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The Dream of “Good Governance“

1. Water Levels and Bicycles

To the relief of market participants and not lastly their financial advisors, the conditions on the financial markets have improved since the beginning of the second quarter. Yet by no means does clarity exist or even agreement concerning the reasons for the weakening of the economy, which now is no longer only digging deep furrows in the USA but is also rapidly extending to Europe. The analysis of American growth figures show very atypical characteristics in comparison with “classic” recessions. Neither did a definite inflationary period precede the weak phase nor did consumption figures and the construction sector deteriorate in the downturn, which has typically occurred during the course of all earlier recessions. Rather investment spending activity – and in particular information technology spending! – has collapsed within the space of a very few months. In the meantime, building and consumption are continuing at a lively pace.

The European numbers are still too fresh to be able to carry out an analogous analysis. We suspect that more traditional cyclical powers are at work on the old continent. Therefore, the great structural differences between America and Europe should be taken into consideration when assessing the future prospects. The task of the forecaster is difficult since experience is missing with respect to the current weakening of the US economy – such an investment spending crash has never happened in recent economic history, and the analogy to the history of the railroad era is not appropriate because all the other economic conditions are completely different. It is equally difficult to forecast the economic prospects in Europe since it is unclear how the difficult-to-assess European System (i.e. the Minister Council, the EU Commission, the ECB and the individual governments) will deal with the diverging growth rates among the European economies.

Anyhow, the financial markets have obviously assessed the stock prices at the beginning of April as altogether too low and have presented us with a warm spring shower of price gains, which have calmed the soul and awakened within us the spring feeling. Whether what has been achieved will be lasting, will have to be the focus of intensified analyses in the coming weeks. Further data concerning the economic situation in the USA as well as data concerning the earnings of businesses in the shattered technology sector will hopefully bring more clarity to the picture.

In the meantime, we still have to deal with the remnants of the financial market contraction, whereby the term “remnant” may be somewhat too weak. At the level of the specific investment opportunities (in other words the individual companies and their stocks), developments, which can be classed as dramatic, have been in progress for quite a while. In the past few months, Swiss investors (but certainly not only the Swiss) have suffered a crisis of confidence in the highest levels of management of the largest companies. This justifies posing the question as to what extent an investor can or should be prepared to provide equity capital. We cannot easily forget the losses of SAirGroup or Zurich Financial Services.

In Dutch towns, the canals are periodically drained of their water, in order that they may be cleaned and structurally repaired. It is quite interesting to see what surfaces during such occasions, many rusty bicycles, sofas, while here and there photophobic canal rats escape the sudden transparency. Financial market contractions typically lead to a drastic shortage of liquidity. The entire private equity sector has been suffering from a complete dry-out for months, and even in traditional sectors of the economy, investors have started to ask more difficult questions. Low water levels increase the value of more accurate information; we can find navigable channels only with a depth sounder. The present Investment Commentary attempts to help cleaning up the canals and ditches of the financial markets before liquidity again clogs up the sewers and before all too merciful price developments permit an illusion to arise that there never were any rusty bikes and there can be no talk of the existence of canal rats at all.

2. Between Glory and Condemnation

The Swiss Commercial Registry Office has had its hands full for some time. At present, Boards of Directors are being replaced at an extraordinary rate, presidents are being removed, and complete management floors are being cleared out. In the case of Swissair, the Board of Directors so to speak pulled the carpet out from under its own feet– a rare event.

Unfortunately the discussion concerning the events at Kuoni will most likely not progress any further than listing the strengths and weaknesses of the people involved. Admittedly, it is naturally exciting for the media to report the attacks against an Eric Honegger or to publish the almost physical clash between a Kuoni President of the Board of Directors and his Vice President. Today’s world needs such stories, and at the moment there are plenty of them around.

Of course, in the end it is always individuals, with all their positive and less positive features, who make the decisions and who also have to accept responsibility. However, when too many blunders arise within a short time frame, then the analysis should not focus purely on people related questions. Rather an inquiry should be made whether a more general malaise exists within the system, whether there is a problem with the corporate governance of companies, or possibly even with the legal system.

Today, heaven and hell are not very far apart for business leaders. Mario Corti, a member of the above-mentioned, retreating Board of the SAir Group, is still around and we wish him well as he strives to rescue a Swiss flagship from bankruptcy. It is difficult not to underestimate the difficulty of turning around the airline of a small and powerless country, which is not integrated in the European Union, operating in an overcrowded industry glutted by manifold nationalistic sentiments. Yet perhaps, hopefully, the magnitude of this task will release extraordinary energies which will result in a corresponding success...

