COMPLIMENTS OF:

VOLUME 26 | NUMBER 4 | FALL 2014

Journal of APPLIED CORPORATE FINANCE

In This Issue: **Are U.S. Companies Underinvesting?**

The State of the Public Corporation: Not So Much an Eclipse as an Evolution	8	*Conrad S. Ciccotello, Georgia State University*
Capital Deployment Roundtable: A Discussion of Corporate Investment and Payout Policy	22	*Panelists: John Briscoe, Bristow; Paul Clancy, Biogen Idec; Michael Mauboussin, Credit Suisse; Paul Hilal, Pershing Square Capital Management; Scott Ostfeld, JANA Partners; Don Chew and John McCormack,* Journal of Applied Corporate Finance. *Moderated by Greg Milano, Fortuna Advisors.*
Capital Allocation: Evidence, Analytical Methods, and Assessment Guidance	48	*Michael J. Mauboussin and Dan Callahan, Credit Suisse*
Bridging the Gap between Interest Rates and Investments	75	*Marc Zenner, Evan Junek, and Ram Chivukula, J.P. Morgan*
An Unconventional Conglomerateur: Henry Singleton and Teledyne	81	*William N. Thorndike, Jr.*
The Icahn Manifesto	89	*Tobias Carlisle*
Off Track: The Disappearance of Tracking Stocks	98	*Travis Davidson, Ohio University, and Joel Harper, Oklahoma State University*
The Gap between the Theory and Practice of Corporate Valuation: Survey of European Experts	106	*Franck Bancel, ESCP Europe-Labex ReFi, and Usha R. Mittoo, University of Manitoba*
Are Certain Dividend Increases Predictable? The Effect of Repeated Dividend Increases on Market Returns	118	*David Michayluk, University of Technology, Sydney, Karyn Neuhauser, Lamar University, and Scott Walker, University of Technology, Sydney*

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Capital Deployment Roundtable

A Discussion of Corporate Investment and Payout Policy

New York City | May 28, 2014

Photographs by Yvonne Gunner

Greg Milano: Good afternoon, I'd like to welcome you all to this roundtable on capital deployment. We're very pleased to have a panel that represents such a range of views and experience—one that includes corporate financial executives and investment bankers as well as activist investors. Our plan is to spend the next hour or so talking about the overall strategy for deploying capital while considering all the major alternatives for reinvesting capital in the business or distributing it to shareholders.

Many people have different ideas about what it means to deploy capital. But let me start by telling you how I think about it. Our basic subject here is all the things corporate managers can do with the cash their companies generate both internally through their operations and what they raise from the outside from banks and financial markets. Managers can use that cash to make capital investments, fund research and development, increase working capital, or they can use the cash to grow by buying other companies and forming joint ventures. But if they have more capital than they need, they can distribute it to shareholders through dividends, either regular or special, one-time dividends, or through buybacks of their stock. And, of course, companies also have the option of increasing their financial flexibility by paying down debt or building up cash. And so that's our main topic for this afternoon: How do companies make these decisions—and how should they be doing it?

Of course, there are lots of other things CEOs and CFOs need to do, but I've increasingly come to the conclusion that the capital deployment choices made by executives may well be the most important determinant of how well their share price performs over the long run. You can reshape a company through acquisitions and divestitures, grow it through capital investment, or shrink it by distributing cash to shareholders. In fact, you can completely change what industry you're operating in—because your ability to sell assets and raise capital to buy others gives you the power and the means to change it.

But before we proceed any farther with the discussion, let me say a bit about the people who have agreed to join us today.

John Briscoe was recently named Senior Vice President and CFO of Bristow, the Houston-based leader in providing helicopter services for oil and gas transportation and search and rescue. Previously, John was Chief Financial Officer of Weatherford International Limited for about two years. Before that, he had almost 30 years of experience in different parts of the energy industry, mostly in oil field services, but several other areas, including a number of energy MLPs.

Paul Clancy is the CFO of Biogen Idec, a biopharmaceutical company that Paul has worked with for about 14 years, the last seven as CFO. Prior to that he spent about 15 years at PepsiCo.

Michael Mauboussin is head of Global Financial Strategies at Credit Suisse, where he advises corporations and investors on topics related to capital markets theory, valuation, corporate strategy, and decisions. Before that, he was Chief Investment Strategist at Legg Mason Capital Management, where he worked with Bill Miller on lots of issues, including investment process.

Paul Hilal is a partner at Pershing Square Capital Management, a well-known activist hedge fund that manages about $18 billion. Paul has served as a shareholder representative on the boards of three public companies over the years.

Scott Ostfeld is a partner and co-portfolio manager at JANA Partners, a $10 billion value oriented hedge fund known for its shareholder activism.

Don Chew has been the editor of the *Journal of Applied Corporate Finance* and its predecessors for well over 30 years now. He was a founding partner of Stern Stewart & Co.—a firm I later joined for 10 years and became a partner of. During Don's tenure as editor, the *JACF* has been sponsored or owned by a number of financial institutions, including the Midland Bank of England, Continental Illinois, Bank of America and, most recently, Morgan Stanley. A little over a year ago, Morgan Stanley sold the *JACF* to Don, his associate editor John McCormack, and Carl Ferenbach, the retired co-founder of the private equity firm Berkshire Partners who now serves as Chairman of the Environmental Defense Fund.

And last but not least is **John McCormack**, who, as I just mentioned, is associate editor and co-owner of the *JACF*. Before joining Don as associate editor, John was an analyst at Morgan Stanley who focused on questions of accounting and value—and before that, he worked as a consultant at Stern Stewart specializing in serving the energy industry.

And as I told you already, I'm **Greg Milano**, CEO and co-founder of Fortuna Advisors, a shareholder value-focused

strategy consulting firm that advises companies on everything from business strategy, portfolio management and capital deployment to performance measurement and incentives. We differentiate ourselves through the thoroughness of the training and coaching we provide to help managers think more like private owners inside the public company.

So, that's our cast of characters. And before I give up the floor, let me also mention that the idea for this roundtable started with a book that Paul Clancy first suggested to me. The book is written by a highly regarded value investor named William Thorndike, and it's called *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success.* The book provides accounts of how the CEOs of eight American companies managed to create extraordinary shareholder value over time. And one of the book's main themes is how successful CEOs vary their strategies in response to major changes over time in both the capital and product markets. They adjusted their strategies in response to changes in industry competition and the capital markets. At one point in its history, a company might have succeeded with well-planned and executed acquisitions. But a few years later, in a very different environment, the same company stopped acquiring other businesses and used its excess cash mainly to buy back its own stock.

The main lesson of the book, then, is that the value-maximizing capital deployment decisions depend on not only the internal operations of the company, but also the external environment in the capital and product markets. To me that's where to find the special sauce for creating long-run value. And since Paul was the one who suggested that I read that excellent book, I will start by asking him for his views on the overall process of coming up with the right capital deployment strategy.

Paul Clancy: Greg, I agree that capital deployment and capital allocation are very important and can really determine a large amount of a company's value creation over time. But I would add that operating performance, innovation, understanding your business, and having great strategies all allow you to be better at capital allocation—because they all give you more choices, more opportunities to use capital in a way that creates future cash flow and value.

It's also important to keep in mind that corporate managers are by nature competitive. They are always comparing themselves to competitors and peers—and that kind of competition has been a major contributor to the success of corporate America. But there is a caution here—one that stems from the reality that the typical corporate scorecard usually has a short-term orientation. The metrics most commonly used for performance evaluation tend to be earnings in a given month, quarter or year. But a company's value depends on its long-term cash flow and its return on capital deployed as opposed to its current earnings. Think about companies like Amazon—and it's also true of Biogen, where I work. In such cases, it's easy to see the importance of allocating capital in ways that are designed to increase the long-run stream of expected cash flow, or what I like to call "intrinsic value per share." And when I say intrinsic value per share, I'm thinking about a measure of value that includes not only the next quarter's earnings and cash flow, but also the expected long-run effects of today's decisions to allocate capital. Intrinsic value per share should be the lens that is used to evaluate all forms of capital deployment, including dividends and share repurchase as well as acquisitions.

Viewed in this way, the capital allocation process necessarily involves a rich conversation that draws on practical experience as well as research findings, and it's taking place in a world with forecasts that involve lots of unknowns and unknowables.

Milano: John, as our other corporate representative, do you want to weigh in on this?

John Briscoe: I think companies need to be sure that they're really getting back to the substance of the capital budgeting or allocation process. Is the budgeting process just something that you go through mechanically each year? Do you look mainly at what was invested last year, and use that as your baseline? Or do you really try to start with a clean slate and ask what will generate the best returns for the cash available? And what does your company do when its cash position is not equal to its attractive capex opportunities? Do you simply limit capital investments to your immediately available cash resources? Or do you consider raising new funds?

