OPINION

How to determine if a stock investment has a CEO right for the job

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Berkshire Hathaway Chairman and CEO Warren Buffett speaks during an interview in Omaha, Neb., on May 7, 2018.

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A few years ago, my students and I visited with Warren Buffett in Omaha. One of the students asked him how he chooses managers. The co-founder and chairman of Berkshire Hathaway said that it was easy: He said I take them for lunch and, if I realize they are there for the money, I do not hire them.

This may be easy for Mr. Buffett, who has an uncanny ability to judge character, but how about the rest of us? How can we judge managers, especially when it comes to CEOs?

CEOs perform two roles. One is that of an operator and the other is that of a capital allocator.

What are the characteristics of good operators?

We can judge them in two ways: quantitatively and qualitatively. The quantitative part of it is easier to carry out. One needs to examine several of the company's financial ratios such as asset turnover, operating margin, return on equity (ROE), return on assets (ROA), return on invested capital (ROIC), working capital ratio, among others, over time and compare them to the ratios of peers. The better the company's ratios in relation to those of key competitors, the better job the CEO has done as an operator.

The qualitative examination focuses on the manager's character.

Charlie Munger, the late vice-chairman of Berkshire Hathaway, was asked once what advice he would give to young managers. He said: You must have two things – discipline and integrity. Compromise either and you will fail. Integrity means that you mean what you say and say what you mean. Managers who tell you one thing and they do a totally different thing are not to be trusted. Enron's managers, for example, had discipline but no integrity.

Some questions to ask that could raise red flags.

Do they produce misleading reports? Do they incur recurring non-recurring charges?

Read interviews from the CEOs: Do they make projections that are off actual performance? Here's an example: The ex-CEO of General Electric, Jeff Immelt, gave an interview three weeks before the company announced earnings and made a forecast that was way off the actual numbers. While GE was too complex, and difficult to manage, Mr. Immelt still had a credibility problem.

Do they have proper incentives? Are they paid reasonable salaries and bonuses? Or do they have excessively large incentives from shares or options? Do they display evidence of an extravagant lifestyle? Enron's parking lot was full of Ferraris, Maseratis and Bentleys. Have they put together highly complex corporate or ownership structures and are they active in mergers, especially unrelated acquisitions?

And most importantly, do they understand the business? One needs to examine their background, experience and education. Do they have what is needed to run the business and, given their background, will they be able to understand the business? This is of make-or-break business importance.

Running a commodity business will lead the company into bankruptcy if the CEO does not understand the business or will save the company if they do. A case in point is Denis Durcotte, who had deep knowledge of the business, and whose hiring saved a struggling Algoma Steel from bankruptcy. On the other hand, running a business with barriers to entry, a manager poorly qualified to run the business will diminish the franchise but will not inflict mortal damage, as Mr. Buffett likes to say. A case in point is when Carly Fiorina, a marketing executive, was hired to run a very sophisticated, high-tech business such as Hewlett-Packard. Or, when Dave Calhoun, an accountant by education, not an engineer or an aviation design expert, was hired to run Boeing. Both CEOs diminished the franchise, but they did not destroy the companies. Contrast them with Steve Jobs, who understood and cared for Apple's business deeply.

The other role of a CEO, equally or even more important, is to be a good capital allocator.

That means the CEO must have the skills necessary to take the cash that the company generates and deploy it to the best value-maximizing opportunity, be it buying another company, buying back shares, paying higher dividends, reinvesting within the company and so on. These are all investment decisions. In other words, the best CEOs are those who are good value creators, as well as good value seekers, i.e., good investors, more importantly value investors. For example, do they buy back shares at low price-earnings ratios (P/E) or high P/E ratios (evidence shows that most CEOs buy back shares at the peak of the market), or do they pay high P/E or

EV/EBITDA – the ratio that compares the company's enterprise value (EV) to its earnings before interest, taxes, depreciation & amortization (EBITDA) – when they acquire other companies (evidence shows that most CEOs overpay for acquisitions and destroy value in the process)?

According to my research, on average, superior capital allocator company stocks outperform the inferior ones by 33 per cent over a cumulative three-year period over several recent decades. Moreover, superior capital allocator CEOs attract the most patient and focused shareholders (i.e., quality investors) according to corporate governance expert Lawrence Cunningham. These are shareholders with the longest average holding periods and most concentrated portfolios. Good CEOs tend to attract quality investors and vice versa, i.e., Berkshire Hathaway and Fairfax Financial.

While good CEOs can march to their own drum, they are all efficient operators (i.e., value creators) and diligent capital allocators (i.e., value seekers).

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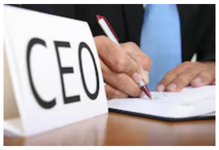

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