A ~~XXXXXXXX~~ QUESTIONNAIRE ON STOCKHOLDER-MANAGEMENT RELATIONSHIPS

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In June 1947, ~~XXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXXX XXXXXXXXX~~., the writers of this report, at their expense, sent a questionnaire to the members of the N.Y.Society of Security Analysts, comprising ~~XXXXXXXXXXXX~~ seven questions on Stockholder-Management Relationships.* A total of 573 replies was received. It is our intention to include the results of this questionnaire in a comprehensive revision of our textbook "Security Analysis", upon which we are now engaged.* The members of N.Y.S.S.A. may be interested in the following discussion of the various questions and of their answers thereto.

**Question 1** -Do you believe that the competence of management is a practical consideration in the selection of securities?

**Replies** - Yes ~~XXX~~ 558
No 14
No answer 1

**Discussion**:-The keyword in the question is "practical". Everyone will agree that the competence of the management has a most important effect upon the success of any stock investment. But can that competence be appraised by a security analyst in such wise as to enter into his selection of common stocks? The analysts themselves have answered overwhelmingly in the affirmative. Clearly, they do try to form some idea of management competence in their practical work of analysing securities.

**Question 2** -Of 100 listed companies taken at random, about what percentage do you think would have a fully satisfactory management?

The replies covered a wide range, and are ~~XXXXXXXXXXXXXXX~~ summarized as follows:

*The questionnaire was sent out at our expense.

| Per cent "Fully Satisfactory" | Replies |
|---|---|
| 0 - 25% | 142 |
| 26%- 50% | 143 |
| 51%- 75% | 140 |
| 76%-100% | 61 |
| | 486 |
| No estimate | 87 |
| ~~Total Replies~~ | ~~575~~ |

The mid-point of the estimates is slightly under 50%.

<u>Discussion:</u> -Most of the analysts were willing to express some idea, admittedly rough, of the prevalence of good or poor management. We used the phrase "fully satisfactory" without explanation. In our view the management would be "fully satisfactory" if no concrete criticism could be offered against it. Those not entirely satisfactory might deserve to be retained, but presumably their methods could be improved upon. The replies show a very wide variation in the view of our members as to the prevalence of "fully satisfactory" managements. Regardless of just how the phrase might be construed, the ~~medium~~ median figure of under 50% would seem to signify that in the minds of security analysts there is wide room and perhaps need for changes in managerial methods or personnel. ¶If the analysts are right on this point, then it would seem that stockholders, as the owning groups, should interest themselves actively in the question of managerial competence. Where it seems to be lacking they should take whatever steps are reasonably appropriate to improve the situation.

In the opinion of the writers, if as low as 10% of the corporate managements ~~were~~ are unsatisfactory, it would mean that the issue ~~was~~ is of real significance in the investment field.

<u>Question 3</u> -Do you favor cumulative voting for Directors?

<u>Replies</u> -

Yes 349
No 169
No answer 55

**Discussion:** Cumulative voting is one means by which a fairly large minority group of stockholders can exercise some part of the managerial function by securing representation on the Board of Directors. A few states - e.g. Pennsylvania, Michigan - have made cumulative voting a mandatory privilege; in most others it may be provided for by inclusion in the By-laws. If the majority view of our members on this point is sound, stockholders would be well advised to move for cumulative voting in their respective corporations. The procedure would be to introduce a resolution to that effect at an annual meeting.

**Question 4** -Do you believe that a majority (or a substantial minority) of the Directors of the typical corporation should be independent of the operating management - in particular, that they should not be recipients of salaries or other substantial income from the corporation?

**Replies** -

| | |
|---|---|
| ~~Yes~~ | ~~291~~ |
| ~~No~~ | ~~80~~ |
| ~~A substantial minority~~ | ~~120~~ |
| ~~No answer~~ | ~~82~~ |
| ~~Total -~~ | ~~573~~ |

| | |
|---|---|
| A majority | 291 |
| A substantial minority | 120 |
| Neither | 80 |
| No Answer | 82 |

**Discussion:**- Critics of our corporate machinery often contend that the typical Board of Directors, while in theory the selector and appraiser of the operating management, does not in fact exercise independent judgment in this field. This is clearly the case where the officials themselves constitute a majority of the Board, or where the majority is made up of themselves and other directors closely associated with them by ties of friendship or function.

Our question proposed a fairly radical solution of this problem, by making the majority of the Board independent of the operating management. As an alternative we suggested a substantial minority rather than a majority. Since three replies were possible, there was a wider distribution of answers to this question than to the others. About half voted in favor of a majority of independent directors, and more than 2/3 preferred either a majority or a substantial minority.

In the writers' opinion, the prevailing view here is eminently sound. It would be appropriate for stockholders to move to change the setup of many corporations so as to provide a majority - or at least a substantial minority - of independent stockholder directors. We do not imply that when the officers dominate the board the result is always unsatisfactory to the shareholders. On the contrary, a number of our most successful corporations have had such an arrangement. But certainly these companies would not have been hurt by the presence of several representative outside stockholders. And many relatively unsuccessful corporations might have greatly benefited by the injection of new and independent thinking into their boards.