Although limiting corporate investment to internal funds may not be a

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Paul Clancy

bad way to approach things for many companies, it's not the best way to approach it either. It also may not be the most reliable way to create or maximize shareholder value. If you've got a great project that needs to be funded, the capital markets will be available to you on reasonable terms, provided you do a good job of communicating your prospects.

Milano: Michael, you've spent a lot of time during your career thinking and writing about capital deployment strategy. How would respond to the comments you've just heard?

Michael Mauboussin: I agree with pretty much everything that you, Paul, and John just said, but I'd like to add a couple of things. First, along with my day job at Credit Suisse, I've served as a member of the adjunct faculty of the Columbia Business School for 22 years. And like Paul and Scott, our two representatives from the investing and hedge fund communities, I'm proud to be associated with the program.

Paul Hilal: That's right, I graduated with a JD/MBA in 1992.

Scott Ostfeld: And I was in the JD/MBA Class of 2002.

Mauboussin: Business schools tend to teach strategy in one department and finance in another. So in strategy, you learn about Michael Porter's five forces and disruptive innovation and game theory; and then when you cross the hall and take your finance class, you talk about efficient markets theory and the Black-Scholes option pricing model. But these two disciplines never seem to come together, even though they should be joined at the hip. The litmus test of an effective strategy is whether it creates value—and I too like Paul's term "intrinsic value per share"—and you can't do a thoughtful valuation without understanding a company's strategic position

So, you can't make intelligent capital allocation and valuation decisions without understanding the strategic position of your company and the profitability of

your industry. That's an important message of the Thorndike book, of which I too am a big fan. As an investor, you have to be living at the intersection of these two areas.

Another important message of the Thorndike book, as Greg mentioned, is that the right investment and financing strategy varies with time and circumstances. And for that reason, I think the best answer to most of the questions we will be discussing today is: "It depends." Is buying back stock good or bad? The right answer is, it depends on a lot of variables—on your investment opportunities, on your current stock price, and maybe even on the tax preferences of your investors. Is an acquisition likely to be good or bad? And the answer again is, it depends on the company's strengths and capabilities as well as the opportunities in the markets. When evaluating companies, the most thoughtful and sophisticated investors try to understand how corporate managers think about these questions, and how likely they are to be thoughtful and judicious as they allocate the capital.

The last thing I'll say here is that there are sometimes major conflicts between incentive compensation plans that are based on short-term performance metrics and the overall goal of long-term wealth creation. As real-world practitioners, we need to address that issue.

Some Historical Perspective on the Corporate Investment Decision

Milano: Michael, you're now working on a big research project at Credit Suisse that looks at corporate investment decisions over a long period of time. Would you mind giving us a brief preview of the main findings?

Mauboussin: We're working on a project now where we have tried to estimate, for every year starting with 1980 through the end of 2013, the total amount of corporate capital allocated to each of the following activities or transactions: (1) M&A; (2) CapEx; (3) R&D; (4) stock buybacks; and (5) dividends. We also looked at divestitures. And we then tried to make sense of the data by tying it to the findings of academics to understand the merits of each of these different investments and distributions of capital over time.

One of our most interesting findings is that the average corporate return on invested capital in 2013 for the top non-financial 1,500 companies—calculated using a measure called Cash Flow Return on Investment, or CFROI—reached an all-time high for the last 60 years. In other words, what might be described as corporate efficiency in using capital is today at record levels. But, at the same time, the growth in corporate assets has been below average for the past ten years. As a result, there has been an unusually large accumulation of cash. In fact, the cash held by the S&P 500 in aggregate was $1.7 trillion at year-end 2013. While about $1 trillion of that cash is offshore, it is still a very large number.

Now, as any valuation model will tell you, value is a function of growth as well as return on capital. And although the high rates of return have been applauded by many investors, our findings raise the possibility that companies could be sacrificing value-adding growth by limiting investment while pushing for ever higher returns. The goal of financial management, after all, is to maximize not returns on capital, but net present values. And as many of us were taught in business school, maximizing NPV means taking not just the highest-return projects, but all projects that are expected to earn at least the cost of capital.

So what does our research say about the relationship between value and growth? Over the years, we have examined the relationship between total shareholder returns, or TSRs, and growth in EBIT. Until quite recently, this relationship had a negative slope, which means that higher-growth companies actually produced lower rates of return for their investors than slower-growing companies. But when revisiting the study last year, we found that the relationship had turned positive. And at the moment, the companies that are growing fastest are also getting the highest TSRs.

John McCormack: When was the inflection point, Michael?

Mauboussin: Probably in the last 4 or 5 years, basically since the financial crisis.

Another interesting observation from our work is an apparent change in the market's response to M&A in recent years. Past academic studies of corporate M&A have suggested that as much as 70% of deals not only fail to create value for the acquirer, but actually end up reducing its market value. But according to our survey of more recent work, that ratio has now fallen below 50%. In other words, a majority of deals now appear to create value for

I've spent much of my career criticizing companies for an excessive focus on growth and too little attention to returns. But with our latest report, I now find myself in this weird situation where I might begin arguing the opposite. The case of Amazon.com is especially interesting to me because it's growing rapidly off a large base. What that suggests to me is that the market may be saying that it's no longer high returns on capital, but rather growth, that is the scarce commodity investors are willing to pay up for.

Michael Mauboussin

acquirers. And when you control for the size of deals, the type of transaction—that is, cash versus stock, small deals vs. large, and so forth—you can really get to a very high batting average.

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Milano: This may be a reflection of the success and influence of value-based management thinkers who have been pushing companies to focus more on returns, which may have caused the pendulum to swing too far in discouraging unprofitable growth.

Mauboussin: There are a lot of other factors, too. Technology, education, and more effective compensation schemes since the 1980s have all likely played some role in this shift.

Milano: The recent financial crisis created a level of fear and discipline that didn't exist previously. As a fairly direct consequence of that experience, many companies today have higher hurdle rates now than they did before the crisis—and they worry more about "execution" than about investing in their future. That's all great but when you take that to an extreme, you end up with just a few really good projects and you keep accumulating cash you don't know what to do with. If everybody does that and just keeps paying out cash as dividends and buying back shares, then what happens to society's capital? It's got to be invested productively somewhere. And I for one have been arguing for a couple years now that many companies could increase their values by investing more, even if that means lowering their returns on capital.

M&A Strategy

Milano: But let's turn now to one kind of corporate investment, M&A. What kind of industry factors make for a better acquisition process? Does it seem to matter whether an industry is growing or not growing, whether it has high returns or low returns? Is there a particular type of company or type of industry where acquisitions are likely to be better? Michael, can you summarize what the studies tell us about these questions?

Mauboussin: Well, let me start by mentioning a book that came out last year called "*Masterminding Deal Breakthroughs and M&A Strategy and Analysis.*" The authors looked at several categories of deals and assessed M&A results. Interestingly, they found that when two declining companies in the same industry get together, that actually tends to be a good merger and creates value. That's what people refer to as an "industry consolidation." The authors' second category of profitable deals are "bolt-ons" and "line extensions." But, when you start getting into new markets you've never been in before—what some people like to call "strategic" deals—acquirers tend to have a very low batting average.

Now, in response to your question about particular industries, although I don't have specific answers, I do think there are some findings that can be applied to the kinds of deals that take place in certain industries. As I just mentioned, the overall returns to acquirers, although historically negative, have improved in recent years. And we have pretty persuasive evidence that the type of deal matters. For example, studies have consistently shown that acquisitions financed with cash tend to receive a much more favorable reaction from the market than those that offer stock. And those that offer to pay higher premiums over market, as one might expect, tend to get less favorable reactions.

So, there are a number of characteristics of M&A deals that can help predict success or failure from the vantage point of the acquiring company's shareholders.

Clancy: I think the studies also show that a series of smaller deals tends to create more value than one large deal.

Briscoe: That's true. But I'm sure there are some large acquisitions that have turned out well. It's just that there tends to be so much management distraction with really big mergers that investors tend to be skeptical, and rightly so. And the distraction's not just at the executive suite level, but it cascades down through to the line managers. People are unsure whether they are going to lose their jobs because of the cost savings effort.

Clancy: Divestments create a lot of value, too. You're getting rid of this nuisance.

