Governance Watch™ Webcast #3: What Investors Look for with Respect to Board Governance

Egon Zehnder and The Conference Board Governance Center are pleased to present a new Governance Watch webcast focused on what investors look for with respect to board governance. Boards need clarity and alignment around governance, corporate strategy and leadership.

In this discussion, Mayree Clark, Managing Partner of Eachwin Capital and a Director of the Board of Ally Financial Services talks about her experiences as a director and shares her perspectives as an investor whose approach relies strongly on evaluating corporate governance and leadership. The webcast is moderated by Francisco J. Paret, Leader of Egon Zehnder's U.S. Financial Services Practice, and Douglas Chia, Executive Director, The Conference Board Governance Center.

Douglas Chia: Hi, welcome to another segment of Governance Watch here at The Conference Board presented in conjunction with Egon Zehnder. I'm Doug Chia, Executive Director of the Governance Center here at The Conference Board. Today we're going to talk about what investors expect with regard to board governance. Our guest is Mayree Clark. Mayree is the Managing Partner of Eachwin Capital, an investment management firm that focuses on U.S. public equity markets. Mayree is also a member of the board of Ally Financial Services where she is the chair of the risk management and compliance committee, and a member of the audit committee. Joining us as the moderator of our conversation is Francisco Paret, who is with Egon Zehnder where he leads the Financial Services Practice for the Americas.

Chapter 1: Leadership & Board Governance Drive Performance

Francisco Paret: Thank you for being with us, Mayree. It's good to see you.

Mayree Clark: Happy to be here. Thank you.

Francisco Paret: Very interesting topic to which you bring an interesting perspective, both as a former operating executive as well as an investor and a board member, but for now let's focus on your perspective as an investor. Investors always talk about the importance of strategy and leadership in making investment decisions, but in founding and building Eachwin Capital you actually put leadership at the core of your investment approach. In kicking off today's conversation, tell us about your firm and why you came to this fundamental tenet of leadership and talent as fundamental to your investor view. Then, let's talk about the role of the board.

Mayree Clark: Great. Thank you, Francisco and thank you Doug for having me here. Eachwin Capital focuses on the U.S. markets. We invest in publicly traded securities and as you said, leadership is at the core of what we do. The reason we chose this path is because all of our partners had the experience of being in many organizations and following and watching the activities and results of many different leadership teams. What we found, which is not a novel concept, is that there's a vast difference in performance based on the quality of leadership and managerial actions, and the board itself. I came from an operating background at Morgan Stanley where I ran several businesses. One of my partners was a semi-conductor executive for twenty years, another came from the media industry, and a fourth had a classical investment background. All of us felt that not only is there a big difference in operating performance, in fact the market doesn't fully capture that difference. That is because most portfolio managers don't have operating experience and can't spend as much time on the subject as we do. They are inclined either to be taken in by charisma as is often the case, and there are many examples of that, or they are not willing to fully ascribe a large enough premium to a truly effective team. We felt that that hole in the market, if you will, would create an opportunity for us to deliver outsized investment returns to our clients and that taking this approach would be a wonderful way to screen and find opportunities as well as then to evaluate opportunities and ultimately make our investment decisions.

Francisco Paret: Very interesting. Quite unique in the investment ecosystem I would say.

Mayree Clark: We think so. As you say, many people talk about management, but digging in and learning about the management teams takes quite a bit of extra effort. You can't just listen to them and what they tell you because of course they're selling. As directors we all know that we want our management teams to be selling when they're talking to investors. One of our partners is an ex Wall Street Journal reporter, and he helps us really dig in and find out, what are these management players really like when they're actually making decisions, by talking to people who've been in the room with them when that's happening. Another one of our team members has been a head hunter in the past. Like you, she brought to us the techniques of referencing, which helped tremendously when we're evaluating a management team.

Douglas Chia: Independent investigation, like the journalist you're talking about.

Mayree Clark: Precisely. Yes.

Francisco Paret: Very interesting. Then let's talk about how the board comes into play as a safeguard of shareholder interests as part of this investing approach.

