



When Corporate Governance Goes Bad!

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A Brief Outline



- **A Statement from the President of the United States**
- **Share Holder vs. Share Owner**
- **Some Examples of Bad Corporate Governance**
- **Back Dated Stock Options**
- **The Difference between the US and the UK**
- **The Impact of Bad Governance on The Equity Cost of Capital**
- **A Demonstration of the Impact of Good Governance**
- **Some Final Thoughts on Culpability**

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And Now For Some Corporate Governance

A Statement from the President of the United States

“I see in the near future a crisis approaching. Corporations have been enthroned and an era of corruption in high places will follow until all wealth is aggregated in a few hands.”

Abraham Lincoln (1864)

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A Challenging Statement about Shareholder Activity



- **“The typical American stockholder is the most docile and apathetic animal in captivity. He does what the board of directors tell him to do and never thinks of asserting his individual rights as owner of the business and employer of its paid officers.”**
- ***Security Analysis*, Benjamin Graham & David Dodd, 1934.**

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Another Statement about Stock Ownership



- **“The choice of a common stock is a single act; its ownership is a continuing process. Certainly, there is just as much reason to exercise care and judgment in being a shareholder as in becoming one.”**
- ***Security Analysis*, Graham & Dodd, 1934.**

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Why Governance is Necessary



- **All companies experience inevitable periods of stock price appreciation & decline.**
- **These periods will occur for both good and poorly governed companies.**
- **However, accountable governance may mean the difference between prolonged periods of underperformance and responding quickly to a new course of action.**
- **Shareholders must demand this accounting.**

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The Etymology of “Shareholder”



- Once upon a time, physical assets defined an individual’s net worth:
 - “Land Barons” were aptly named.
- But over time our economic society changed from an agricultural one to an industrial one.
 - A new denominator of wealth was born: **The ownership interest in the production of goods and services.**
 - Initially, voting rights of corporations were governed by common law not statutory law—with a *per capita* rule (one person—one vote).
 - It wasn’t until 1926 that the NYSE adopted a one vote per share rule.
- **Bank & Trust companies became the custodians of wealth accumulation:**
 - Initially, they held land deeds, mortgages, jewelry, and bullion.
 - But beginning in the late 1800s they also became **“Holders of Shares”** in industrial ventures.

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A Different term: Share Ownership



- “Share Ownership embodies two important principles. First, the term **shareowner** reminds all interested parties—executives, directors, creditors—who is the ultimate owner of the company. Second, with the acknowledgement of share ownership comes the obligation to continue to exercise ownership rights in a public company.”

Robert Carlson, Charles Valdes and Mark Anson, “Share Ownership: The Foundation of Corporate Governance,” Journal of Investment Compliance, 2004.

The Term “ShareOwner” has now been adopted by the CFA Institute.

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An Example of Bad Governance



- **At the annual shareholders meeting for Home Depot in 2006, Robert Nardelli, the CEO for Home Depot presided alone.**
 - He appeared with no other directors.
 - Shareholders – the owners of the company – could ask only 1 question
 - And, Shareholders could only speak for 1 minute
- **When a shareholder asked about board independence and conflicts of interest, Mr. Nardelli replied:**

“This is not the forum in which to address these comments.”

- **Mr Nardelli was sent packing in 2006, but he received a \$210 million severance package to ease him into retirement.**
- **By the way, where is Mr. Nardelli today?**

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How about another bad example: CareMark RX



- **Caremark’s CEO agreed to merge the company with CVS. The Directors of Caremark then agreed to:**
 - CVS agreed to pay **No Premium** to existing Caremark Shareholders. The offer was \$48.50 but Caremark’s shares traded in the \$50s.
 - Caremark’s CEO & directors all kept their jobs **AND** they were allowed to claim a **Change of Control** which triggered their stock options.
 - Caremark agreed to pay CVS a **\$675 million break up fee** if the deal did not go through—essentially the price of admission for other bidders.
 - Caremark’s directors also agreed to a **“no shop”** clause with CVS—This prohibited the Caremark directors from soliciting other bids.
 - **And Last:** After the CVS bid of about \$21 billion total, another unsolicited bid from Express Scripts was tendered at \$26 billion, **and Caremark’s directors rejected it!**
 - TheStreet.com labelled this deal:
 - **No. 1 of the Five Dumbest Things on Wall Street.**
 - **This deal did close but not until CVS agreed to increase their bid to \$27 billion**

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More Bad Governance: Compensation—How Much is Enough?