Briscoe: Yes. I just think people underestimate the impact of the management distraction. That doesn't mean that you can't do things to try to mitigate that risk. You have to recognize it up front and then try to put in place things that will limit that because you've done it a lot. I've been part of two organizations where we did a lot of acquisitions, as many as 40 of them—and we got pretty good at taking these companies and folding them into the larger company. And in all but a handful of cases, things have worked out well.

Mauboussin: John—and you too, Paul—from your corporate vantage point, do you think the M&A investment opportunity set today looks better or worse than it did say five, ten, or 15 years ago?

Clancy: On the whole, it looks better. But, as you say, Michael, it depends; you can't generalize too much. Take the conventional academic wisdom you just cited that two thirds of acquisitions historically failed to create shareholder value for the acquirer. We devoted a lot of time to research that question last year, which included taking a careful look at the McKinsey study that was done over 20 years ago. When you actually parse the data, a couple of really key things came to light. One is that there is a huge difference between acquiring businesses you're already in and those that are not related to your core; acquiring unrelated businesses is almost always viewed with skepticism by the markets, while business add-ons and extensions are often well received. And we also find significant differences between the profitability of larger acquisitions and smaller deals, which are usually easier to integrate.

Milano: Companies usually justify acquisitions on the basis of cost-cutting synergies rather than growth synergies. Our research on acquisitions over the last 15 years shows that companies that experience higher growth rates in the years after an acquisition than in the years leading up to it have better share

price performance around the time of the acquisition. But having worked for an investment bank, I can tell you that all the pitch books were focused on cost synergies with almost no emphasis on extra growth.

Mauboussin: Well, M&A has been studied at least 10 different ways over the last 40 years. McKinsey did a survey in which they asked executives about cost synergies vs. revenue synergies. They found that, in a decent percentage of the cases, the companies nailed their cost synergy numbers, but very few got their projected revenue synergies. So, investors are still a bit skeptical about growth synergies.

Milano: I'm not sure that "growth synergies" is the right way to characterize my point. The real story is that there is a big difference between buying a company that's stagnating just to take out costs, and buying a company that has growth opportunities that can be funded and their potential realized. A big acquirer can take a small acquisition and grow it to three to five times its previous size in a few years—something the smaller firm could not have done alone. These are often the best acquisition strategies as long as the purchase prices can be kept within reason.

Clancy: Conceptually, then, that means that some companies are better owners of assets than others.

Milano: Right—and some companies are just better acquirers than others. Some companies are better at finding, negotiating, pricing, and closing deals—and after the deals close, better at executing and realizing the expected benefits. One of our Fortuna studies has shown that the more frequent acquirers deliver better share price performance. And I think that a lot of it is just practice: you get good at something that you do over and over again.

Investors' Take on Capital Deployment

Milano: But let's turn now to investors' perspective. Paul and Scott, when you look at a company, what do you think of the quality of the capital deployment choices? What are the attributes of companies that make good decisions? What causes other firms to make poor choices? What do you think companies should be doing differently than what they're doing now?

Hilal: Each of the alternatives for excess capital—capital expenditures, acquisitions, return to shareholders, and repayment of debt—can be either an excellent or a poor use of cash. Investors tend to worry least about capital expenditures. But the expected return from an acquisition is not only uncertain, but reduced by the competitive price the acquirer must pay for the target. By contrast, companies can capture excess returns from internal capital projects without having to invest at market-competitive prices—because the opportunity is captive. They can invest in these projects at cost, and earn return well above market returns.

But having said that, I think there are some problems with the corporate capital allocation process. During the budgeting process, CFOs receive a menu of capital project proposals. If the people developing these opportunities—whether they are new business development executives in a capital-intensive industry, or internal efficiency-focused six sigma teams—know that the hurdle is 12%, they will find opportunities that clear that hurdle, develop them, and present them for funding. If the CFO raises the return hurdle to 14%, those same people won't waste time developing 12% projects. Instead, they will keep looking until they find projects that return 14%—and they will ultimately find them, or at least innovative ways to squeeze 14% returns from a 12% project.

In this sense, then, CFOs get from their teams the capital projects they settle for. If more CFOs raised the bar, they might be surprised by the better opportunities they get.

At the same time, though, I also often see managers struggle—and this is a different problem—to balance rates of return and growth. At a Bernstein conference I attended recently, the CEO of one of the presenting companies explained that their capital projects have required rates of return that range from 12% for ultra-safe capital projects to 20% for more risky ones. One of the people in the audience asked, "Given how strong your rates of returns are, and the wide margin by which they clear your cost of capital, have you considered lowering your bar a little bit to accelerate growth?" The executive said, "No, we're happy with our hurdle rate where it is." He later conceded that this was based on a subjective feel for running the business, and was not the output of an intellectual framework.

And in fact, very few CEOs and

If I were given the chance to offer one prescription to all companies, it would be that managements should take a strategic view of the company's businesses that is dynamic—that is, subject to the possibility of continuous change. Companies need to monitor their businesses, and revisit the logic for continuing to hold them, on a regular basis.

John Briscoe

CFOs seem to have a framework for deciding where the bar should be, and how to balance growth and returns on capital. Without such a framework, managers just respond to the incentives that are presented to them. Incentive design is a prime area for improvement in public companies.

Milano: Scott, what's your response to what you've heard so far?

Ostfeld: First of all, I thought Michael's comments on strategy and capital deployment were extremely well put. And to just build on that, strategy is inextricably tied to capital deployment in the sense that if you're a "commodity" business with no really compelling comparative advantages, all that matters is how you deploy capital; that's really the only way you can add value. But if you're a business that actually has a strategic advantage or competitive advantage that you want to exploit, then capital allocation, while still meaningful, may not be as critical.

But let me go back to Greg's earlier question about what tends to go wrong. We often find managers choosing what they believe is the "shareholder-friendly" thing to do, but what is in fact not the value-maximizing alternative. Many managers view themselves as operators, not capital allocators or value traders; and when they see a business with subpar margins or returns on capital, their normal response is to "fix the business." The problem, however, is that "fixing" such subpar businesses often requires capital expenditures that cannot be economically justified, and that end up destroying even more value. These are often the kinds of businesses that should be denied capital and sold or exited in some way.

We run into this tendency to throw capital at failing businesses all the time. And that's why we so often find ourselves advocating strategies of what we call "addition by subtraction." By exiting a failing business, you not only liberate capital, but you avoid the drag of a failing business on management's time and focus. And that's why an event like a sale of a business can cause us to upgrade our rating of an entire company.

Milano: Our research supports this. In a study we did a few years ago, we looked at total shareholder returns of the S&P 500 companies over a ten-year period and found that the median top quartile

company created twenty times as much value as was destroyed by the median bottom quartile company. Now, imagine if those two companies represented two different divisions of the same company. In that case, the corporate leaders would be better off selling the losers for 50 cents on the dollar and focusing their attention on creating every drop of value in the winners.

Briscoe: To put that same thought another way, management teams tend to focus on execution. That is, they focus on doing things right rather than doing the right thing. They try to keep doing what they have been doing for the last five years very well. What they generally fail to do, however, is to have a strategic brainstorming session about what they should be doing, and indeed about what businesses they should be in.

If I were given the chance to offer one prescription to all companies, it would be that managements should take a strategic view of the company's businesses that is dynamic—that is, subject to the possibility of continuous change. Companies need to monitor their businesses, and revisit the logic for continuing to hold them, on a regular basis, especially in very cyclical businesses like energy, where things can change so quickly and dramatically.

Hilal: There are a number of common themes one finds at companies that struggle with capital allocation.

One is the background of CFOs. Some CFOs come to the position because they started out as CPAs—and they may have been the company's auditor before becoming a controller. The problem with this is that such people often don't get much formal training in finance or investing; and as a result, they tend to think more in terms of accounting profits instead of focusing on creating shareholder value. And this problem persists and is reinforced because too often these CFOs are evaluated—by their compensation committees and their CEOs—based on EPS accretion rather than value creation.

The other big problem in my experience is the so-called "agency" problem, the loss of potential corporate value that arises from the reality that, for most senior executives, their annual compensation package is more material to them than the appreciation of the equity they already hold. If the incentive package is not appropriately designed, the executives' focus on maximizing incentives rather than the value of their shareholdings can lead to perverse outcomes.

I recall talking with one CFO who believed that his company's stock was significantly undervalued, and that he had no material high-return uses for his surplus cash. He believed this with conviction—and while I know that's a pretty common belief, this guy had fairly specific and plausible reasons supporting his belief. And my advice to him was to use his considerable spare debt capacity to promptly repurchase a substantial percentage of his company. I explained that a self-tender could be the best way to carry out his strategy.

