What corporate executives can learn from leading value investors

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Abstract

Despite differences of opinion regarding what to include as a "top risk" today, many executives agree that 2021 and beyond will likely be a period of uncommonly broad-based risks. Given the breadth of potential exposures, an alternative way to strategically approach both the challenges and opportunities generated from the global risk landscape is in order. The principles of value investing—based on the lessons learned from prominent practitioners—present just such an approach to corporate strategy and management. Our strategic research into these principles have been distilled into six core managerial considerations. In theory, the prescriptions of successful value investing appear straightforward, but in practice it takes an active shift in mindset to consistently and effectively apply them over time, especially in a corporate context. To do so requires that operational skillsets are augmented with those of both an astute investor and a discerning banker while balancing one's attention between conventional and unconventional sources of information. This will enable the required patience and grit to "go against the herd" when it is appropriate, but likely very unpopular, to so do, and to focus firmly on longer-term compounded returns instead of quarterly, or even annual, earnings.

Key Words: Corporate Management, Corporate Strategy, Information Advantage, Value Investing, Value Realization

JEL Codes: G30, L10, L20, M10, M21

Despite differences of opinion regarding what to include as a "top risk" today, many executives agree that 2021 and beyond will likely be a period of uncommonly broad-based risks. Given the breadth of potential exposures, an alternative way to strategically approach the challenges and opportunities generated from the global risk landscape is in order.

The principles of value investing—based on the lessons learned from prominent practitioners—present just such an approach to corporate strategy and management. Our research into their successful practices and behaviors can be distilled into six core

managerial considerations. These six considerations, and the practices to adapt to them, have been used by both successful investors and effective executives, and will likely be increasingly valuable during the challenging times ahead:

- Adding cost-effective resource allocation to the strategy tool kit
- Conservative financing
- Balancing managerial time and attention
- Clarity about the complexity of risk
- Humility in times of uncertainty
- Focusing on compounded returns

Adding cost-effective resource allocation to the strategy tool kit

The first consideration is one that is generally absent from many definitions of corporate strategy: cost-effective resource allocation. One vivid exception is Warren Buffett, who continuously has executives lining up to sell him their corporate assets for pennies on the dollar. As a value investor, Buffett invests at a discount to conservatively estimated value, or at a "margin of safety." While this concept is easy to understand, it is incredibly difficult to apply in real time, especially in a corporate environment. Consider, for example, the following: Why would someone trade with you at a discount? Do they know something you do not? Are there hidden risks or legal ramifications with the deal? Answers to questions like these must be addressed before a strategic move is initiated. Buffett has clearly done this at Berkshire Hathaway, as have other successful executives who operate in a similar manner including the late Henry Singleton of Teledyne, Carl Lindner of American Financial, John Malone of Liberty Media, and Prem Watsa of Fairfax Financial.

There are three general ways to incorporate the margin of safety into corporate strategy (more advanced approaches are beyond the scope of this paper): First, is to actively search out cost saving opportunities such as wholesale buying opportunities via long-term discount purchases, trade credits (i.e., early invoice payment savings) and volume discounts. As common as options like this may seem, they are frequently overlooked by many executives. Next is an extension of the preceding approach via the purchase of favorably priced assets from competitors, suppliers, etc., that are experiencing operational and/or financial difficulties. Lastly, cost-effective purchases can often be made during volatile periods such as financial crises, natural catastrophes (including a pandemic), etc.

Conservative financing

A strong balance sheet, defined by little-to-no debt, is a critical enabler of cost-effective resource allocation over time.[1] If a corporate balance sheet is not strong, an executive's strategic alternatives will become constrained during periods of distress, which could cause a business to become a "forced seller" to cost-effective/strategic buyers.[2] To prevent this from occurring, capital structure should be approached conservatively.[3] This statement may strike some as odd given -- as of early-2021 the many firms that are aggressively leveraging their balance sheets due to very low interest rates and "soft" credit underwriting (e.g., few if any covenants).

One key lesson of financial history is that successful long-term executives and investors have not excessively leveraged their balance sheets during "boom" times, and as a result their balance sheets were not distressed during periods of extreme volatility.[4] High levels of debt (leverage) is risky,[5] but it is a special kind of risk in that it can magnify the impact of other risks.