- **Consider Hank McKinnel the former CEO of Pfizer.**
 - He presided over the decline of \$137 billion of shareholder value.
 - He finally was asked to step down.
 - Yet, he received an \$82 million pension.
 - And his total retirement package, including stock options, retirement benefits, deferred compensation and other perquisites totalled \$200 million!
- **But the “kicker” that really grates:**
- **Shareholders even had to pay \$305,644 for Unused Vacation Days.**

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Another Problem in the US: Back-Dated Stock Options



- **What are they?**
- **Backdated options are options that are granted to a corporate executive today but the “grant date” is dated at a prior time when the stock price was lower to give the option holder an immediate boost in value.**
- **Is this a problem? You bet.**
 - Back-dated stock options are a “Freebie”— executive is awarded for NO EFFORT because the back-dated grant date already reflects an increase in value.
- **To date, the US Securities and Exchange Commission has investigated over 200 cases of back-dated stock options, including IBM, Pfizer, Home Depot...**
- **Apple, for example, has acknowledged 6,500 cases of improper stock option backdating!**
- **To date, Accounting Restatements and Revised Charges total over \$40 Billion.**

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Back Dated Stock Options: An Example



- **Dr. William McGuire, the founder and former CEO of United Health Group came under fire for backdating options.**
 - He received almost \$1.5 billion in backdated options—the rest of UHG employees received about \$100 million.
 - Fascinating Question: How did the UHG backdating scandal get uncovered?
- **In defending his free gift of backdated options, Dr. McGuire said:**

“This isn’t a giveaway of money that occurs out of the premiums of health care recipients.”

“These are Shareholder Dollars.”

- **Fortunately, Dr. McGuire was given the sack.**
- **In December 2007, the SEC was able to “clawback” almost \$500 million of these options.**

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Vitesse Semiconductor



- **Louis Tomasetta – Vitesse Semiconductor, president and chief executive**
- **Total grants: 9 = \$4,164,226**
- **Odds: About 1 in 26 billion**
- **Examples of options granted (Stock prices adjusted for splits)**



- **Company's Response at Date of Publication (March 18, 2006):**
Mr. Tomasetta said the grants were "approved by the board and the price set at the close of the day of approval." Alex Daly, a member of the board compensation committee, said there was "nothing extraordinary" about grant timing.

Source: WSJ

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More Corporate Scandals



- **In January, former Brocade CEO Gregory Reyes was first executive convicted in backdating fraud**
 - Sentenced to 21 months in prison
 - Fined \$15 million
 - Legal fees paid with taxpayer money: \$90 million

- **Broadcom: largest financial restatement related to options backdating in the US**
 - In January 2007, several years of financial statements were restated totaling \$2.2 billion in additional expenses
 - Former CEO Henry Nicholas also charged with drugging industry executives and Broadcom board members – allegedly he used ecstasy, cocaine, meth

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A Final (Bad) Example of Back-Dated Options



- **From an actual filing by CableVision, a US public company listed on the NYSE, with the Securities and Exchange Commission regarding Back-Dated Stock Options:**

- **“One of these two awards was to the company’s former compensation consultant (which was subsequently cancelled in 2003)...**

- **...and the other award related to an executive officer whose death occurred after the stated grant date of the award and before the actual grant date.”**

- **Translation: CableVision awarded stock options to a Dead Guy!**

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Forbes review of 2007 of Executive Compensation