But he didn't see it that way. His reaction was, "Well, I could do that, but if instead of levering to do a self-tender, I repurchase shares gradually over the years, I can enjoy a long-term earnings per share growth tailwind, and I have the flexibility to repurchase more shares in those quarters where I am concerned about hitting my EPS target."

But that was not, of course, the way a value-maximizing manager—or investors like us—would view the situation. I asked him to pretend that he owned the whole business—that it was all he owned, and that it is what his whole family depended upon. Under those assumptions, he would be evaluated not on whether he showed smooth earnings growth, but on the value of his equity in 20 or 30 years. His response was that, although he personally understood the benefits of such a strategy, he didn't feel that comfortable pursuing such a plan because his shareholders might not approve.

Chew: What you might have told him, Paul, is that he wouldn't have to worry about his shareholder base because it would have changed as a result of the transaction. That's what happened when Sealed Air borrowed 90% of its current market value back in the late 1980s and paid it out as a special dividend. In that case, the shareholder base almost completely turned over. In place of the widows and orphans—and the pension funds that invest much of their money—who were relying on dividends, hedge funds like Tiger Management lined up to buy their shares. And after turning the capital structure upside down, the company made remarkable improvements in operating performance—in part because they had to service debt, but, more importantly, I think, because management, together with the hedge funds, now had large equity stakes in the business.

Hilal: That's a perfect illustration of the point. The CFO in my story said that he liked his shareholders and didn't want to alienate them, and that they liked a predictable story. If you're beholden to shareholders who for some reason want a smooth EPS trajectory, you'll get one set of shareholders. But if you demonstrate that you will predictably act to increase shareholder value, you will get a different kind of shareholder—and, in my view, a more sophisticated investor that will be capable of assigning higher values to your shares. But I didn't persuade him.

Chew: In my experience, most managers think that their shareholder base is a given; it's something they're stuck with and have no way to influence or change. They inherit their shareholders with the job, and they have to support that constituency through thick and thin.

Hilal: Precisely. Not many CFOs are interested in the turbulence that comes with a turning shareholder base.

Clancy: When talking about this question of investor clienteles, I think it's important to distinguish between the habits and preferences of individual shareholders and the process of shareholder value creation. People tend to confuse the two. Individual shareholders are, of course, human beings with all the strengths and limitations we expect of them. Many shareholders, for example, have really short time horizons, much shorter than the planning staffs of most corporations. But many other shareholders buy and hold. Some shareholders want dividends, while others favor growth through acquisitions. And some want share repurchases.

But underlying all these differences, the most fundamental demand by investors as a group—what we refer to as "the market"—is for the creation of shareholder value. And as Michael reminded us, the best way to create shareholder value is to follow the NPV rule: take only those projects that are expected to earn more than the cost of capital. And make sure that your existing operations earn at least the cost of capital—and for those that can't meet that standard, then be prepared to shut them down or sell them to another owner that thinks it can.

By following these principles, companies have the best chance of maximizing their "intrinsic value." In the end, that approach is likely to drive the most value. Of course, in some cases even well-thought-out strategies don't work out—and well-run companies can fail. But, in my view, the most reliable way for companies to achieve long-run success is to use the value creation principles at the core of finance theory to drive both current performance and continuous innovation in the business.

Briscoe: I agree completely, Paul. Companies ought to focus on how to create the most value and not on keeping their current shareholders happy. If you focus on how to create the most value—and you do a reasonably good job of explaining your approach to the investment community—you will find shareholders who appreciate what you're doing and want to buy your shares.

Michael mentioned the importance of aligning management's interest with shareholders.' Companies should ensure they have a compensation plan in which managers cannot win unless the shareholders do. To me, a system that rewards corporate managers for meeting or beating EPS targets is almost certain to lead to some kind of accounting manipulation. There are just too many ways to create earnings that don't end up increasing cash flows or long-run value. You have to find performance measures that show where capital is either generating cash and high rates of return—in some cases, measured after depreciation, when depreciation is a real cost of the business; in other cases, before depreciation and R&D, when such expenses really represent an investment in the company's future. The stock price of Amazon.com, by the way, represents the best illustration of the market's ability to make that discrimination that I can think of.

Milano: I think that much of corporate America's capital budgeting mistakes can be attributed to the law of unintended consequences. Most corporate managements set out to do the right thing by their shareholders—but then they often get side-tracked by relying on proxies for value that end up misleading them into bad decisions.

We did some work for a very large company that was earning very high rates of return on capital. We evaluated corporate-wide and divisional performance, and we were shocked by the low rate of reinvestment in their highest-returning business. When we asked management about it, we were told that there were no more promising investment opportunities in this business.

But we found that the compensation plan was driven by how much you could *increase* the return on capital. This meant

If you have a great capital allocator sitting at the top of a company, then you don't need the constraint of dividend payments to help make them avoid negative-NPV investments. In that case, I agree that an opportunistic capital allocation approach is the right way to do it. Let the Warren Buffetts of the world continue to hold on to their capital and use it at their discretion.

But there are a lot of companies out there where this model won't work, a lot of companies that benefit from the discipline of either high leverage, or paying out capital on a regular basis in the form of dividends. If what I was saying was wrong, the business model of hedge funds like Pershing and Jana would not have produced the high returns and attracted as much capital as it has.

Scott Ostfeld

the best-performing business with, let's say, a 40% return on capital would be better off only if new investments yielded more than 40% to bring up the average. But in the other businesses that were earning only, say, 10%, they could invest in 15% projects and bring up their average returns.

So the company was turning down 35% return opportunities in one area while investing in 15% projects in another. At the same time, the company just kept piling money into buybacks and dividends. They were not thinking like owners.

Chew: What they needed, Greg, was our old EVA financial management system or

something like it. That way, all the divisions would have had incentives to take all projects that earn more than the cost of capital. Even though it's been many years since we both worked at Stern Stewart, I still think EVA is as good a single period measure as you can find.

Briscoe: I'm a fan of EVA, but I don't think that you can depend on just one metric applied in exactly the same way at every company. You have to create different flavors for particular companies. You need to be able to measure performance internally so that line managers can understand how their performance affects the whole. And you want the line managers fully aligned with both senior managers and shareholders.

Mauboussin: Do the investors in this group agree with that? And have you seen companies with really well-designed compensation systems?

Hilal: I agree completely with what John just said about educating the team further down the line. The CFO can fund only the value-creating projects that are presented to him or her. Employees who don't understand shareholder value creation can't be expected to do as good a job spotting value-creating opportunities. As a result, the quality of the capital projects presented to a CFO will suffer if the team below isn't properly trained.

A good example is the rail industry. One of our big investments is in Canadian Pacific, which is an enormously capital-intensive business—railroads typically spend as much as 18% of revenue each year on capital projects. One way that the new CEO of Canadian Pacific has helped improve performance is by educating the team all the way down the line on what return on capital means. He starts with broad company addresses to groups that include the employees from all levels at the company. To illustrate the concepts, he talks about a hypothetical lawn-mowing company that people can easily imagine. Using that company as an example helps each employee develop an intuitive feel for the cost of capital and shareholder returns. He likes to talk, for example, about "sweating the assets." This education has a very powerful effect on behavior.

So, I'm a big supporter of John's point about the importance of driving education and incentives down through all levels of the organization.

Businesses with Different Time Horizons

Milano: Paul Clancy, you're in a business that, at least on the outside, appears to behave an awful lot like the situations we're talking about; it produces a large and fairly stable stream of cash flow. But you also have another part of the business where you're trying to develop future value from your research. It may be hard to manage business activities with payoffs far in the future using the kinds of tools and incentives discussed here. How do you cultivate a value mindset in such businesses?

Clancy: You have to tailor your performance evaluation and compensation systems for businesses with longer payoffs and time horizons. But you also have to impose some discipline on capital spending, even in R&D. Over the last 20 to 30 years, the pharmaceutical business has shown that within the same industry some firms can produce very high rates of return in R&D, while other firms can end up wasting large amounts of capital.

Why does this happen? As companies get bigger, there is a well-known tendency for bureaucracies to develop that, once they get established, can be very hard to manage. Bureaucracies have proven to really impair the scientific discovery process.

For us, R&D decisions are bigger decisions than many acquisitions or share repurchases. Over the course of five or ten years, the deployment of capital to R&D is often larger than the return of capital to shareholders or acquisitions. So, it is the crucial determinant of value creation. And when assessing R&D expenditures, you have to have a multi-year time horizon—and you must take a portfolio approach since a lot of the projects are not going to come to fruition.