Having ample cash holdings, along with little-to-no debt, enables cost-effective resource allocation over time. Executives should take note, especially today when corporate cash holdings have grown to historic levels due to the Covid-19 pandemic,[6] that there is a difference between holding large amounts of cash to enable a long-term cost-effective resource allocation strategy, and holding large amounts of cash to ride out a natural catastrophe/pandemic before proceeding with business-as-usual. The former is an effective long-term strategy, which executives should consider emulating, while the latter is a purely defensive tactic that could backfire by inspiring a hostile takeover offer or by attracting the attention of shareholder activists.

Balancing managerial time and attention

Strategically approaching global risk often requires investors and executives to act against conventional wisdom and take pains to avoid confirmation bias. The term "confirmation bias" comes from the field of behavioral economics. It holds that, "people … seek data that are likely to be compatible with the beliefs they currently hold."[7] Corporate advisors and researchers who have observed this bias firsthand hypothesize it is driven by factors such as:

- Many executives start their careers by training within specific fields or industries, which results in their development of highly specialized operational skill-sets.
- Skills that fall outside of the core, such as deep investment and financial skills, tend to be assigned to experts--those who have been formally trained in the discipline and operate according to well-established theories, processes and procedures.
- Many executives read and listen to the same basic information, which leads to a herd consensus. Few people seriously pay attention to information that is contrary to the consensus.

In contrast to the conventional approach, some leading value investors are beginning to take a more balanced view by appraising "managements in their competencies as operators, investors, and financiers."[8] An assessment of cross-discipline competencies benefits from an appreciation of alternative information sources and methods of analyses. The history of the Oakland A's use of sabermetrics to gain competitive advantage in the game of professional baseball is a seminal and popular example.[9] Another example is the experience of the investors who profited from "the big short" in 2007-2008.[10] Note that this does not mean conventional information and methods of analyses should, or even can, be ignored. It does, however, mean that such analyses/information should be continually balanced with insights from non-traditional sources of information.[11]

Clarity about the complexity of risk
Corporate executives are facing an ever broader and increasingly complex array of risks. Consider the risks facing executives in 2021 as cataloged in a recent *Forbes* article:

- The virus causing COVID-19 mutates (external risk);
- Business suffers in the fallout from a government action (political risk);
- Diversity programs fail (reputation risk);
- Startups disrupt markets (competitive risk);
- Grow is stymied (business risk);
- Key talent leaves (operating risk);
- Plain vanilla competition wins market share (competitive risk);
- A sudden market pivot trips planning (strategic risk);
- IT security is threatened (IT risk);
- The business needs to pivot again—HARD (pivot risk).[12]

Adding to these risks, executives must take into account other risk sources such as the growth and complexity of financial products and governmental regulations, the volatility stemming from the millennial demographic shift, etc. For many executives, running a successful business in such an environment can seem Herculean. They can benefit from studying helpful lessons garnered from observing how successful value investors determine which companies to allocate capital to, and which companies to stay away from.

As a guide to this ongoing struggle, some professional value investors augment formal valuation analyses with behavioral-based insights. An example is the concept of "rationality," which is a way of monitoring executive behavior to ensure that stated goals, objectives and strategies reconcile to business actions over time.[13] Despite the seeming simplicity of this concept, rationality-based analysis has proven to be useful in both investment and corporate M&A analyses.

A rationality case. During one firm's M&A deliberations intense focus was directed towards evaluating a target's asking price, which was high but nevertheless consistent with private market valuations at the time. To enhance the firm's analysis, the target was compared to its peer group in terms of the consistency with which the performance of each firm conformed to the public statements of its corporate managers over time. The data from this analysis are proprietary, but the target in this case scored lower than its peers, thereby suggesting potential value realization issues that warranted a lower valuation. Issues like this may have been eventually discovered during due diligence. But by actively looking for them, guided by the rationality concept analysis, enabled a much more insightful result, which ultimately resulted in the firm making a lower bid than a traditional private market valuation had suggested.[14]

A key enabler of rational management is clear and transparent communication, which has been an issue for some executives. One way to avoid issues is to communicate simply and clearly, and to ensure consistency across communications, including financial statements. Mismatches in financial reporting (e.g., performance results that are profiled

in a shareholder letter not reconciling to the financial statements) is a key "red flag" that professional investors actively search for.[15]

Humility in times of uncertainty

Humility is rarely stated as one of the preferred or most valuable attributes to look for in a CEO,[16] yet the opposite has been identified as an impediment to an executive's effectiveness and success, especially in times of high risk. In Robert Sutton's, *The No Asshole Rule: Building a Civilized Workplace and Surviving One That Isn't,* he highlights an issue that continues to plague some firms: an "imperial CEO" who thinks he or she is the proverbial "smartest person in the room," and demands that everyone act accordingly. This effectively closes the leader off from alternative sources of information and advice, which can be counter-productive,[17] dangerously so when risk and uncertainty are on the rise.

