White Paper No. 22 – *Corporate Crooks and Investor Trust*

Corporate America has got to understand there's a higher calling than trying to fudge the numbers.

– President Bush, June 28, 2002

It's gotten to the point where we're afraid to turn on the news or pick up a newspaper. Like most investors, Greycourt has been deeply disturbed by the chicanery and outright fraud that have come to characterize too much of corporate America. But before we give in to despair and take investment action that could be damaging to our wealth, let's step back and try to put the current, appalling situation in perspective. While it is too early for any of us to understand all the implications of the Bubble Markets of the late 1990s and the resulting corporate scandals, some of those implications are already apparent. Not all of them will be palatable to investors, but the willingness to stare unpalatable truths in the eye is one of the hallmarks of successful investing. Here is a summary of those implications:

- First, whether we like it or not (and we certainly don't), periodic epidemics of bad corporate behavior are an inevitable part of the price we pay for the benefits of a free market economy.
- Second, the seeds of the current crop of corporate scandals were planted not by corrupt executives but by greedy investors and their Wall Street cheerleaders.
- Third, while the current scandals involve a small minority of companies and executives, a fundamental change has occurred – namely, the acceptance and, indeed, encouragement of "earnings management" by corporations. This change has important implications for investors, the main one being that the dangers associated with holding concentrated securities positions is now extreme.
- Finally, on the bright side, corporate scandals, collapsing markets, and investor fear and distrust are likely to present a once-in-a-lifetime opportunity for thoughtful investors to create wealth.

Bad behavior and free markets

Starting with "first principles," let's not forget that free capital markets require that we trust individual corporations and their executives to make decisions that, within reason, are

in their own best interests. We know perfectly well that executives will sometimes make wrong or socially undesirable decisions, particularly when faced with considerable temptations. As a result, we establish constraints – civil, criminal, and cultural – on individual decision-making at roughly the point where we feel that the undesirable consequences overwhelm the importance of individual decision-making. Because we know that millions of individual decisions will produce better outcomes than one state-imposed decision, we tend to err on the side of giving people more, rather than less, discretion.

One result of this free market approach is that, periodically, we will experience epidemics of bad corporate behavior. These epidemics peak at exactly the point where the incentives for self-enrichment at the expense of the broader good are at their greatest – in other words, during Bubble Markets. The names of the miscreants of the modern era resonate with the tenor of their times: Robert Vesco, Michael Milken, Marc Rich, and, of course, Enron, Tyco, WorldCom, *et al*. Today's epidemic is certainly the worst of our professional lifetimes, but then the Bubble Market and Cinderella Economy of the late 1990s was the most extreme since the boom of the 1920s. (After the Stock Market Crash of 1929, the Pecora Hearings in the early 1930s shocked and titillated Americans with tales of astonishing greed, brazen stock price manipulation, insider trading that would make Martha Stewart blush, incredible interlocking trusts that controlled vast industries, and similar exposes.) The bigger the boom, the bigger the bust.

Still and all, while criminal corporate behavior needs to be appropriately punished and the constraints we impose on individual decision-making need to be re-examined, we shouldn't forget that periodic bad behavior is part of the cost we bear for the benefits we derive from a free market economy.

Investor complicity

While politicians are making hay with voters by criticizing executive greed, there is plenty of blame to go around, and some of it lies at our feet as investors. For example, during the peak of the Bubble Market (roughly 1996 – 1999), companies were brutally punished for missing consensus earnings targets by mere pennies.[1] CEOs who missed targets two quarters in a row were summarily fired, to the loud applause of enraged investors. Moreover, companies who consistently met consensus earnings expectations saw their share prices soar, and CEOs of those companies were rewarded beyond the dreams of Croesus. Faced with the choice of being fired or getting unimaginably rich, how surprised ought we to be that most CEOs began to "manage" corporate earnings?