Mayree Clark: The way we think about it is the board sits at the top. It definitely should drive management's approach, if only by selecting the ideal managers. Again, what we find is the business of understanding the board becomes a topic in the investment community typically when there's under performance rather than when there's high performance. We believe that serving on a board is a team sport. What we're looking for is high performance teams. Like any other team there are typically roles and responsibilities amongst the players. The first thing that we look for, of course, is the right players. That wants to be a mix of people with operating experience, often as sitting CEOs, or retired CEO's, but there also should be other disciplines that are represented. For example, you want somebody who has the responsibilities and capabilities of serving on an audit committee. Somebody with a deep finance background, and similarly when you think about the compensation committee, in particular the chair of the compensation committee, it's important to make sure that that person is both unconflicted and also in a position to be able to lead the discussion of how management should be incented. Ultimately, that needs to be tied directly to strategy. We have a number of ways of evaluating the likelihood that the board is doing a good job. We start with: Do we have the right set of players and are they in the right roles? Then, one of the real telltales is what sort of incentive arrangements have they created for management? We believe that you want to marry the investment hypothesis with the assessment of governance.

We want to see the strategy of the company. We want to see it played out well and we want to see that it matches management's incentives, as driven by the board. When you see a set of incentives, and I'm not talking about the amount I'm talking about the structure, that match what we expect management to be doing in order to be competitive and to increase their competitive position, then we can infer, I think, that the board is switched on.

Douglas Chia: You're coming up with a method to try to show causation as opposed to correlation, which is a classic conundrum for anything in corporate governance: to show that one actually leads to the other, as opposed to kind of close correlations?

Mayree Clark: This is the trouble. When you look at these things from an academic point of view you want to be academically vigorous, which leads you into a rules-based approach. A rules-based approach is limited when you're looking at variables that are situational. As we know, from having been around and in this area for a long time, the right board is right for the right situation. You wouldn't want to see the board of BlackRock, to pick one, to be operating a restaurant company and vice versa. That has to do with the maturity of the company, it's place in the life cycle, the industry itself. Many things. The governance itself also needs to play into that. Things like, whether or not there is a poison pill. We own a company where there is a poison pill. We think it's a great thing for that company in this setting, as it is, but that requires digging in and understanding the investment opportunity and marrying that with the governance.

Chapter 2: Investing with a Long-Term View

Francisco Paret: Mayree, you touched a couple of times on the importance of proper alignment with the board and management around strategy. I think it was Ben Graham, seen by many as the oracle of value investing and quoted by Warren Buffet and many others over time, who said that in the short-term the market is a voting mechanism but in the long-term it is a weighing scale, it's a weighing machine. Meaning that in the short-term it's a popularity contest - it responds to momentum - and in the long-term it reflects fundamentals, the underlying reality. You're a believer in long-term investing yourself, but how can boards focus on the long-term direction and strategy of a company and reconcile that with the short-term pressures of the markets' voting mechanism? What's your perspective?

Mayree Clark: It is a conundrum and increasingly so recently, but we believe in building value for the long-term, at least to sustainable-investing; it leads to better outcomes for all of the stakeholders, we think. What becomes important in the short-term is credibility. One of the things we believe is that there are many elements of the management strategy that they may not want to flag for the competition. It's entirely reasonable not to communicate every single element of a strategy and particularly at certain times. Certainly the board needs to understand the strategy though, and support the strategy and oversee the development of the strategy if you will, but typically the strategy itself should spring from management's good thinking, its understanding of the competitive landscape. Its understanding of what the customers need or might need over time. For us, the important thing is the long-term strategy, but then communicating what's going on right now becomes important to bring along employees, many of whom are compensated with equity, and financing sources, both debt and equity. One of the purposes a board can serve is to focus on that balance between long-and short-term, to allow management to have a sounding board to share some of these trade-offs with, but we find over and over again that the best companies are in fact built for the long-term. They understand the patience required for various different investments to play out and they're very conscious about building for the future, and knowing that they have to be able to play for the future - which means they have to be able to be effective over the next six, twelve, eighteen months and so forth.