One of our strategies is to identify as quickly as possible the projects that aren't going to work and then shut them down. If done right, that process alone can create meaningful shareholder value. The choices you make are so early in the process that you really need to make those decisions based on science—because at that point the financial projections are so uncertain. At this stage, you can't really put together a model of probabilities and say this is the NPV. We do some financial calculations, but the approaches are very probabilistic; they're based on thinking about a number of different scenarios, and trying to assign probabilities and cash flow outcomes to each of them.

Milano: So R&D is so early in the production process that you have to make decisions based on science rather than projected cash flows, right?

Clancy: We still maintain some guardrails that are tied strongly to an economic model. I think most companies have seen that when you do scientific work in areas that you actually know about, you have a higher chance of success. It's when you stray in the pursuit of diversification—and this is true not only of R&D projects, but also acquisitions—that companies generally don't make wise or informed decisions.

Briscoe: But it seems that ultimately the present value of future cash flows still applies, even if a little bit differently in different industries. In some cases, the cash that you're investing may not pay back for years, while in others you may generate cash returns almost immediately. But that said, I think you're always going to end up in a better place with tweaks and adjustments to performance measures that are designed for the particular industry.

Stock Repurchase: Buying High and Selling Low

Milano: Ok, we've spent a good deal of time talking about corporate investment decisions. Let's now discuss how companies decide to distribute capital, either through dividends or stock buybacks.

First, can someone tell me why companies spend four or five times as much on stock repurchases when their stock is expensive than when it's cheap? The S&P 500 companies spent over half a trillion dollars buying back stock in 2007 and they spent about a quarter of that buying back stock in 2009 when the market dropped in half. It should be the exact opposite. How many managers of public companies are thinking like owners and about NPV and intrinsic value per share when making these decisions?

Michael, you've done a lot of work in the behavioral economics area. Is there any role for management "irrationality" in explaining corporate buybacks and M&A?

Mauboussin: Well, let me start with the simple point that companies tend to buy back shares when they have lots of cash, and that tends to be when earnings and stock prices are at relatively high levels. But when their stock prices are low, their earnings and levels of cash also tend to be low—and so they're less likely to buy back stock when you might think they should.

And the same thinking applies to M&A. Managers are likely to fail to seize opportunities during deep bear markets because they, like investors, are scared; and when you're scared, the natural response is to conserve capital.

But having said that, I also think that executives effectively make a distinction between dividends and buybacks that I'm not sure they are aware of making. CEOs try very hard to avoid cutting dividends, even in downturns. And they are also pretty reluctant to cut capital expenditures. So, with dividends and capex both pretty much fixed, that makes share repurchases a "residual." If we've made our investments and paid our dividend, and we still have some money left over, then we'll consider doing a share repurchase.

In 2009, corporate managers were scared like everybody else. With cash levels then relatively low, very few managers were prepared to do buybacks. And the opposite is true during good times when residual cash is higher but, unfortunately, so are share prices.

Milano: I like to call that the "pecking order theory" of capital deployment. Companies do buybacks only when they have nothing better to do with money, which tends to be when you're producing more cash, which also tends to be when your share price is high.

Ostfeld: That's true of cost cuts, too. You generally get massive cost cuts only when revenue drops. Why? Because management psychology and confidence can matter a lot. We like to say that corporations are momentum buyers. It's the confluence of higher cash levels, confidence in your own business, and good feeling about your external environment that drives companies to buy and invest—and the price becomes almost irrelevant. The record for stock buybacks was set in the fourth quarter of 2007.

But after the financial crisis set in, the buybacks stopped—and dividends became the main if not the only way to pay off excess cash.

Clancy: Michael, what do you think is the best way for companies to think about the question of dividends versus stock buybacks?

Mauboussin: Dividends can be a positive signal to the market, but if your stock is undervalued, I prefer to see buybacks. There's the possibility of a better rate of

return, and the shareholder can time his or her tax consequence.

Briscoe: But what if you're expecting your dividends to rise over time? Does that change the analysis?

Mauboussin: I don't know if that really matters. If dividends are not paid, or are paid but not increased, then shareholders still own part of a company that is holding on to that cash. And it's the total return—that is, capital appreciation plus dividends—that matters to investors.

Ostfeld: But if you think about the dividend as an investor, you may prefer to get that cash directly because that return of capital prevents managers from wasting the money. And for that reason alone, a growing dividend strategy could result in significant capital appreciation.

Mauboussin: Absolutely. That's Mike Jensen's "free cash flow" theory: paying out money to shareholders in any form prevents management from doing something dumb with the cash.

Milano: There is a difference, though, because you can distribute free cash flow either through dividends or buybacks. And to me the most important difference is provided by all the evidence we now have that companies do a bad job of timing their buybacks, buying when their stock prices turn out to be high.

Mauboussin: I'm not sure I agree with that statement about the evidence on buybacks.

It's important to recognize that stock buybacks are a relatively recent phenomenon; they came about in the early 1980s as a result of a change in the legal and regulatory environment. Until the creation in 1982 of a legal "safe-harbor" for companies buying back their shares, buybacks couldn't really happen in a major way. And this means that we still have only a little over 30 years of history of significant buybacks.

Now the studies of the first 15 of those 30 years showed that buybacks actually added a lot of value for the existing shareholders. But the results have been different for the most recent 15 years. The work I've seen suggests that buybacks are still good for shareholders. But that tends not to be true for companies that do buybacks for the wrong reasons—for example, to offset anticipated dilution from executive stock option grants.

Ostfeld: When we talk about "good for shareholders," are we talking about significant abnormal returns on the announcement of the buybacks, or are we talking about the long-term effects of the buybacks?

Milano: Both, but to me the longer-term effects are more important. And there's more recent data showing that companies that deploy a greater percentage of their cash flow toward buybacks deliver lower total shareholder returns over time.

But I want to go back to this question of bad market timing. At my company, we've come up with a measure we call "Buyback ROI" that quantifies the annualized return of buybacks based on where the share price goes after the buyback. If you buy back stock at 20 and it rises to 25 over the next year, that's a 25% Buyback ROI. By taking this approach over time, with buybacks happening quarterly over a two-, five-, or ten-year period, we see the returns are often quite poor, simply because companies keep buying their stock when it turns out to have been most expensive. The remaining shareholders that don't sell into these buybacks are often worse off.

Clancy: In the last 15 years we had two bull runs each followed by bear markets. Will we see a repeat of that over the next fifteen years or are we going to see something totally different? We don't have as much historical data as we need to draw strong conclusions.

Ostfeld: In my view, all you have to know is that stocks tend to rise over time. If you believe that, then it's axiomatic that buybacks create value in the aggregate, notwithstanding the evidence that they are poorly timed.

Does The Wealth Transfer Matter?

Mauboussin: Okay, but I think we're missing something important here that I want to try and explain. There's a value conservation principle that's very important to keep in mind when thinking about the effects of buybacks.

Here's my point: the value of a company following a payout to its shareholders is the same whether it's a dividend or a buyback. What's different is how shareholders are treated. If you buy back overvalued stock, the sellers benefit at the expense of the ongoing shareholders. If you buy undervalued stock, the ongoing shareholders benefit at the expense of the sellers. Only in the case of a dividend, or a purchase of stock at fair value, do all shareholders get treated equally. Also,

Our average hold at Pershing for our activist investments is about four years, which is much longer than a normal passive institution will hold a stock. When we make an investment, we consider ourselves long-term partners with the company.

In many cases, we have had very open and constructive dialogues with the companies. In fact, they tend to view us as free consultants. They're getting a study from somebody who's got an enormous amount of skin in the game, who is aligned with their shareholders, who will give them advice based on the best interests of the shareholders and who will be around long enough to reap the benefits, or suffer the consequences of the advice. An outside consultant will want a fee and a banker will want a transaction fee. We're not getting a fee from anybody. We just want the shareholders to win. And there are CFOs and CEOs that recognize that and actually welcome the conversation.

Paul Hilal

if you are the shareholder of a company that is buying stock, doing nothing is doing something—increasing your percentage ownership in the company.

So, Greg, I think I'm right when I say that the focus of all of your comments and analysis is on the ongoing shareholders.

Milano: That's right, my focus is on the shareholders that stay with the company, the ones that don't sell. I do care more about the investors that decide to hold my stock than the ones that have sold it. To make an analogy, when I evaluate acquisitions I don't commend management because the shareholders of the company they just bought walked away with a huge gain—even though that might be good for society. I care about what's in it for the buyer's shareholders. And in buybacks I care most about the shareholders that remain.

Chew: But if you take Michael's position that selling shareholders are as important as the existing shareholders, then there's really only one question that matters in terms of whether buybacks are "good for the economy." What you want to understand is whether companies perform differently, better or worse, as a result of paying out all the cash. Was it really excess cash—and did the payouts thus help prevent companies from making bad investments? Or did the company actually have good investment opportunities that the payouts caused management to pass up?