Of course, there is a big difference between "managing" earnings and "manipulating" earnings. (Think of this analogy: it is acceptable for individual taxpayers to arrange their affairs so as to *avoid* payment of income taxes, but it is a criminal act to arrange our affairs so as to *evade* payment of taxes.) Since investors prize consistent earnings growth, sensible CEOs "manage" company earnings to insure quarter-over-quarter growth. The

earnings they are reporting are real and accurately reflect the fundamental value of the company, but those earnings would not have arrived on so conveniently consistent a schedule without substantial attention to earnings management techniques.[2] The most talented of these earnings managers – Jack Welch at GE, Lou Gerstner at IBM, Bill Gates at Microsoft – have become icons, and their strategies are studied by other executives and at every business school in the world.[3]

But note what a change this represents from the way CEOs operated a mere decade ago. In those days, Old School CEOs followed conservative accounting practices and let the earnings chips fall where they may. In some quarters their companies' earnings greatly exceeded consensus expectations and in some quarters they fell far short. Those practices passed muster in the 1980s, but in the 1990s, and especially during the Bubble Market, Old School CEOs either changed their stripes or were summarily fired, usually just ahead of investor lynch mobs.

Now let's turn to earnings *manipulation*. Most modern CEOs are pragmatic folks who understand that an important part of their jobs is to produce strong and consistent quarter-over-quarter earnings growth. As noted, they are willing to engage in legal and (for the most part) ethically acceptable accounting techniques to accomplish that goal. But they draw a line in the sand somewhere, beyond which they simply will not go, no matter how loud the howls of protest may be from Wall Street and the investor community. But Bubble Markets and greedy investors also produce a different kind of CEO, the kind who believe their job is to give investors whatever they want and to engage in whatever accounting techniques are necessary to do so.[4] These CEOs are not engaged in managing real earnings to insure that they occur at the right times, but in *creating earnings where none exist*. These are the executives who have created the scandals we read about every day.

In any event, the larger point is that, whenever investors demand the impossible, there will be companies around willing to deliver exactly that. Politicians can rage all they want about the need for conservative accounting practices and higher ethical standards, but the Old School CEOs long ago fell by the wayside – at investor insistence – and their type has all but disappeared from the corporate gene pool.

Implications for investors

Distressing as the corporate scandals of the early twenty-first century may be, they represent both an important lesson for investors and, ironically, a very rare opportunity for sophisticated investors to create significant, permanent wealth. Here are some of those implications.

What used to be a conflict is now a synergy.

– Jack Grubman, telecommunications analyst at Salomon Smith Barney, during the Bubble Market, mid-1999

Conflicts of interest matter. When markets are so strong that any daytrader can easily select stocks that are certain to appreciate handsomely, concern about conflicts of interest can seem quaint, or even a sure mark of unsophistication. Indeed, now-disgraced Salomon Smith Barney telecommunications analyst Jack Grubman used to brag that it was precisely his conflicts of interest that made him useful to investors. Because Grubman was so close to Bernard Ebbers at WorldCom, for example, Grubman claimed that, "What used to be a conflict is now a synergy. They [investors] know I'm in the flow of what's going on."[5]

The trouble was that, while "everyone knew" that research analysts were really just a sales force for their firms' investment banking services, no one dreamed how much wealth could be lost by relying on their analyses. Similarly, "everyone knew" that public accounting firms considered their auditing functions to be nothing more than loss leaders for the sale of far more lucrative consulting services. But no one imagined that the enfeebled auditing function would one day be the last, hopeless line of defense between corporate fraud and massive investor losses. And, of course, "everyone knew" that the huge stock options packages granted to corporate executives badly misaligned executive and shareholder interests.[6] But no one could have foreseen how dramatically this conflict would enrich executives while investors lost billions.

The simple fact is that conflicts of interest matter. They matter during bull markets and bear markets. They matter whether the conflicts are large or small. They matter because an advisor is either working for you or against you. There is no "synergy" between an investor and an advisor who is working the other side of the street: you are either a guest at the dinner or you are the main course.

Put all your eggs in one basket – and watch that basket!

– Warren Buffett[7]

Diversify, diversify, diversify. The important lesson is this: earnings management is here to stay, and it is virtually impossible for any investor to know in advance the difference between a company that is managing its earnings and a company that is manipulating its earnings.[8] As a result, no one can know for sure that any company, no matter how squeaky-clean its current reputation, won't be the next Enron, WorldCom, Tyco, Global Crossing, or Bristol Myers Squibb. As a result, having any significant part of your wealth concentrated in one or two companies, always a risky business, has become immeasurably more perilous. Here is a simple test: if a concentrated security position represents so much

of your net worth that if it's stock price went to zero your lifestyle would be seriously impaired, *you need to diversify, and promptly*.