As an alternative, humble management helps to produce a positive work environment, which helps to attract and retain highly talented employees, which in turn helps to increase firm productivity and profitability. The late Henry Singleton, a CEO who personified this approach at Teledyne, achieved relative outperformance during his tenure (see Exhibit 1, "Teledyne Relative Performance Profile"). Subsequent to the publication of an article in this journal on Teledyne's success,[18] we had the opportunity to speak with several people who had worked for him. To a person, their eyes lit up when they spoke of Singleton, and they all pretty much agreed: "He was absolutely brilliant. And he was tough; a real taskmaster, but he was always fair. Most of all, though, he was just a good man."[19] Another example of this approach is evidenced by value investor Warren Buffett's legendary matter-of-fact demeanor, proving that someone can be both a successful long-term CEO, and a multi-billionaire, without being arrogant.

Exhibit 1: Teledyne Relative Performance Profile

	Earnings Per Share			*Net Asset Value Per Share*			
Issuer	1984	1975	change	1984		1975	change
GATX	$2.37	$3.47	-32%	$30.35	(A)	$32.22	-6%
Crown Cork & Seal	$4.98	$2.43	105%	$40.61	(B)	$14.32	184%
Tandy	$2.75	$0.25	1,000%	$10.64	(A)	$1.33	700%
Teledyne	**$20.61**	**$2.57**	**702%**	**$123.36**	**(B)**	**$9.57**	**1,189%**

Source: Martin J. Whitman, *Value Investing: A Balanced Approach* (NY: Wiley, 1999), p. 257. (A) Excludes the value of extraordinary distributions of the common stocks of subsidiaries. (B) Ten years to 12/31/83. Change percentages and boldface font were added by us.

Focusing on compounded returns

The "bottom line" of our managerial considerations is the "compounded return," which is a measure of the constant rate of return that is earned over a period of time, rather than a simple annual return measure or stock price. Focusing on compounded returns

mitigates the risk of short-termism, which is prevalent today. In many ways, we live in a "bullet point" society where the current stock price and social media profile are all that seem to matter. However, in the long-term, neither of those is very important. For example, market prices that appear low today based on conservative valuation can provide strategic opportunities that could translate into attractive compounded returns over time.

The focus on compounded, rather than short-term, returns is also something observed in successful investors and executives. The managerial tenures of Henry Singleton and Warren Buffett are examples of this. For another example, consider the work of value investor Marty Whitman.[20] In an interview, he indicated that the successful executives he knew considered market prices—including the price of a company's stock—as something to take advantage of when the time is right. Market prices certainly were (and are) not something to worry about or micro-manage in the short-term. Favorably priced assets, including securities, enable allocative efficiency, which is a compounding multiplier. Executives should embrace this concept in their strategizing, which has notably been adopted by successful CEOs such as Carl Lindner, John Malone and Prem Watsa.

The strategic advantage: Adopting the mindset and practices of a value investor

By extending the traditional definition of corporate strategy to include cost-effective resource allocation, and employing the principles and behaviors of leading value investors, corporate executives can be better prepared to meet the ever-expanding array of risks head on, and exploit the advantages that a strong balance sheet provides. To facilitate this, executives should address the following core questions:

- How can cost-effective resource allocation enable your differentiated value proposition?
- Can your balance sheet comfortably weather the next crisis? Are you positioned to buy when others are forced to sell?
- Do you evaluate, or discount, non-traditional sources of information and methods of analysis?
- Does your performance closely reconcile to your stated goals, objectives and strategies over time? If not, could you communicate more clearly and transparently?
- What is your management style, and how do you think your employees characterize it?
- What is the compounded return of your management tenure, and your plan for improving it?

In theory, the prescriptions of value investing appear straightforward, but in practice it takes an active shift in mindset to achieve over time. Executives need to augment their operational skillsets with those of both an astute investor and discerning banker, balance their attention between conventional and non-traditional sources of information, and exhibit the patience and grit to go against the herd and focus on longer-term compounded returns.

