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CASE STUDIES

"Case Studies" presents a case pertinent to contemporary issues and events in investment management. Insightful and provocative questions are posed at the end of each case to challenge the reader. Each case is an invitation to the critical thinking and pragmatic problem solving that are so fundamental to the practice of investment management.

Jack L. Treynor, Senior Editor

BETTING ON MANAGEMENT

At the time it seemed like a good idea to Harley Pinkett, Chairman and CEO of Endless Chain. His executive vice-president and all three group vice presidents had been enthusiastic. The investment bankers who brought the idea to him termed it "bold, visionary" and had called him a "decisive, forward-looking leader" for going ahead. Mary ("Mamie") Persons, the chairman and CEO of Precision Sprocket, was clearly ready to hang up her pedal pushers. But now, three years later, Pinkett was still trying to understand exactly what happened.

Precision Sprocket had a reasonably good track record. And the acquisition had seemed to promise marketing synergies. Who could have foreseen that bicycle chains, which wore out, were sold primarily to repair shops, whereas sprockets, which did not, were sold primarily to manufacturers?

Yet, instead of rising when Pinkett announced the intended acquisition, the share price of Endless Chain had fallen—almost as if the shareholders, most of whom did not know one end of an Allen wrench from the other, had foreseen the problem.

DISCUSSION

Those who make essential contributions to a company but do not want to bear its risks—including the risk of bad management decisions—are looking for a margin of protection. The purpose of a corporation's equity is to provide that margin. In the long run, good decisions do not reduce the equity. But active investors in the company's stock, who determine its value, are often obliged to evaluate management decisions long before the consequences are clear.

It does not, of course, consume equity to make decisions investors like. The problem is that corporate management and the investors use different decision processes. Consider the large, public companies where there is little communication between shareholders who have little say over boards of

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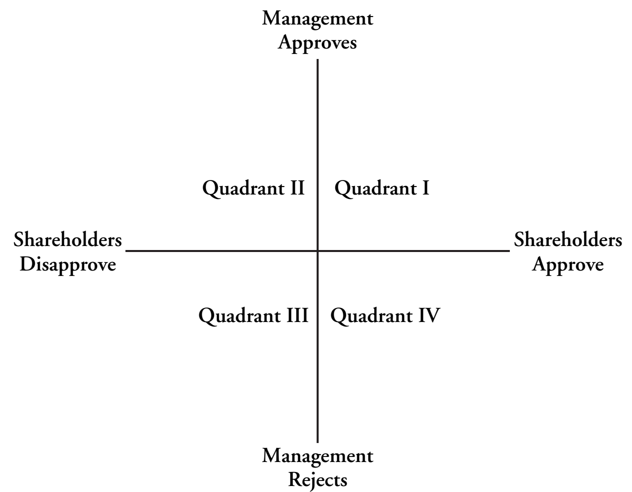
directors, and managers, who own a small fraction of the stock on one hand. There are often thousands of active investors with little or no opportunity to confer, so their assessments benefit from Francis Galton's discovery about independently formed opinions.[1] On the other hand, management is a small, closely knit group with a shared culture, deference to authority—the antithesis of Galton's "crowd."

When management bases decisions on its own evaluations of the gain or loss rather than the shareholders' evaluations, projects shareholders like do not get done; projects shareholders dislike do get done. So share value suffers *two* kinds of damage. Consider the following four quadrants.



(1) *Quadrant I.* Management approves all projects. Shareholder's evaluation can be more or less favorable than management's but is still positive.
(2) *Quadrant II.* Projects management undertakes, but shareholders disapprove. Damaging to share price.
(3) *Quadrant III.* Projects shareholders disapprove, but management rejects. No change to share price.
(4) *Quadrant IV.* Projects shareholders approve, but management rejects. Damaging to share price.

Whereas Quadrants I and II merely confirm shareholders' expectations, Quadrants II and IV are *bad news* quadrants.

Sometimes, however, management knows something the shareholders do not know. Then management can be right even when the shareholders disagree with management. Because shareholders never know how complete their own information is, they have to consider two possibilities:

(1) management is wrong or
(2) it has more information.

They will divide into two groups, depending whether they choose to give management the benefit of a doubt. Some active investors will translate their opinions into action—the first group selling shares, the second group buying—in effect, trading with each other. The skeptics will hurt the share price. When the truth emerges

(1) if the skeptics are right, the price will fall further;
(2) if the skeptics are wrong, it will rise.

The price action will reward one group and penalize the other.

Equity and management's power

When management's decision is actually justified by private information, wealth will transfer from the first group to the second, reducing the skeptics' future influence on share price. Unlike decisions based on public information which, on the average

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and over time, can only be a losing game, private information can consequently be a winning game for management.

We see that, with regard to such decisions, management and Wall Street have conflicting objectives. Every action will generate trading between the skeptics and the believers—and that is good for Wall Street. But only actions justified by private information benefit management.

Note

[1] Bernstein, P. (2000). *Against the Gods*. New York: Wiley, pp. 151–152.

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