap (!!!) on the day he made the newspapers ...plus a raise in the recently instituted dividend to 50 cents annually from 24 cents. Where have directors been here? Since the start of 2001 Cisco has earned a negative return of 55% (!!!) while the NASDAQ composite gained 13%...and repurchased \$70 billion of its shares at \$20+... and sank another \$34 billion into acquisitions, a NY Times article reported on 4/16...while, as we write, the stock has fallen even further, to around \$15 per share. That’s \$104 billion of shareholder cash that totally vaporized over the past ten years...with not a single cent of the company’s free cash paid out to shareholders until October, 2010.***

***Next, let’s note that at a recent Wall Street Journal convocation of “a select group of the world’s leading chief financial officers” – four of their top five priorities called for more strategic use of cash, specifically, “Become a Strategic CFO... Drive Value Through Capital Appreciation...View Cash as a Strategic Tool...Provide Short-term and Long-term Balance and “ensure that the board of directors understands the sources of the company’s long-term value creation and how those sources are being nurtured.”***

***Last, let’s note that we in the U.S. are way behind the curve here: U.K. and European governance rules have called for shareholders to authorize the size of proposed share buybacks, and the basic terms, for as long as we can remember.***

How stupid it is, really, to brand things like ratifying the selection of auditors as a “good governance measure” – or those shareholder proposals to separate the Chairman & CEO roles... or all those calls for more reports to shareholders on various social and environmental issues for that matter – when the vast majority of companies are not doing an adequate job of explaining, and asking for ratification of their stewardship of our cash – something that goes straight to the heart of directors’ fiduciary duties! If we weren’t so busy doing what we do, we’d be filing shareholder proposals like crazy....