Milano: I agree with you that companies pay out cash because they view it as excess cash; management doesn't see profitable ways of reinvesting it. But our own studies show that in recent years, and on average, the companies that have reinvested a larger fraction of their cash flow have had better share price performance than the companies that reinvest less. And those doing the biggest buybacks tend to reinvest less and their share price suffers. It's as if the buybacks crowd out the investment; it's an easier path to quick EPS growth.

Chew: But could much of the better share price performance reflect the fact that those companies have much better growth opportunities than the companies that choose the higher payouts?

Milano: Possibly—but it could also reflect the growing tendency of companies to pay people for improving their returns on capital. Remember Michael's point that companies are now delivering higher cash flow returns on capital than they have in any of the last 60 years. New investments tend to drag down short-term returns, so less investment tends to boost returns. With the exceptions of a few industries, such as commodity chemicals, we found that the higher the reinvestment rate, the higher the TSR.

So, when you say that buying back stock keeps companies from making bad investments, that will be true of course for the companies that *are* in fact making bad investments. But, on average, we find that those companies that are investing more are delivering better share price performance for their shareholders.

Hilal: That's an interesting conclusion, but, as I think Don was suggesting, you have to be careful about causality. Does the higher TSR result simply from higher investment budgets or greater opportunities, or, maybe from a third factor, the quality of management?

McCormack: Well, take the case of Exxon, which distributes a lot of capital through dividends and buybacks. When the company announced a reduction in its capex last fall, the market reacted negatively. But since investors like Warren Buffett have taken a big stake in the company, the price has regained its ground and more. And I think, as Paul suggests, that investors look at both corporate investment and payout decisions as important indicators of management quality. As Michael suggested earlier, it just depends on the situation.

A Brief Look at Private Equity

Ostfeld: Well, to provide another vantage point to look at this, let's consider the case of private equity. There the idea is that high leverage can add value by forcing management to pay out excess capital while also improving the operating efficiency of the business. And it's easier to make riskier investments for growth when the board and shareholder are one and the same—though the high leverage could discourage you from doing investments with a weak business case.

Chew: But, Scott, the equity in such transactions is also really expensive, don't you think—more expensive than in the case of public companies, with their diversified shareholder base and low leverage ratios?

Ostfeld: I agree that the cost of equity is very high in private equity deals.

Chew: And, in addition to the very high leverage ratios, I think one important reason the cost of equity is so high is that, if you don't have many profitable growth opportunities and you have too much equity on your balance sheet, investors know that there's a good chance that you're going to waste that capital on bad investments. And that's why, for the kinds of low-growth, stable cash flow producing companies that PE tends to invest in, debt is generally a much cheaper source of capital than equity.

Another reason debt is cheaper for PE transactions is that PE firms are really good at managing leveraged capital structures; in fact I would say that managing high leverage is one of the key core competencies of private equity. If one of their portfolio companies gets into financial trouble and needs more equity, the PE firms will often put more into their own deals.

Milano: I too am a big fan of the private equity model, and I agree that it has been a tremendous success. There have been some spectacular disasters, but on average it's been wildly successful.

But I don't think the high leverage model works well for public companies. If you look at public companies and separate them by industry, in all but a handful of industries the companies with above average leverage ratios have lower TSRs. And so, leverage works well in a private company situation probably because of the huge ownership incentives that the managers get. High leverage in public companies does not work so well.

Chew: I agree. Most public companies cannot manage leverage effectively. And the possible downside of missed growth opportunities is typically too high for most of them.

How Do Dividends Add Value?

Chew: But I'd like to come back briefly to this question of how corporate payouts can add value—that is, how they actually increase the expected operating values of organizations.

I think there are two very different reasons why dividends produce higher returns for shareholders. First is what academics call the "signaling" effect. Unexpectedly large increases in dividends are a pretty reliable sign that companies are producing a lot of cash, and that management expects the company to continue generating cash. The second main way that dividends add value is more subtle but also, I would argue, more important. Dividends reflect managers' commitment to pay out excess cash to shareholders, which in return allows them to earn higher returns on the capital left in the business.

If you look at the performance of the world's developed economies for the past 130 years for which we have the data, the highest average stock returns have been produced by the economies whose companies pay out the most in dividends. And it's because of both of those two factors. Yes, they're generating more cash that can be paid out, but there are also forces in those markets that are pressuring managers to pay out the cash. In countries like Japan and Italy, companies have historically paid out very low percentages of earnings—and in Japan, stock buybacks were illegal until 1996. Shortly before the legalization of buybacks, I remember a group of Japanese policy makers coming to our Stern Stewart office in New York to discuss buybacks. And those discussions really impressed on me how "unnatural" it is for a corporate manager to want to return capital to investors, whether in the form of dividends or buybacks. After all, you're taking an asset that is now under the control of management and you're volunteering to pay it out to complete strangers.

But that's consistent with the essential principle of Western market capitalism—that capital belongs to the investor. And in that view, any dollar that gets paid out is really in some sense a sign of management's commitment to efficiency. Managers know they work for the shareholders, so they pay it out if they don't have a great investment opportunity.

McCormack: Perhaps the clearest example of this principle at work today is the case of energy master limited partnerships, which are pass-through organizations that pay no corporate income taxes. To maintain their tax-free status, MLPs have to pay out at least 90% of their earnings. So where do they get the capital for growth? The answer is that most MLPs have been low-growth, steady-state enterprises that don't require much capital. But there is a small but steadily increasing group of "growth MLPs" that pay out 90% of their earnings and then, in the same year, turn around and issue equity for roughly the same amount of the distribution—and to many of the same investors.

This is a lot like how U.S. public utilities operate, paying out large fractions of earnings and then coming out with large secondary equity offerings every

couple years. And I can very clearly remember Don's and my old boss, Joel Stern, saying that this practice makes "no sense at all." In Joel's view, companies should never pay dividends because you're just putting it out with one hand and taking it back in with the other, and the only parties benefiting from the process are the bankers that underwrite the equity issues.

Well, to me the answer to Joel Stern's conundrum is the success of today's growth MLPs. The MLP practice of annual distributions and roughly comparable equity issues is essentially a governance mechanism—it's one that says that if you make a dollar and agree to pay it out in dividends, then you will get it back the following year. And this mechanism has proven to be very productive—investors have shown themselves willing to assign very high values to these MLPs because they know they have complete control of those dollars.

Briscoe: The MLP form works because it's an expression of commitment. It also gets management laser-focused on maximizing cash flow.

And I agree with both you and Michael that dividends impose taxes and transaction costs on companies. But one important practical reality is, if you're a company that could pay dividends and has chosen not to do so, there is a subset of shareholders that will not invest in you. So, paying a dividend does open up a pool of investors that otherwise would not consider you.

Mauboussin: Well, the market capitalization of the S&P 500 is around $17 or 18 trillion. And if you add in all the other U.S. companies, there's a couple trillion of market cap out there, and I find it hard to believe that a well-run company won't find people who will want to buy its stock if it doesn't pay a dividend.

Briscoe: Well, that would mean turning away a certain set of our shareholders, and I'm not sure that we can get comfortable with the idea of doing that.

Clancy: We are one of the eight companies in the S&P 100 that are not paying dividends. We haven't paid a dividend because we haven't reached the level of product diversification that we'd like. I agree that paying a dividend can add value by getting excess cash off the balance sheet. Permanent excess cash on a company's balance sheet is generally invested at low yields, thereby eroding value. But I think management should have the discipline not to waste cash flow. Dividend-paying companies can make bad investment decisions, too.

Hilal: Paul, I want to expand on your point. Years ago, investors would look to regular dividends as a disciplinary mechanism for management teams that might run off the rails. But, in the recent decades, engaged shareholders like JANA and Pershing have helped management stay focused on shareholder returns. As these engaged shareholders exert greater influence, there is less need to rely on the regular dividend to maintain discipline.

Chew: Have you ever suggested to a company that they cut their dividend and reinvest more of their capital in the business?

Hilal: Yes. And I think that if you have a good management team—or one that is at least responsive to shareholders' concerns—then I don't think you need to have a regular dividend to constrain them. As an investor, I'd much prefer that companies pay no regular dividends, but rely instead on opportunistic share repurchases and special dividends

Chew: Do you feel that these companies are missing investment opportunities because they insist on paying the dividend?

Hilal: Yes, that's one concern. Or they could be missing share repurchase opportunities. If a company has a big dividend and their stock happens to be unusually undervalued at that moment, they can't buy back as much as they would otherwise because they have to fund this dividend. Or they may miss a big acquisition opportunity.