Francisco Paret: Interesting. From the outside looking in as an investor, how do you know when there is that constructive alignment between the board and management around strategy and long-term focus?

Mayree Clark: The best clue is compensation. We are outsiders. We typically don't interview the board, although we're able to talk to one or two directors for one reason or another, but obviously they have to be careful about what they say to an outside investor; and, today, I think, there's not necessarily a consistent venue for communication between directors and investors. It can be a little bit more catch as catch can. What you can watch is behaviors and those behaviors are manifest in things like the composition of the board, a company that is trying to be forward-looking about the application of technology will often add a member to the board who has those kinds of skills or experiences. Then, the compensation has all kinds of clues in it. There are short-term measures of performance as well as long-term measures of performance in a good compensation plan. Those are spelled out. We like to see some subjective measures of performance as well, because we think it's like anything else that we're talking about. If you have a rules-based system, it can be gamed. We want a board that is capable of making judgments, but the business of communicating what they're looking for through specific guidelines which are available to all employees and also available to shareholders is a very good practice.

Francisco Paret: You point out something interesting. There are not many mechanisms for investors such as yourselves to engage with the board. We're in an era that some would argue has seen a fundamental shift from a perhaps more deferential model of engagement to a more skeptical, shareholder-centric model of engagement that's evidenced by increasing shareholder activism. With that backdrop, how should boards engage with the investment community?

Mayree Clark: Boards should be proactive with investors. There are many different ways to initiate such a dialogue. One can be with one-on-one discussions with individual investors. Sometimes people do a smart thing by bringing a few investors together in a relatively intimate setting where there can be real give and take, but to such an extent where investors can get a sense for some of their own similarities and differences in terms of what they're looking for. Sometimes that can be useful in the company's attempt to communicate what it's doing. Sometimes a longer term oriented shareholder will have some positive impact on a shorter term investor. I'm a believer that the shareholder meeting is not adequately used today, because it was abused by small shareholders over time. The shareholder meeting is a wonderful venue where typically all the directors are present, all the senior management is present. Very few investors take advantage of that.

Instead, what we find is that up until very recently investor relations were relegated to a staff member who reported to the CFO. That person was responsible for coordinating, but also being an important mouthpiece, and often that person has never sat in a board room, as opposed to say, a corporate secretary, who's sat in the boardroom many times, but typically hasn't had direct interface with investors on a regular basis. There's still plenty of room for evolution and raising the bar in terms of how this communication happens. I've been a member of the Shareholder Director Exchange group that set the protocols which has been a progressive suggester of how each side should respect each other. I hope to see more initiatives like that over time.

Douglas Chia: In terms of communicating the long-term view, it's tricky these days to articulate why investors should be patient -- what we call “patient capitalism” -- when you have such pressure for short-term results. How do you see that playing out in today's market place, especially with respect to increased activity by shareholder activists, hedge funds, etc.?

Mayree Clark: Some very good work has been done by a group called Focusing Capital on the Long-Term Initiative. One of the critical points they make is that there are many groups of shareholders who get evaluated on a short-term basis and that leads them to then in turn evaluate management teams on a short-term basis. This is a fairly unfortunate thing, if you will. To me, directors have a fiduciary responsibility to think about value and when you think about value in a big picture way, it's awfully hard to escape the notion that value is not created in a day, and that tomorrow's stock price simply isn't the measure of effectiveness or the driver for building over time. I think directors have a huge responsibility to stand up to the pressure that has been circling. One of the things we talked about a little bit in preparation is that, and it goes back to this notion of a board being a team sport, I've been in boardrooms where one director's advocating short-term performance and another was advocating a longer term perspective.