In the Investment Commentary we have on occasion pointed to the considerably greater variety of strategic possibilities which are now available to every kind company, whether “Old” or “New economy” (if this concept really exists at all), as a result of the technological development. Multi-optionality is the word. The corollary to this multitude of strategic alternatives is definitely the *heightened possibility* of making strategic mistakes. As a member of the Board of Directors, the probability of sliding from the gleam of glory down into the anathema of condemnation has certainly increased.

The personalization of the debate does not do justice to the problem in any way. Whoever assumes that there could be or must be people, (e.g. Boards of Directors), who do not make mistakes, is hanging on to an illusionary idea of an economic paradise on earth. Basically, our interest should not focus on the Cortis, Hüppis, Mühlemanns, Vasellas and whoever else may be involved. They all make mistakes just as we do. We should be much more interested in structures, or processes which

- help to keep the *error rate* in strategic decisions to a minimum,
- in this time of multi-optionality and high speed decision-making, ensure sufficient *flexibility*,
- avoid that a business and its shareholders will fall victim to *misuses of power*.

Let us examine these points more closely below. We are talking about the important question of “Corporate Governance“.

3. The Bad Shareholder Value

More or less all slip-ups that have surfaced recently in the financial markets as the water levels in the canals have lowered, in the form of rusty bicycles or surprisingly opulent (bonus) sofas or light-shy canal rats, have been quickly, and without further ado, blamed on excessive “shareholder value” thinking. There are hardly any statements from allegedly economy-friendly politicians without the politically correct bashing of “shareholder value” thinking. However, in almost all instances exactly the opposite is the case: When management acquires a helicopter in the Caribbean, such as in the Vontobel case, and lightheartedly sinks a few hundred million Swiss Francs into an Internet banking project, then there are certainly those who will profit from these decisions – although it is quite certain that the “shareholder” is not among them. If an airline becomes entangled in unmanageable and expensive subsidiaries and one of the pilots navigating at the time of the crash attempts to secure a golden parachute for himself, then this has nothing to do with “shareholder value” thinking. On the contrary. If, in the end, an insurance boss, who is overly sure of himself, and is so convinced of the chances of success of Internet based distribution that he accepts a halving of profits in order to make the required investments, then this has also not anything to do with “shareholder value” thinking. Internet could possibly only be a hobby of stakeholder Hüppi...

To follow up on the question of an optimal model or the optimal models of corporate governance, it is necessary to start with a well thought through statement of the corporate mission and objectives. Who are the shareholders, who are the stakeholders, and what are their respective interests? Where do they possibly coincide?

The current opinion distinguishes between the shareholders on the one hand, those who own the equity capital of a company, and the stakeholders on the other hand, those individuals or groups who stand in a more or less close relationship to the company, but have no direct but rather implicit claims on the equity of the company and its profits.

We can subdivide the group of shareholders into majority and minority shareholders, whose interests are not necessarily the same. In many cases these interests may even collide. Already in the frequent omission of this – important – subdivision of the “shareholder”, the discussion of shareholder value has often proved imprecise and misleading. If the talk is of shareholder value, then which interests of what shareholder do we mean? For example does a majority shareholder always have an interest in high dividends and high share prices, or does he not rather have an incentive to hide away “value“ from the minority shareholders?

Even more complex and conflicting objectives exist in the group defined, in this discussion, as the stakeholders; this term includes all possible groupings, beginning with those who have wide ranging interests in general society, whose interests are difficult to understand (for example unemployment insurance or environmental protection agencies) up to management and employees. In the literature, the conflict of interest between the company and its owners on the one hand and the management on the other hand is dealt with at length. An entire branch of economics deals with the “Principal Agent” problem. Nevertheless, this is simply a subset of the general conflict of interest between shareholders and stakeholders. Management is only one of the possible stakeholders, not more and not less.

Now the question arises whether this commonly used, but no longer completely up to date model of shareholders and stakeholders is in fact accurate and whether it has explanatory power. At first glance this seems to be the case. It is obvious that the interests of the shareholders and stakeholders are contrasting in nature. High wages for instance lead to high personnel expenditures and therefore reduce the profit margin of a company. Consequently the stakeholders’ interest in higher wages conflicts with that of “shareholder value” thinking. Also, the costs for social or cultural activities fall under “expenses” and contribute to the lowering of corporate profits – in this simple model – of shareholder value.