Another important consideration with dividends arises from the fact that a lot of these institutional money managers manage wealth offshore as well as onshore. And because dividends paid to offshore shareholders are subject to withholding tax, offshore LPs end up getting less of every dividend dollar than domestic shareholders. So that's another reason to cut back on dividends.

Clancy: In practice, regular and special dividends aren't mutually exclusive; companies could do both.

Ostfeld: I want to take the other side of this argument about the role of dividends. I agree completely with Paul Hilal's statement that if you have a great capital

Many companies today have higher hurdle rates now than they did before the crisis—and they worry more about "execution" than about investing in their future. That's all great but when you take that to an extreme, you end up with just a few really good projects and you just keep accumulating cash you don't know what to do with. I have been arguing for a couple years now that many companies could increase their values by investing more, even if that means lowering their returns on capital.

Greg Milano

allocator sitting at the top of a company, then you don't need the constraint of dividend payments to help make them avoid negative-NPV investments. In that case, I agree that an opportunistic capital allocation approach is the right way to do it. Let the Warren Buffetts of the world continue to hold on to their capital and use it at their discretion.

But there are a lot of companies out there where this model won't work, a lot of companies that benefit from the discipline of either high leverage, or paying out capital on a regular basis in the form of dividends. If what I was saying was wrong, the business model of hedge funds like Pershing and Jana would not have produced the high returns and attracted as much capital as it has. If many corporate managements were not doing a bad job of allocating capital, Pershing and JANA would be returning all our capital to our investors.

So there are real benefits to taking that cash on a regular basis out of the hands of management and putting it into the hands of shareholders. Once they have it, they can reinvest it in the economy anywhere they feel the prospects are better. And like Don and John's example of the energy MLPs, I think that investors place a high value on that option to receive the cash and make the reinvestment decisions themselves.

In support of my argument, we have all kinds of data from you guys saying that buybacks and acquisitions in general are done at prices that are too high—and that, in general, R&D in the pharmaceutical space has not generated its cost of capital. Given these kinds of findings, I think dividends are an effective mechanism that generally works to protect shareholders' interests—though not always—by paying out excess cash.

The MLP practice of annual distributions and roughly comparable equity issues is essentially a governance mechanism—it's one that says that if you make a dollar and agree to pay it out in dividends, then you will get it back the following year. And this mechanism has proven to be very productive—investors have shown themselves willing to assign very high values to these MLPs because they know they have complete control of over those dollars.

John McCormack

Milano: But what I see many companies try to do—especially in businesses that have very high returns—is to accumulate cash and then occasionally distribute it in large chunks instead of committing to an ongoing dividend. They usually justify this practice by saying that a regular dividend would chew up 40-60% of their cash flow, which in turn could limit their ability to seize good opportunities later on that might earn three or four times the cost of capital. And because these companies distribute the large chunks of cash almost exclusively through buybacks, the companies create these market timing and wealth transfer problems that we have been talking about. Although I understand the tax issue for offshore investors that Paul mentioned, I also think that special dividends are a woefully underutilized tool. For companies with ongoing uncertainty about their investment opportunities that want to maintain their financing flexibility, you can often get a more balanced approach by paying special dividends from time to time.

Hilal: There is another reason that special dividends are less common. Employee stock option packages adjust the strike prices for some events but not others. For example, if a company spins off a division, the strike price of the options will be reduced pro-rata to reflect the value of the spun-off division. But because there is no such adjustment for special dividends, companies that award a lot of stock options have at least one motive for avoiding special dividends.

Ostfeld: And even if they have the adjustment, they are more likely to use the cash to buy back stock since they get a boost in their EPS, which is typically what drives their compensation in the first place.

Briscoe: Which is why there's a problem with having compensation driven purely off of EPS. The last reason I would want to do a share buyback is because it's going to increase my EPS.

The Market Reaction to Divestitures

Mauboussin: One subject in corporate finance that doesn't receive enough attention is divestitures. What little research there is on the topic shows that divestitures create a lot of value for sellers.

Why is it so hard to create value through acquisitions? I think a lot of that has to do with the reality that it's a competitive sale process; everyone on the outside can evaluate the cash flow and the price tends to get bid up to the NPV neutral or even NPV negative point. M&A creates value in the aggregate; it's just how it's parsed between the seller and the buyer.

Milano: And in a lot of cases, more than 100% of the benefits went to the seller.

Mauboussin: Right, and that's why I think divestitures are so interesting. In those cases, sellers invite others to take a look at them and provide all the information. And because of the selling process, there is a good chance it will turn out to be a winner's curse situation in which someone will bid exactly what it's worth or more.

Briscoe: And that's another reason companies and management teams should take a hard look at all their assets and lines of business and then ask themselves: Are we the highest-valued user of these assets? Do we need to be in this business? Is this something more valuable to someone else than it is to us?

And I think the same thought process should also apply to capital expenditures. Managers often justify low-return capital projects on the grounds that they are "strategic." What this generally means is that management can't justify the investment on the basis of the cash flows, so they will defend it on the basis of an expected increase in market share or on access to new markets. These businesses may have some very good attributes, but they ultimately have to be justified on the basis of cash flows and cash returns.

Milano: That's the opening line of the article I published in CFO! It really bothers me when people say, "You can't use finance to evaluate this project because it's strategic." My response to that is that unless there's a pretty good chance that it will someday become financial, then it's probably not very strategic.

Briscoe: You should always be able to provide numbers for the strategy that you're trying to execute. And you have to do a careful job of weighting the risks to do a good valuation.

Active Investors as Potential Partners for Corporate Management

Milano: Scott, do you ever see corporate acquisitions as a catalyst for an investment, or a reason to become active?

Ostfeld: Acquisitions get our attention both on the acquirer side and the target side. On the target side, we have blocked at least four deals because we thought the target was undervalued and was not getting a fair price, or because we thought the merger strategy of the acquirer didn't make sense. We have also blocked acquirers, although those situations have tended to be pretty complicated. A recent case involved a transformative, cross-border M&A deal that involved a mix of cash and stock by a company that had done only one big deal before—and that deal had resulted in a complete write-off. In my experience, you can usually tell fairly quickly from the outside whether a deal has a high likelihood of success or not. The deals where we've blocked the acquirer were ones where success looked highly questionable to anybody not involved in the deal.

Chew: Scott, do you find a lot of targets willing to accept below market prices?

Ostfeld: Those situations almost always arise from managers' incentives. For example, we have seen a few cases where managers are going to roll their stock into equity in a private deal; and in those cases, they either see the opportunity to be the CEO or to get a big change-of-control payment and maybe retire—or maybe they've just gotten tired of dealing with public shareholders. They may reason that having one shareholder is better than having 1000.

Chew: Lucian Bebchuk at Harvard has a new study that has gotten a lot of attention that shows that the average hedge fund has a longer holding period than the average mutual fund. Does that sound right to the hedge fund representatives here?

Hilal: Our average hold at Pershing for our activist investments is about four years, which is much longer than a normal passive institution will hold a stock. When we make an investment, we consider ourselves long-term partners with the company. We think and act as if we

own the whole thing, and we plan as if we're going to own it forever. We consider each activist investment as part of a growing legacy for creating shareholder value.

Chew: Do you get board seats?

Hilal: Sometimes. It just depends on the situation. And in some cases, we do try to get companies to invest more capital. One example was a tech firm with a very interesting opportunity to buy a company whose growth was expected to be flat or possibly negative over the coming years. Although there were a lot of cost synergies and this company could be bought at a very attractive price, the tech company CEO was afraid the acquisition was going to create a drag on his revenue growth. He was trying to show top line growth for his tech industry shareholders and the other company with flatter or negative revenue growth would have diluted his revenue growth.

We tried to get this CEO to understand that this deal would create shareholder value by raising his returns on capital, and that he didn't have to worry about pleasing the particular shareholders that were focused on revenue growth. But he wasn't responsive to our argument.

McCormack: Paul, the kind of deal you're talking about sounds similar to the strategic change in Morgan Stanley that was reflected in their decision to buy Citi's Smith Barney brokerage. They said, "We used to be a fast-growing business, but now we're making a decision to reduce our earnings growth and take a lot of risk out of the business." And by taking risk out of the business, we are reducing our cost of capital and so increasing the value of the firm—again, while consciously reducing earnings growth.

Before James Gorman took the reins about five years ago, the main focus of Morgan Stanley was matching Goldman's earnings growth. But today, after five years of shifting the business away from fixed income and other trading businesses, Morgan Stanley is getting recognition from the street in the form of a considerably higher P/E ratio despite the slowdown in earnings growth.

