

# Management Matters

---

By Michael Kemp

*[Written after Michael's] fourth annual trip to the US, each timed to coincide with the Berkshire Hathaway Annual General Meeting held in Omaha Nebraska on the first Saturday of every May.*

Most of you will recognize the corporate name, Berkshire Hathaway, but for those of you who don't, allow me a brief introduction.

Berkshire Hathaway is a US corporate giant, currently placed fifth on the scoreboard of US stock market capitalization (Apple is presently the largest listed company in the US). But fifth place understates the reality. Berkshire Hathaway is actually running close to second in the corporate cap contest. At \$US364 billion it's presently neck and neck with fellow second place contenders, Microsoft, Google and Exxon Mobil.

And, in introducing Berkshire Hathaway, let's not forget that, for the last 50 years, it has been controlled and subsequently managed by the world's wealthiest investor, Warren Buffett.

With the introduction over, let me explain why I travel 30,000 kilometres each year to attend an AGM.

My motive is probably best compared to why people attend their doctor for an annual flu vaccination.

Whilst the principle is the same, the inoculation is different. For me it's an inoculation of the three corporate C's: "Corporate common sense", "Corporate culture" and "Corporate correctness".

This article explains how important these three factors are to successful investing, but before I do let's get the obvious discussion out of the way.

## **Yes....The AGM has become a Circus**

Most articles describing the Berkshire Hathaway AGM focus on the excesses and while that's not the purpose of this article, let's dispense with the big numbers right off the bat. It will appease those who get a kick from reading them.

More than 40,000 people attended this year's AGM. That meant more than half the attendees (who jetted in from 53 countries around the globe) were unable to find a seat in the venue where the AGM is held. That's because Omaha's largest indoor sports and entertainment arena, the Century Link Stadium, hits capacity at just under 20,000. Therefore most attendees were ushered into overflow rooms at Century Link's adjacent convention area and the Omaha Hilton across the street.

You'd expect the drawcard pulling those sorts of human metrics to be something akin to a Rolling Stones concert. And while the entertainment was no less captivating, it did consist of two elderly gentlemen sitting front and centre fielding questions from the massive audience for a very entertaining six hours (guess you had to be there to appreciate that one!).

The two elderly entertainers were CEO Warren Buffett and Vice-Chairman Charlie Munger who are now respectively 84 and 91 years of age. But the clincher for me isn't that they've both managed to avoid admission to a retirement village, rather the following.

Buffett has just clocked up 50 years as the top dog at Berkshire Hathaway. Where else, or for that matter, when again, would you see a CEO's reign span five decades? What's more, shareholders aren't calling for his corporate departure; instead they live in fear of when that will inevitably occur. This leads me to the focus of this article.

There must be something profoundly correct about the management culture at Berkshire Hathaway. Not only has it transformed an ailing 1960s New Bedford linen mill into the strongest conglomerate in the world, but the "rags-to-riches" metamorphosis has been singularly overseen by a person who still yields the highest degree of respect I've ever seen dispensed in any corporate environment.

To me Berkshire Hathaway provides a model of corporate success, measured not simply in terms of dollars, but one measured in terms of corporate behaviour and values. For any investor a study of Berkshire Hathaway delivers an insight into how desirable managerial qualities should be measured when sizing up any potential stock market investment.

### **Remuneration**

In 2006 Buffett began the process of returning his personal wealth back to society principally through a commitment of ongoing donations to the Bill and Melinda Gates Foundation. Had Buffett not started that process then today his personal worth would be \$US112 billion, easily eclipsing that of the world's wealthiest person, Bill Gates.

More importantly his personal wealth was achieved without being gifted a single share option or a single company share. Buffett bought his shares, just as every other shareholder did, on the open market. In terms of corporate compensation he is currently paid \$100,000 per annum (it's always been low). Remember this occurs in an environment where CEOs of corporate America are receiving self-enriching pay packets measured in terms of tens and sometimes hundreds of millions of dollars per year.

How then does this relate to your own search for companies on the ASX?

I would suggest that you search for corporate leaders that, like Buffett, align their financial success with yours. Look for leaders with plenty of skin-in-the-game in terms of their own share ownership, but equally ask how they obtained those shares. If that ownership resides with the legacy of having started the company themselves, or having made substantial on-market purchases of shares using their own money, then give them a tick of approval. But if they've sourced their shares at shareholder's expense via overly generous share delivery schemes or the self-gifting of copious volumes of free options then question their motives for being in the top job.

### **Pay close attention to the Annual report**

Let's face it, when you buy shares in a company you become a part owner of the business. So when the Chairman or the CEO communicates with you (particularly through their statements in the annual report) you're entitled to know exactly what's going on.