4. The Time Horizon Changes Everything

This model is simple, too simple because it is static; however this does not mean that it has not found broad application. It not only influences political discussion, but is also the basis of simplified financial analysis. Numerous reference numbers, “ratios”, *taken alone* are based on such statistical and past-related data, above all the famous “return on equity” (ROE). But also a great number of profit-centre related financial ratios are based on this overly simple corporate model of mutually exclusive interests of stakeholders and shareholders. Because many bonus systems are either quite simply based on the ROE or tied to some intransparent profit centre ratios, this is a matter of high practical importance.

The described model is too simplistic because it focuses entirely on a momentary snapshot described by the company's profit and loss statement. The future does not count in any way and this is obviously wrong. High wages should certainly be charged to the expense account, but they could also mean better work performance, strengthened employee relations and higher returns to shareholders in the future. Marketing expenses viewed from a static and past-oriented standpoint would be pure loss positions, as would be the social or cultural activities of a company. On the other hand, if we consider wages, marketing and cultural activities as investments in the future of a company, then we would have to book the value of these investments on the asset side of the balance sheet. The simplified division of the accounting into two worlds has proven to be extremely problematic, here the direct expenditures and investments that have an impact on earnings, there due to their largely indefinable effect, the "soft" cost factors,. Definitely closer to the truth is the understanding that any expenditure and investment is subject to *uncertainty* with regard to its future effects. It would probably be more useful to view the degree of effectiveness of expenditures in relationship to the time of their (likely) effect.

With the introduction of such a dynamic component into the shareholder/stakeholder model, the differences between the individual interests of the shareholder and the stakeholder are partially resolved. No business can expect a promising future if it does not make the required investments to secure its long-term competitive position, to maintain its attractiveness internally as well as externally, as well as influence the relevant external conditions of the company. "Investments in the future", or in other words expenditures in "soft" factors, are necessary for survival. But whom do they affect in the first place? Exactly those who have been described as the stakeholders!

In other words, the better the shareholder is doing in the long run, the more likely it is that the stakeholders will also profit. In one respect the discussion is now simpler. Through the (at least partial) overlap in the interests of both parties, the problems involving the so-called "shareholder value" thinking prove to be quite irrelevant and not worthy of any further discussion. However, it is clear that management - Corporate Governance – is a difficult balancing act between actions with a direct effect and investments whose effect is only measurable in the long-term. We are talking about resource allocation between the (immediate profit-oriented) present and the (largely uncertain) future. This *is* difficult. In addition, indirect measures that only have an effect in the long term have been shown in various respects to be completely "soft". Their relationship with the later success of the company is everything but directly causal. Due to the time factor, these measures are also much more exposed to risks and unforeseen developments.

This may sound somewhat theoretical. Let's therefore consider a concrete example: The training of personnel (which, as everybody knows, is *the* most important stakeholder of a company) often bears fruits only years later. A direct connection between a specific training event and the later success at the customer level is often very difficult to measure. The danger that the trained personnel are enticed away long before the results of their training are visible, make the measure even more "soft". And yet it could be that this high degree of employee training was or is or will be *the* strategic platform of success for the company. Where is the degree of training traditionally booked? In the balance sheet? Probably not at all. Most likely in the profit and loss statement under personnel expenditures. How will the training activities be reported? In the usually long-winded prose of the annual report? Will the degree of training be recognized by financial analysts? Maybe. But the earnings per share are still more important. Strange world!

5. Justifiable Mistrust

There are, of course, good reasons mistrust exist with respect to the more long-term effective "soft" factors – the "goodwill". There is the danger of misuse. Moreover we need to take into account where our bookkeeper mentality originated: out of pure industrial production where a furnace was a furnace and a product sold was a product sold. In that world there was no need to ponder over the potential value of any future training. In today's service-oriented era however, this trivial accounting approach is no longer adequate. Even though it is simplistic, it does not prevent misuse. Unfortunately, these limitations also apply to the latest attempts to extend accounting to include "soft" factors (IAS-Standards). Why?

Maybe a bit brutally expressed, we are talking about the question of *theft* and *fraud*. The corporate interests (including those of the shareholder, and ultimately also those of the legitimate stakeholder such as employees, suppliers, etc.), can suffer damage from theft and fraud in two different ways. In the short-term by employing all possible and impossible tricks to deliver nice "reported" earnings - in other words tomorrow's sales are booked today, expenditures in "soft" future factors are cut, a completely absurd exponential path of future earnings growth is stipulated, and on top of it all, unsound investments are made to reach the unrealistic objectives, etc., etc. This is theft and fraud by management. The instruments for this are called *bonus systems*, which are based on too narrowly-defined measures of corporate success, and stock option plans, in which the salary compensation is not booked as an expenditure (which it truly is), but instead hidden as a negative position in the equity capital of shareholders (i.e. dilution of shares). Particularly controversial is the recent practice in bad times of pushing the exercise price of stock options downwards without any hesitation! Theft and fraud by management is typically calculated on a short-term basis, and is equivalent to dipping directly into the till. Traditional accounting practice and an all too simplified financial analysis meet the management half way in that the loss of the "soft" corporate goodwill will not be reported – because it has not been booked!