Mauboussin: On this question of active investors' time horizon, I think it's also important to recognize that, for activist investors who take pretty large positions, there is a trade-off between control and liquidity. When you're running a diversified portfolio and hence have a fairly small position in a public company, you have high liquidity but basically no control. As head of a corporate division, you have really high control but no liquidity. Private equity has somewhat more liquidity than a manager of a corporate division—and then activist investors are somewhere between public companies and firms owned by private equity.

So, for activist investors like you guys to be taken seriously, you have to say "We're ponying up a lot of capital, we will be significant owners, we will be partners with you for a while. We're not going away tomorrow." Without that understanding, it's hard to exert control that's viewed by corporate management as legitimate and constructive.

Ostfeld: We don't exert control or influence decision-making because of the ownership stakes we have. We exercise influence by offering arguments and proposals that are viewed favorably by a majority of the shareholders. And so we have to come up with ideas that are likely to work over the relatively near term as well as the long run because not every shareholder has the same time horizon. There's a natural governance safeguard in our system against shortsightedness. If all we were doing was coming in and "gutting" companies for the next quarter's gain, then the large institutional investors who often support us would say, "These guys will be gone in no time and will destroy value. I don't want to support them." But that's not what happens. We typically gain the backing of these investors because we have built a reputation for getting their support for advocating sensible, long-term policies.

Chew: But, Scott, as I'm sure you know, what you just said runs completely against the grain of the popular perception of what hedge funds and private equities do to and for the companies they invest in. And based on what you've just told us about your MO—and on Bebchuk's findings that I mentioned a minute ago—it seems to me that the managements of public companies who feel underappreciated by the market should be seeking you out. They should be saying, "We want somebody like Warren Buffett on our board. We want somebody who's going to be a long-term holder who becomes our proxy for the market. This way we won't have to try and reach all those faceless individuals out there. We can talk to somebody who represents the market and has this debate

The kinds of investors who hold your shares can end up affecting your performance and value. And what you tell the market can affect the kinds of investors who choose to buy your shares. If you want to attract more sophisticated and longer-term investors, think about ending earnings guidance and talk about your investing and financing and internal governance policies instead.

Don Chew

about what we need to do in terms of our investment policy."

Milano: Have you ever had a management team come to you and invite you in?

Hilal: We've had management teams that have reacted very positively to our approaches. And I'm sure this has happened to Jana and the other top shelf activists that are known as thoughtful. When such investors buy a stake in a company, we almost always immediately get a call saying, "Come on over; we'd love to hear what you have to say."

In many cases, we have had very open and constructive dialogues with the companies. In fact, they tend to view us as free consultants. They're getting a study from somebody who's got an enormous amount of skin in the game, who is aligned with their shareholders, who will give them advice based on the best interests of the shareholders and who will be around long enough to reap the benefits, or suffer the consequences of the advice. An outside consultant will want a fee and a banker will want a transaction fee. We're not getting a fee from anybody. We just want the shareholders to win. And there are CFOs and CEOs that recognize that and actually welcome the conversation.

Briscoe: And, at that point, the consultants go away.

Hilal: Right. Consulting is very different from investing. Consultants don't have to end up holding the pieces after conducting the study or after the acquisition that failed. Consultants don't have to deal with the integration that was so distracting and destroyed a lot of value. But we as owners do have to deal with these things.

So, we are now more welcome than in the past. But we still have to deal with the demonization of activist investors that Don referred to. And, of course, there's an industry of management defense specialists who want to portray us that way.

Briscoe: But if I'm a CFO, why should I treat any shareholders differently? In other words, I shouldn't care who the shareholder is. If they have even moderately significant holdings, I should be communicating with them. And communication to me means not just telling them what I want to say, but also asking them questions and listening. It should be a genuine exchange of views—and it should be happening with all of your shareholders. They will want to understand your strategy and vision and where you're headed. But I want to hear everybody's ideas and views, even if I don't agree with all of it.

Chew: John, you may say that—and it's an admirable position to start out with. But that doesn't change the reality that probably only about 5-10% of your investors are worth talking to. What do I mean when I say that? About ten years ago an accounting prof at Wharton named Brian Bushee studied all U.S. institutional investors and classified them in one of three categories: (1) "transients," which have lots of small positions with very high turnover and are said to account for about 60% of U.S. investors; (2) "quasi-indexers," which have lots of small positions but long holding periods and represent about 30% of the total; and (3) "dedicated holders," people who take large positions and hold them for a long time.

And, John, if I were making a recommendation to your investor relations group, I would suggest that they spend most of their time trying to identify and make contact with this third group of people. I would also argue that you might be able to increase the value of your shares just by getting them to buy and hold your shares. One of the interesting findings of Bushee's study is that companies with a disproportionate share of dedicated holders have less volatility than companies with lots of momentum types. Companies with dedicated holders also tend to provide more historical, but less forward-looking information (such as quarterly earnings guidance), so companies can influence who holds their shares by how and what they choose to communicate. And perhaps the most interesting finding of all: Such companies were significantly less likely to cut their R&D budgets to meet a quarterly earnings target.

So, my point here is that the kinds of investors who hold your shares can end up affecting your performance and value. And what you tell the market can affect the kinds of investors who choose to buy your shares. If you want to attract more sophisticated and longer-term investors, think about ending earnings guidance and talk about your investing and financing and internal governance policies instead.

Briscoe: I agree with you, in the sense that it's only the third category of investors—the dedicated holders—that will engage in a meaningful dialogue about things that matter, about corporate strategy and financial and governance policies. As for the momentum types and the indexers, you can try to reach out to them, but they do not respond.

Closing Thoughts: Back to School

Hilal: Speaking of dedicated holders, Columbia Business School has a value investing program—and it's an entire curriculum built around thinking about shareholder value. But Harvard does not, nor do Stanford, Kellogg, or any of the other schools. And I think the study of finance would benefit from producing more insight into how value investors do their work, and the kinds of returns they actually produce.

Clancy: It's interesting to me that the University of Chicago's efficient market hypothesis has lived on for such a long, long time. By contrast, what seems ingrained in the DNA at Columbia is that the market can be inefficient, right? If you fundamentally believe it's inefficient, you look for the inefficiencies. Great capital allocators at companies look for those inefficiencies and try to capitalize on them very quickly. That doesn't get taught in most business schools.

Chew: In fact, Paul, I think both schools are right about market efficiency. Our financial markets are intensely competitive, as the Chicago School suggests, so much so that 80% of professional fund managers still seem to underperform the S&P 500 in most years. But at the same time, I think the program at Columbia is right about the existence of these dedicated holders—and right about their methods, and the ability of many of them to outperform the markets consistently. As my friend Ray Ball at the University of Chicago likes to explain this, "This kind of outperformance is completely consistent with market efficiency if you view the theory the way I do—that is, as the returns or payoff for providing valuable information in a highly competitive market." And as Paul Clancy was just suggesting, the people at the core of this Columbia program—the Warren Buffetts and the modern-day Grahams and Dodds—do appear to be providing valuable information to the market—and getting handsomely rewarded for it.

Mauboussin: I'm part of the Heilbrunn Center for Graham and Dodd Investing at Columbia Business School, so I welcome both Paul's and your comments. Warren Buffett has this great line: "I am a better investor because I am a businessman and a better businessman because I am an investor." And I think that is the key to all this. The very successful CEOs

in Thorndike's book that Greg mentioned at the outset thought about the world as investors. They thought about intrinsic and market values every day. It was a dynamic process. They didn't believe they had to grow costs at all or that they had to continue doing something simply because that's what had worked for them in the past.

Milano: Let me wrap this up by first expressing my appreciation to each of you for devoting your time to discuss this very important topic. I have thoroughly enjoyed it. Capital deployment choices are at the very core of strategic planning, and corporate managements who view capital deployment as a byproduct of, rather than as a driver of, strategy may be missing an opportunity to shape their future by withdrawing capital from value-destroying activities and finding higher-valued uses for it. As our panel has I think made very clear, it is quite possible—and in fact it should be considered one of the primary responsibilities of top executives—to use the alternatives for deploying capital we've just discussed to propel strategy and value creation in ways that lead to overall corporate success.

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Information for Subscribers: *Journal of Applied Corporate Finance* is published in four issues per year. Institutional subscription prices for 2013 are:

Print & Online: US$548 (US), US$655 (Rest of World), €424 (Europe), £338 (UK). Commercial subscription prices for 2013 are: Print & Online: US$647 (US), US$772 (Rest of World), €500 (Europe), £394 (UK).
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