- **Total pay for the Fortune 500 CEOs totaled \$6.4 Billion—on average \$12.8 million a piece.**
 - Down 15% YOY, first decrease since 2002
 - While the S&P 500 was up by 5.4%
- **Highest Paid? Larry Ellison of Oracle at \$183 million — \$182 of which was from stock grants and options.**
 - Next 4 highest paid also received most of their compensation in options: Average pay among the top 5 CEOs? **\$126 million**
 - But compare to average pay of the top 5 hedge fund managers: **\$2.5 billion**
 - AFL CIO in their annual review estimate that the pay of a CEO is 430 times greater than the average worker in his/her company—up from a multiple of 85 times in 1980.

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Some Differences between the UK and the US



- **Here in the UK, shareholders can sack (terminate) the Directors.**
- **In the US, shareholders cannot sack the Directors of a public company.**
 - Shareholders in the US can only **withhold** their vote for a director.
 - But, **there is no ability to vote against** a Director of a US public company.
 - Therefore, if all votes are withheld for a Director save **a single vote** in favour of that Director (presumably the Director's own vote in favor of him/herself) the Director will still be elected.
- **There have been a few attempts in the US to change this rule, most recently a rule proposed by the US Securities Exchange Commission: **Open Access to the Company's Proxy Statement.****
 - This is the most important Governance Debate of the last 40 years.
 - And the battle rages on pitting Pension Funds on one side vs. Corporate America on the other side.
 - Europeans cannot understand why the US just can't get this right!

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Open Access to the Proxy: Recent History



- **Under current US securities law, Shareholders do not have access to a Company's Proxy Statement--the statement that nominates directors—regulated under SEC Rule 14a-8.**
 - This means that Share **Owners** must wage a prohibitively expensive Proxy Battle if they wish to nominate a director.
 - In 2003, former SEC Chairman William Donaldson attempted to correct this Governance deficiency by proposing a new rule to allow shareholder access.
 - This rule met with tremendous resistance from the business community, notably the Business Roundtable and the US Chamber of Commerce.
 - CEOs complained that “Special Interests” would gain control of the Boardroom.
 - Bill Donaldson attempted to revise his proposed rule with even more restrictions placed on granting access but to no avail. He eventually resigned from the SEC in 2005 and the proposed rule died with him.
 - But a court ruling in September 2006 by the US 2d Circuit Ct of Appeals allowed a union pension fund called AFSCME access to the AIG proxy.
 - This forced the SEC to revisit the Proxy Access Rule. **Over 34,000 comment letters were received—a new record.** Unfortunately, in November 2006, the SEC voted 3 to 1 to maintain a “No access” position.

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The Impact of Poor Governance: A Review of The Equity Risk Premium in the United States



- **The Equity Risk Premium (ERP) is the additional return that investors must earn to hold stocks over bonds.**
- **It is a measure of the **Cost of Capital** in the equity markets.**
- **It can also be used to measure the level of **Investor Risk Aversion** in the stock market.**
- **The ERP is *implied* by current market valuations—it is not directly observable—but you can “back out” the ERP using current stock market valuations.**
- **It is an effective tool to determine whether the stock market is over, under, or fairly priced.**
- **There is a direct **inverse** relationship between the ERP and the level of the stock market: a higher ERP leads to lower stock market valuations.**

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How do you Calculate the ERP?