This is the one side. On the other side – long-term planned theft and fraud by other stakeholders – whether it be an influential shareholder group with voting majority due to a special class of shares, whether it be a tycoon behaving as a principal, whether it be a status quo oriented Board member – are of a more subtle nature. No clear dividing line exists between an appropriate cultural sponsoring program and an absurdly excessive art collection compiled by an insurance company. Where does the legitimate cultivation of the corporate environment stop and the excessive pursuit of one or more expensive hobbies of top managers begin, who, often pursue these hobbies because they do not have to pay for them themselves? The question of appropriate checks and controls is found especially in the area of the "soft" factors.

6. The Theft of Opportunity

Although art collections are visible examples of the exaggerated cultivation of specific stakeholder interests, they do not represent a problem which is of real economic relevance. Much more delicate and of more economic significance is, especially in Switzerland, the maintained culture of continual wall building around the company. What do we mean by this?

Every Board member justifiably sees his main task as securing the long-term survival of the company. There is no model which would not stipulate this. The question is only which method is applied. Seen economically there is only one possibility - the uncompromising and continual strive towards higher *productivity* and *profitability*. Should the company succeed with enough savvy to communicate this to the outside world, then the markets correspondingly recognize the value of the company. The share price will be high and the company will therefore be "expensive"; it is not likely to be the target of a takeover.

Law provides the company with alternative methods; voting shares, transfer restrictions and shareholder agreements are legal ways of forming powerful cartels. The objective of securing independence is mistakenly assumed to be consistent with the goal of preserving the company in an economic sense. "Independence" may have its worth, above all for those who are able to enjoy this freedom; however, it will seldom be translated into value by the capital markets.

We are aware that this argument will be accepted only with difficulty, especially coming from a small bank which has also vehemently hung on to its own independence. Relevant questions concern the nature of public fund raising and the distribution of ownership in the form of shares on the capital market (what the mentioned bank as a limited partnership normally does not do). An Initial Public Offering (IPO) implies increased *responsibility*. We are of the opinion that the issuance of stock to the public betrays its purpose if the ultimate conversion to money is not possible due to legal barriers or other factors. Ultimate conversion into money: This means nothing else than the possibility that the company could sometime in the future be taken over or sold.

Allowing for potential takeovers is not popular, because takeovers are almost always painful in the short-term. Nevertheless, if we eliminate the possibility for takeovers, then the company loses one of its most important strategic options. The alternative to a takeover is namely the perpetual continuation (in the sense of eternal independence, Amen) or liquidation.

Once upon a time there was a nomadic tribe, which, one day, came upon a most beautiful oasis in the middle of the desert. The tribe settled down at this watering hole and made it their home. In order to defend it from other thirsty souls roaming the same desert, they built higher and higher walls around it, which served the purpose of keeping strangers out, but also blocked the view of the outside. After a while, the well delivered less and less water. Only when the well had completely dried up did the former nomads notice that there were no more people outside the wall who desired the oasis. So the dried up oasis was liquidated, if we may use this economic term.

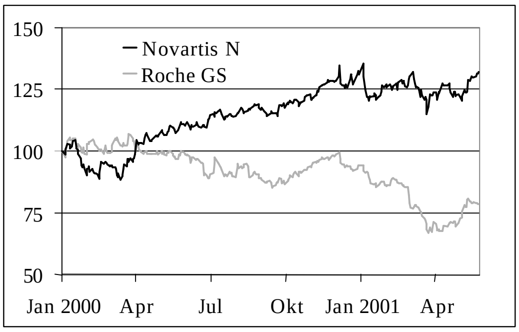
Walls block the view and the path for strategic alternatives. This can be a dangerous state of affairs in a time when flexibility in strategic matters is crucial. The sad fate of our dear national airline Swissair definitely shows how problematic a strategic goal of "independence" can be. In 1993 an opportunity existed to form a European airline together with Dutch KLM, Scandinavian SAS and Austrian AUA. However, most likely there were other factors besides "independence" and national pride which contributed to the failure of the so-called "Alcazar" project.

The "theft of opportunity" is practiced by change resistant Boards of Directors, as well as by many family-owned businesses or corporations in which the state owns a substantial stake. The key issue lies in the never ending communication that independence is a worthwhile goal. In the end the opposite is true.