CAUTION: Greycourt has determined that taking precipitous investment action in revulsion against appalling corporate behavior could be hazardous to your wealth.

Opportunities to create wealth. Sensible investors recognize that the equity markets are likely to generate returns far lower than those of the 1980s and 1990s, and that the techniques that worked in those days – indexing, focusing on mega-cap, Blue Chip names, employing momentum-based strategies – are likely to prove disappointing. But there is a silver lining inside every black cloud. Many inexperienced investors are likely to follow the (among other things, preposterously tardy) advice of self-help gurus like Suze Orman and abandon stocks.[9] Since the markets turned in April, 2000, investors have lost literally trillions of dollars. Many no longer trust corporate financial numbers and no longer believe anything corporate CEOs, research analysts or public accounting firms have to say. These investors have absolved themselves of complicity in the post-Bubble debacle, and may abandon the stock market for a generation. In other words, not since 1974 will savvy investors have faced such an extraordinary set of opportunities in the American capital markets. Those opportunities will have to be exploited thoughtfully and over time, of course, but at least the raw material for once-in-a-generation creation of permanent wealth lies before us, in the very rubble created by the market collapse and the corporate scandals. We would be foolish, indeed, to let it pass us by.

We will be happy to discuss this memo at your convenience.

GREYCOURT & CO., INC.
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(This paper was written by Gregory Curtis, Greycourt's Chairman. Mr. Curtis can be reached at Greycourt & Co., Inc, 607 College Street, Pittsburgh, Pennsylvania 15232, (412) 361-0100, fax 412-361-0300, gcurtis@greycourt.com.)

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[1] According to the New York Times, companies that missed analyst estimates often lost 10% of their market value. Alex Berenson, *Tweaking Numbers to Meet Goals Comes Back to Haunt Executives*, New York Times, June 29, 2002, p. A1. In a desperate attempt to meet consensus earnings expectations, one company (WorldCom) cooked its books sufficiently to meet expectations by 1/100 of one cent (twice)!

[2] "Did Microsoft manage earnings? Does GE manage earnings? Sure, we all know that." Jon Brorson, who oversees $65 billion in equity investments at Northern Trust Company, quoted by Alex Berenson, op. cit. note 1, p. A1.
[3] Even the icons can sometimes step over the line, however. One abusive technique is to create accounting reserves that can be released later when they are needed to boost earnings. Microsoft engaged in exactly this behavior, and was fined for it by the SEC.
[4] Some common abusive accounting techniques involved capitalizing costs that should have been expensed (WorldCom); creating incentives for wholesalers to purchase far more product than the wholesalers believed they could resell to retailers, in effect, cannibalizing future sales to push them into the current year (Bristol Myers Squibb), and engaging in undisclosed off-balance-sheet financing (Enron).
[5] That was Grubman speaking in mid-1999. After WorldCom collapsed, Grubman was singing a different tune about being "in the flow of what's going on." Interviewed on CNBC, he claimed that, "I am as shocked about this as everybody else." See Patrick McGeehan, *Timing of a Rating Shift Is Raising Some Questions*, New York Times, June 28, 2002, p. C5.
[6] When an investor owns shares outright, he or she loses money when the stock price declines. But when an executive simply owns an option, he or she has only upside potential, with no downside exposure. (Indeed, if the stock price goes down and stays down, the executive knows that the board of directors will eventually re-price the options.) Once the options are vested and in the money, the executive will exercise the options immediately – there is no advantage to delay, since the stock price could decline below the exercise price at any time. But once the executive exercises, tax rules force him or her to sell the stock immediately in order to raise cash to pay the taxes. Hence, the executive has every incentive to take whatever action is necessary to raise the stock price in the short term, no matter how unsustainable that price may be. He or she will exercise the options, sell the stock and put the cash in the bank, leaving longer term shareholders holding the bag when the stock price eventually collapses.
[7] For decades many investors have been comforted by Warren Buffett's advice. But with the advent of earnings management it has become immeasurably more difficult to "watch that basket." Perhaps a few geniuses like Mr. Buffett can continue to concentrate their wealth in a few companies, but this strategy has become discredited for ordinary mortals.
[8] And given the appalling conflicts of interest among research analysts, investors can expect no help whatever from this quarter.
[9] Orman made this recommendation on her cable television show in June 2002.