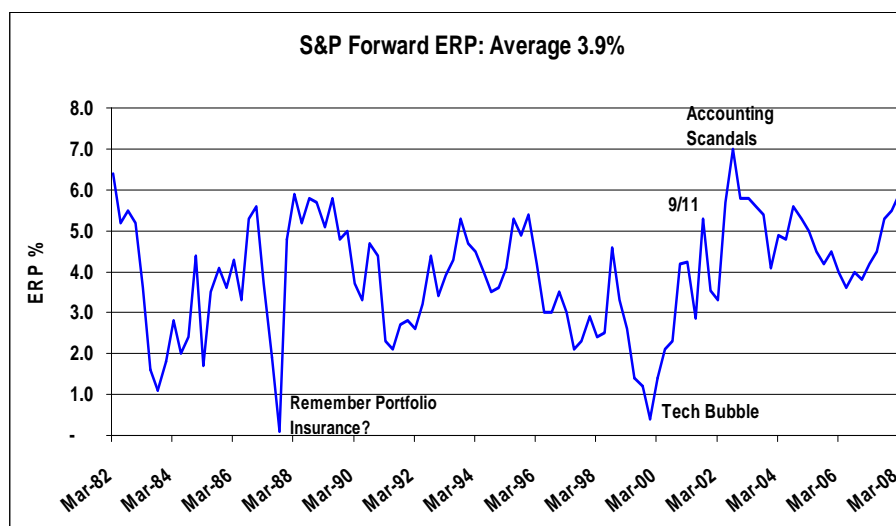


- 1) Start with the current level of the stock market.
- 2) Forecast future earnings for the stock market.
- 3) Then it becomes a present value calculation:
 - a) Determine the discount rate necessary to equate:
 - b) discounted forecast earnings = current stock market value.
- 4) Subtract the return of the 10 year Treasury bond from the discount rate calculated in Step 3.
- 5) The remainder is the ERP: **The additional return or premium over and above Treasury bonds that investors must earn to entice them to hold equity assets.**

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A Graph of the ERP



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What lessons can we learn from the ERP?



- **The ERP has approached zero twice:**
 - The portfolio insurance fallacy of 1987. **We learned that Equity Risk, like energy, must be conserved. It can be hedged but it cannot be eliminated.**
 - The Tech Bubble. **We learned that trees cannot grow to the sky.**
 - In each case, the valuation of stocks was so inflated that investors viewed stocks as no more risky than Treasury Bonds—this cannot be—equity is fundamentally more risky than debt.
- **The highest point of the ERP came in 2002:**
 - The ERP in 2002 was even higher than after 9/11.
 - The cause: Worldcom, Tyco, Adelphia, Enron, et al.
- **Bottom Line: A lack of corporate governance destroyed investor confidence, raised the equity risk premium, increased the cost of capital for public companies, and eroded stock market values.**

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CalPERS' Corporate Governance Investment Program

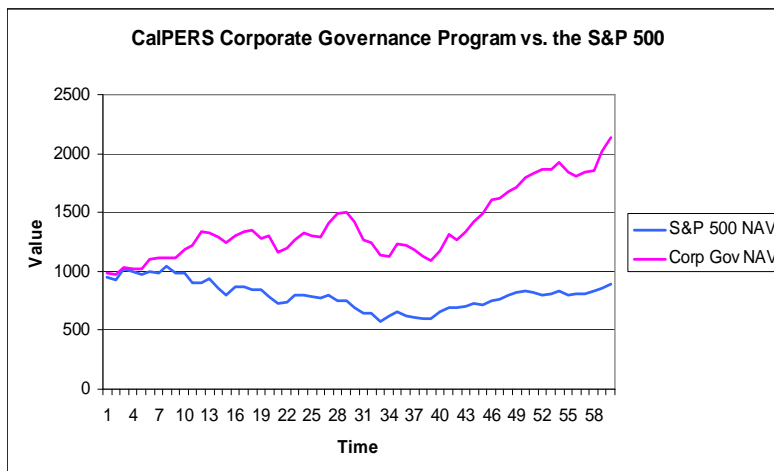


- **CalPERS made its first governance investment in 1997 with Relational Investors.**
- **In 2000, CalPERS Staff presented to the CalPERS Board a business plan to transform the Governance Program into an Investment Program.**
- **Today, CalPERS has over \$5 Billion of investment capital committed to a governance style of investing.**

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Corporate Governance Program vs. the S&P 500: 2000-2005



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CalPERS' Governance Program: The Focus List