This can be healthy in that balance that we talked about at the outset, but this notion of how you actually build value in a corporate or large organization setting, it cannot be done overnight. Directors are in a much better situation to understand that than an investment manager with no operating experience. Given that different level of expertise, it's important to own that as a director and as a team of board of directors. That means you do have to articulate both the long-term strategy and the short-term goals in a way that somebody who may not understand the business all that well can learn it and grasp it. That often means repetition. It means patience in the delivery of the message if you will and it's often helped by human interaction, one-on-one, where questions can be asked and answered and there's a healthy dialogue with a respectful attitude on the part of the communicators as well as on the part of the recipient. The communicator has to take the lead. That's why I make this point about investors have to stand up to their roles.

Douglas Chia: It's called “leadership”!

Mayree Clark: There you go. Exactly.

Chapter 3: Engagement Tips from an Investor, and Director

Francisco Paret: Mayree, you started talking about constructive engagement by the board and some of the dynamics in the room, so to speak, at the board table. I'd be interested in your view and how your perspectives and experiences - as an investor inform your mode of engagement as a board director.

Mayree Clark: That's a good question. Thank you. First of all, I've sat in a lot of boardrooms over time and I've seen lots of different cultures. Today, as an investor, because I study boards all the time, that's kind of helpful in understanding the range of possibilities. I definitely try to bring the benefit of that as well as the perspective of an investor to the boardroom. I'm not in a dialogue with all of our individual investors the way the company management is, but sometimes I can provide some perspective that's helpful and understanding this tension between long-and short-term in a very direct way is also helpful. I am the one in the room who's focused on the long-term and saying, don't worry, don't let these people tell you what to do. I know them. We know that we collectively are better than the people who are observing us, so let's do what we think is the right thing.

It also does have some impact on how I think about new board members. Today, on the Ally board we have a fantastic nomination and governance committee. We started as a brand new company that was invested in by the United States as part of the TARP program. We started with a clean slate in terms of a board and then for some period of time the U.S. Treasury had a lot of impact on who our new board members were. It goes back to this idea that it's a team sport. You want to diversity in the team. By diversity I mean both the traditional ways of looking at it and the nontraditional ways of looking at that, a diversity of skill set, experience, and perspective, and increasingly a diversity of long-term view. This notion that I talked about earlier of having, for example, people who are facil with technology and the direction of technology is the sort of thing that you want on a board.

We see it. Three years ago, one of the companies that we own that's in the water treatment business, went out and specifically looked for an expert in cyber security. Really? They were so at the edge of thinking about what they might need and they were fortunate to find a woman who was an Air Force General who had been responsible for the Air Force's approach to cyber security. They took a risk on someone who hadn't been a director before, but she was able to contribute so much to that board that now she's on the board of one of the major banks, where it's much more obvious that they have this cyber security need. Those are the kinds of things we love to see and that I always have in the back of my mind when we were thinking about our own board.

Douglas Chia: Thinking outside the box: something that you guys do in your line of work.

Francisco Paret: That's right. One, we do a lot of board assessment work and many best-in-class boards are really good about asking themselves, what are the questions in the room that we consistently don't have very good answers to? Or where we might benefit from a new perspective to the point, for example, about certain types of operational or existential risks, cyber security, terrorism, technology, digital innovation being examples of such topics. Very interesting. Thank you.

Chapter 4: The Business Model Versus Management Conundrum

Francisco Paret: Mayree, given the fundamental tenet of your investing approach of which you spoke, I'm itching to ask you a question that I think I know the answer to, but it would be great to hear you talk about it. What's more important, the business model or management?

Mayree Clark: That's a great question. We do get asked that frequently. Clearly they're both important. Warren Buffet says that if you encounter a business with a poor reputation and a management with a good reputation, it's the reputation of the business that will win out. That can be true. We certainly are attracted to good business models and, in fact, all talent is attracted to good business models. By watching the talent sometimes you get good clues, but the more fundamental thing is that business models are conceived and created by human beings. They don't spring out of the air. The same goes for moats, defending a moat. That is dependent on the actions of people. We feel strongly that by looking for strong people we will be led to strong business and investment opportunities.

Francisco Paret: Thank you.

Douglas Chia: That's it for this episode of Governance Watch. Thanks for watching and we thank Mayree and Francisco for being here and our partners at Egon Zehnder. We'll see you next time.

boardroom conversations

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