Notes

[1] As an example, see Clayton Rose and David Lane, "*Going to the Oracle: Goldman Sachs," September 2008*, Harvard Business School case services, 9-309-069, June 16 (2009).

[2] Howard Marks, *The Most Important Thing: Uncommon Sense for the Thoughtful Investor* (NY: Columbia, 2011), p. 26.

[3] There are exceptions to this rule such as utilities, but they are beyond the scope of this paper.

[4] Joseph Calandro, Jr., "Jay Gould and the Union Pacific from the Panic of 1873 to 1880," *Financial History,* Winter (2021), pp. 26-29.

[5] See, for example: Liz Capo McCormick, Craig Torres, Mathieu Benhamou and Demetrios Pogkas, "The Covid-19 Pandemic Has Added $19.5 Trillion to Global Debt:
Here Are Reasons to Be Grateful—and Worried," *Bloomberg*, January 27-28 (2021), https://www.bloomberg.com/graphics/2021-coronavirus-global-debt/, and Brendan Cole, "A $10 Trillion Corporate Debt Bomb Is Waiting to Explode the U.S. Economy," *Newsweek*, July 29 (2020), https://www.newsweek.com/coronavirus-corporate-debt-covid-19-bonds-federal-reserve-1521219#:~:text=U.S.%20companies%20owe%20more%20than,Times%20reported%20earlier%20this%20month.

[6] "U.S. companies' cash holdings hit record high amid pandemic," *Moody's*, November 23 (2020), https://www.moodys.com/research/Moodys-US-companies-cash-holdings-hit-record-high-amid-pandemic--PBC_1254533

[7] Daniel Kahneman, *Thinking Fast and Slow* (NY: Farrar, Straus and Giroux, 2011), pp. 80.

[8] Martin J. Whitman and Fernando Diz, *Modern Security Analysis* (Hoboken, NJ: Wiley, 2013), p. 2.

[9] Michael Lewis, *Moneyball: The Art of Winning an Unfair Game* (NY: Norton, 2003). This approach is now being applied to other professional sports.

[10] Michael Lewis, *The Big Short: Inside the Doomsday Machine* (NY: Norton, 2021).

[11] Joseph Calandro, Jr., *Creating Strategic Value: Applying Value Investing Principles to Corporate Management* (NY: Columbia Business School Publishing, 2020), pp. 157-166.

[12] Tony Ewing, "Top 10 Risks Of 2021 And How You Can Manage Them," *Forbes*, December 20 (2020), https://www.forbes.com/sites/tonyewing/2020/12/20/top-10-risks-of-2021-and-how-you-can-manage-them/?sh=61f057211452

[13] Based on Keith Stanovich, *What Intelligence Tests Miss: the psychology of rational thought* (New Haven, CT: Yale, 2009), pp. 15-17.

[14] The deal did not close but the potential buyer was comfortable walking away for risk management reasons (Calandro 2020, Ch. 6)

[15] L.J. Rittenhouse, *Investing Between the Lines: How to Make Smarter Decisions by Decoding CEO Communications* (NY: McGraw-Hill, 2013), p. 226-232.

[16] An exception is Joseph Badaracco, Jr., *Leading Quietly: An Unorthodox Guide to Doing the Right Thing* (Boston, Harvard Business School Press, 2002).

[17] Not always, however. There are some very well-run firms being led by "imperial CEOs," but it is not an approach or paradigm we recommend, especially over time.

[18] Joseph Calandro, Jr., "Henry Singleton: A Pioneer of Corporate Strategic Leadership and Value Creation," *Strategy & Leadership,* Vol. 38, No. 6 (2010), pp. 29-37.

[19] Some posit that humble CEOs are able to outperform because they are not expected to produce at the same level as flamboyant CEOs. For a profile see Matthew Kassel, "Why Investors Might Want to Bet on Humble CEOs," *Wall Street Journal,* November 3 (2019), https://www.wsj.com/articles/why-investors-might-want-to-bet-on-humble-ceos-11572836641

[20] Joseph Calandro, Jr., "New Insights for Corporate Strategists from a Renowned Value Investor," *Strategy & Leadership,* Vol. 42, No. 6 (2014), pp. 29-36.