On this point we should like to quote from a letter sent us in answer to our questionnaire by a member holding a high position in one of our leading banks:

> "It is my opinion that the primary job of a director is to see that there is good management. If a majority of a board are members of the management, that makes it self-perpetuating and it is impossible to get rid of a management that is bad. I think it is extremely important that a majority of a board should be independent of the operating management. However, they should have salaries in an amountthat would make it possible to attract the right kind of men to those boards and to compensate them adequately for the risks they take as directors. It is becoming more common every day to pay directors salaries up to $5,000 and in some cases as high as $10,000."

The suggestion that a fair-sized annual salary be paid to independent directors was made in several of the replies. Such compensation would ordinarily not be so substantial as to make the directors the equivalent of additional operating personnel.

Question 5 - If a company's average earnings fail to show a reasonable return on the stockholders' equity, and if they are substantially lower than in the industry as a whole, do you believe that this fact calls for inquiry by shareholders?

| | | |
|---|---|---|
| Replies - | Yes | 539 |
| | No | 18 |
| | No answer | 8 |

Discussion: - This question shifts our emphasis from the makeup of the management to measuring its results. If poor management is to be improved upon, it must first be identified as poor. The test given in our question ~~proved~~ affords *prima facie* evidence of the need for improvement. We did not suggest that if the results are bad the managers should be changed - as usually happens in baseball - but only that the owners then proceed to look carefully into the question.

The overwhelming vote in favor of an inquiry by shareholders, in such cases, might seem a bit surprising when we reflect that such action is almost unheard of in practice. In our view this vote is perhaps the most significant in the questionnaire because it highlights the wide gulf between what should happen and what does happen in stockholder-management relationships.

Machinery for ~~the setup of~~ setting up such an inquiry by shareholders is readily available. As in the case of cumulative voting, all that is needed is an appropriate resolution at an annual meeting. The resolution should call for a study of the ~~managerial~~ methods and general efficiency of the management to be made by established experts in the field, who should report directly to ~~the~~ a committee of independent stockholders named in the resolution.

If the security analysts would support stockholder efforts of this kind in practice - as they apparently favor them in theory - it would not be long before this technique ~~was~~ is widely adopted as a means of improving the position of the ~~stockholder~~ ownership interest.

Question 6 -Do you believe that it is the duty of the Directors to pay such dividends, within the average earnings of the business, as will be reasonably commensurate with the intrinsic value of the shares, as they determine such value?

| | | |
|---|---|---|
| Replies - | Yes | 329 |
| | No | 162 |
| | No Answer | 74 |

Discussion:-One source of complaint by stockholders is inadequate dividends. The management invariably justifies a niggardly dividend on the ground that the Company and the shareholders will benefit from keeping the earnings in the business. Our question suggests as a simple criterion of proper dividend action that, where earnings are large enough, the stockholders should receive a dividend commensurate with the value of their investment. Under present conditions, an appropriate rate would be not less than 4% upon such value. Since the latter term is subject to much argument, our question suggests that the Directors form their own idea of the value of the enterprise and then do their best to keep the dividend policy reasonably in line with that value.

A number of replies remarked ~~the~~ that dividend policy ~~you~~ must take into account the Company's financial position and needs as well as its average earnings. This is undoubtedly true. A weak financial position clearly calls for conservatism in dividends. But the real controversy generally arises when the management has expansion in mind. The stockholders might well contend that such expansion would be better financed through the sale of additional stock rather than by withholding dividends, since the latter choice often condemns their shares to both an unduly low income and an unduly low market price. Which policy should be followed to finance expansion will depend on the particular case. But it would be of advantage to stockholders for Directors to be guided by the premise that they should pay a reasonable dividend on the reasonable value of the stock unless compelled to act otherwise by conditions which left them no sound alternative.*

Question 7 -Do you believe that it is the duty of the management to transmit to stockholders any offer to purchase a substantial number of shares at more than current market price?

| | | |
|---|---|---|
| Replies - | Yes | 477 |
| | No | 67 |
| | No Answer | 21 |

Discussion:-One way of improving unsatisfactory management is thru acquisition of control by new interests. They are sometimes willing to pay well above the market for such control, especially since the market might be quite depressed because of the short-comings of the incumbent management. Our members take what seems the obvious view that every stockholder is entitled to decide for himself whether or not to accept such an offer for the shares. Yet managements have been able to find legal sanctions for their refusal to make such offers available to the owners of the business. As in other matters covered by this questionnaire, the difference here between the opinion of the security analysts and what actually happens indicates clearly that stockholders should wake up.

* Cf. The following from the Wall St. Journal of August 7, 1947, in discussing stockholder relations: "Company officers privately tell Exhange representatives that the best stockholder relations are steady dividends at a satisfactory rate" (Italics ours).

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