- **Since 1992 CalPERS has published a list that focuses on poorly governed companies.**
 - Candidate companies are selected from our internal US equity index fund—approximately 1700 candidate companies.
 - Each year CalPERS' Staff review every company's operating performance and governance structure.
 - Select 20 to 25 companies to meet with—engage the CEO and independent directors in a dialogue of governance.
 - Publish an annual list of 5 to 10 poorly governed companies.
- **CalPERS' publicly commits to improve the governance of the companies on the Focus List.**

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The Shareholder Wealth Effect of CalPERS' Focus List



CalPERS Focus List: Cumulative Excess Returns

	T-180 to T-90	T-90 to T	T to T+90	T to T+180	T to T+365
Mean CER	-0.18%	6.20%	12.93%	29.40%	59.36%
T Statistic	-0.04	1.46	3.03	4.21	4.91

Cumulative Excess Returns are the extra returns earned over and above a risk-adjusted rate of return for the Focus List Stocks—It represents an additional return premium to investors.

Results are published in: Good Governance Pays: More Evidence from CalPERS," Journal of Asset Management, 2004, by Mark Anson, Ted White and Ho Ho.

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CalPERS' Focus List: Large Cap vs. Small Cap Stocks (Excess Returns)



CalPERS' Focus List: Small Cap Stocks

	T-180 to T-90	T-90 to T	T to T+90	T to T+180	T to T+365
Mean CER	-3.81%	2.93%	11.79%	13.70%	38.28%
T Statistic	-0.66	0.51	2.03	1.44	2.33

CalPERS' Focus List: Large Cap Stocks

	T-180 to T-90	T-90 to T	T to T+90	T to T+180	T to T+365
Mean CER	2.53%	7.91%	20.15%	35.50%	68.04%
T Statistic	0.4	1.24	3.15	3.39	3.75

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CalPERS' Focus List: Good Performers vs. Bad Performers (Excess Returns)



CalPERS' Focus List: Good Performers

	T-180 to T-90	T-90 to T	T to T+90	T to T+180	T to T+365
Mean CER	-0.48%	15.51%	9.53%	18.87%	33.55%
T Statistic	-0.1	3.34	2.04	2.46	2.54

CalPERS' Focus List: Bad Performers

	T-180 to T-90	T-90 to T	T to T+90	T to T+180	T to T+365
Mean CER	8.20%	-6.65%	19.67%	33.98%	83.65%
T Statistic	1.34	-1.09	3.2	3.38	4.8

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Another Example of Activism: Hedge Funds



	Average Excess Return	T Statistic	Significance
Day -20 to +20	6.8%	5.822	0.0001
Day -10 to +10	6.0%	6.238	0.00001
Day 0 to +2	2.3%	5.663	0.0001
Day 0 to +10	4.2%	6.577	0.00001
Day 0 to +20	4.8%	5.509	0.0001

"Hedge Fund Activism, Corporate Governance, and Firm Performance," Alon Brav, Wei Jang, Frank Partnory, and Randall Thomas, Duke University white paper, 2006

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Summary of Performance



- **Corporate Governance Pays**
 - But, this is an Investment Strategy, not a Trading Strategy.
 - It is a long term process, not a quick fix.
 - It is an alpha driver.
 - Even better: it is an alpha driver with large capacity.
- **Investors can implement this strategy**
 - But it requires the patience to be a long term investor.
 - Short term investing is avoided; portfolio turnover is low.
 - Own stocks, don't rent them.

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Culpability For Bad Governance Must be Shared



- **Not all of the blame can be placed at the feet of corrupt corporations.**
 - Unfortunately, *Short Term Investing* remains the primary investment paradigm in both the US and the UK.
 - Short Term investors rent stocks, they don't own them.
- **For example, the average annual turnover for a US mutual fund is over 100%.**
 - **With such a high turnover rate, ownership does not apply.**
 - Asset Owners put pressure on Asset Managers to produce quarterly and annual out performance vs. their benchmarks.
 - Asset managers, in turn, demand short term out performance of the companies in which they invest.
 - This puts pressure on public companies to focus on short term earnings rather than long term growth.
 - A vicious circle results.

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