Their report to you should to be akin to a chat with your best mate over a few beers down at the Pub, not some homogenous white wash delivered by a public relations machine.

Buffett sits down to personally write his annual letter to fellow shareholders. And he takes the process very seriously. That means his letters sound like few others I've ever read. It's not surprising then, that for years,

publishers have been compiling his letters into books and selling them in their thousands. There are certain distinguishing qualities his letters carry:

- Buffett claims none of the company's success as his own, rather he bestows it on others within the organisation and he makes a habit of naming them in the report.
- His report is written in a language free of ambiguity; simple language that every shareholder can understand.
- Not only does he avoid financial jargon but he avoids the use of motherhood statements typically employed by many CEOs to allay blame; for example phrases relating substandard corporate performance to "soft market conditions" or "the present state of the economy".
- He alerts shareholders to poorly performing divisions rather than "burying" their substandard results in consolidated financial statements.
- He refers to all Berkshire Hathaway's shareholders as his partners.
- Buffett does something you will rarely, if ever, seen done by any other CEO. He alerts shareholders to his faults of omission. That is, he quantifies how much better off shareholders would be today, if he had made different choices in the past. It's worth exploring a perfect example of how Buffett does this.

In 1993 Berkshire Hathaway acquired the US shoe manufacturing business, Dexter, for \$420 million. Cash didn't change hands, rather Buffett paid for the acquisition using Berkshire Hathaway stock. Cheap shoe imports from Asia have since rendered Dexter's business extinct. But rather than sweeping the mistake under the carpet, Buffett still reminds shareholders today of his folly. It would be easy for Buffett to quantify the cost of the mistake to shareholders as the \$420 million acquisition price. Instead he continues to equate it to the current value of the Berkshire Hathaway stock he used to make the acquisition. He recently told shareholders that it is now close to \$7 billion!

What can you take from this behaviour? The fact is a lot can be learned regarding the key management of any company by a thorough reading of its annual report.

Firstly ask whether the Chairman's and CEO's letters sound like they've been written by a well-oiled public relations department or whether they sound like a warts-and-all discussion of how the company's been performing. And secondly, if problems have arisen, ask whether senior management is providing concrete ways of improving corporate performance in the future.

It's also a useful exercise to compare successive annual reports, to note past promises (particularly those embellished with rosy forecasts) and see how things actually turned out.

And finally ask whether the CEO's letters to shareholders sound self-serving or do they recognize the efforts of other members of the corporate team, particularly the unsung heroes, that is, the workers and managers behind the scenes.

### **Facts not Fanaticism**

I haven't come to the above conclusions lightly.

In addition to spending more than three decades as an investor, my several visits to Omaha have added plenty of perspective. They've provided me the opportunity to:

- Spend a total of more than 60 hours with the CEOs of several of Berkshire Hathaway’s fully owned subsidiaries (most of it behind closed doors) listening to their views on Buffett and the Berkshire Hathaway culture.
- Twice listen to long-time Berkshire Hathaway board member, Ron Olson, express his views on corporate culture.
- Become friends with, and discuss the issues with, Bob Miles, author of several Buffett books, including *The Warren Buffett CEO*.
- Spend a total of 5 hours with one of Buffett’s own children.
- And, most importantly, I’ve spent a combined total of over 20 hours listening to Buffett and Munger discuss the principles that guide them in running Berkshire Hathaway.

The most important message I’ve learned from all of these interactions is, when investing, don’t simply seek out CEOs with a strong mercenary streak. Also seek those with a strong moral compass. Over time they will perform well as the custodians of your invested capital.

To me the search for exceptional management is the most neglected aspect in the search for great investments

## To read more of Michael Kemp’s work

### Previous Articles

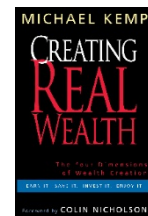
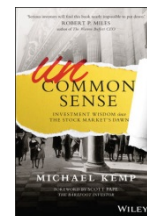
All Michael’s previous articles for the website are now on the *Michael Kemp Articles* page on the Free Resources menu. They are now listed by title with a brief description of their contents.

### Books

Michael has written two books, both of which are available for purchase from the **Buy Books** menu:

**CREATING REAL WEALTH** - The four dimensions of wealth creation

**UNCOMMON SENSE** - Demystify the complex world of investments and make your own investment calls



*Michael Kemp is the chief analyst for the Barefoot Blueprint and author of “Uncommon Sense”. Published under the Wiley label “Uncommon Sense” delivers a deeply considered and logical approach to the otherwise complex world of investing.*