7. The Independence Paradox

In the process of cleaning up the canals and ditches, we urgently advise that the legal and governance structures of various companies in Switzerland are examined. This should even be in the interest of the stakeholders concerned. We believe, for example, that the Oeri-Hoffmann family, which holds, capital-wise, a 10% minority shareholding in the Pharma group Roche, but holds the majority of voting rights (50.1%), has become its own worst enemy in the past few months. Clinging on to the mentioned capital structure was, among others, a reason for the poor performance of the Roche shares over the past few months.

Source: Bloomberg;



Roche became visibly cheap, so cheap that it was worthwhile for a competitor to take over 20% of the voting shares *despite* knowing the full facts surrounding the voting situation. This investment only makes sense when it can be resold some day at a much higher price, or when its owner, the competitor Novartis, can take over the whole firm. In either case, the capital structure of Roche will have to be changed.

By holding on to a capital structure which guarantees independence at any cost, family Oeri-Hoffmann has deprived itself of future strategic options. Their equity holding resembles a piece of property where their mother-in-law holds the right of residence. It has drastically lost value. The family must also ask the question what sense such an investment makes when the members of the family are not prepared or not in the position to bring in adequate executive leadership with its voting rights.

Is a bulk risk in the form of holding a single pharma company an investment strategy which actually withstands the test of portfolio theory regarding diversification? Or is the family so wealthy that such considerations are unnecessary?

Roche and Oeri-Hoffmann do not stand alone in the Swiss corporate landscape. For example, the fact that Zellweger-Luwa shares trade about 20% *below* their book value (www.zeluwa.com), shows what the market thinks of the desired independence of Family Bechtler. The Kuoni case has clearly showed the drawbacks of trusts. But we must not only examine critically families and their desire to freeze inherited wealth, but also other, similar structures. For example, it will take much persuasion to convince us that the rigid structures of Helvetia-Patria or Waadt are commensurate to the future changes in the international insurance market.

As paradoxical as it sounds; the elevation of independence as the only viable strategic objective *endangers* exactly that praised independence more than a strategy of openness, which is constantly confronted with the danger of being taken over. If we want to reduce the conspiscuously high number of “rusty bicycles” which have been revealed due to the water drainage of the past months on the Swiss financial markets, then the investment banks, the consultants, and above all, the Boards of Directors of the concerned firms need to act. In too many of these boards the lawyers - those undisputed world champions in wall and fence building - have the final say. We should replace them with business-oriented personalities who are not so tempted by the theft of opportunity.

8. Once Again: Incentives Matter!

It is a naïve person who does not believe that those who are entrusted with the executive duties in a company, will again and again attempt to pursue their own individual interests. He or she will react with shock and disappointment whenever such misuse comes to light. But watch out! Such a time full of opportunities, as the canal draining of the past few months will not occur again quite so quickly, and the theft of opportunity will be carried out on tiptoe.

Rather being sceptical than naïve, we should equip ourselves with a toolbox of Corporate Governance. At the beginning we have called for structures which guarantee a high measure of strategic competence, sufficient flexibility and low risk of misuse. Our Bank has built up over the past few months a corresponding scorecard – partly due to witnessing and experiencing Corporate Governance problems in Swiss companies in which we have traditionally invested.

For example, in the area of *strategic competence* the following questions should be posed. What is the accumulated experience of senior management? Is the Board of Directors an exotic collection of individuals or a committee with relevant management and industry skills? How much time do they dedicate to their Board membership? Are the incentives of top management and the Board actually geared to the long-term?

In dealing with the question concerning *strategic flexibility*, conflicts of interest of managers or Board members with regard to shareholder cartels is of prime importance.

The last crucial question regards the *fairness* of the treatment of shareholders. What are the rights of the shareholders? Are there voting limitations? Will the shareholders be equally treated during share buybacks? Are there (possibly hidden) shareholder cartels? Are there sufficient checks and balances at the highest levels? Are the distinct roles of the chairman and CEO also personally separated? How transparent is the communication of “soft” factors (these “soft” factors should be of high interest for the investor since they are often the source of sustainable competitive advantage)? Ultimately, do the top managers and the Board of Directors also hold a considerable part of their private assets in “their” company? Is the sale of these securities restricted in any way so that the interests of management and shareholders are congruent?

The showdown of the Swiss Board of Director culture is painful. As investors and also as advisors, we will need to continue stubbornly asking delicate questions in the future. “Shareholder value” thinking or not, we are talking about the money of investors which the company is using to finance its operations. Surely as investors, we have the right to ask a few questions, and next time rather a little sooner than later! Rules for Corporate Governance could give us some help.

KH, June 21th,2001