It's Just Life And Fortune, But It's *Sacred* Honor

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. - John Maynard Keynes

Richard Nixon lied to you. But he betrayed me. - Jerome H. Simons, 1918-2002

None of us can be reminded too often of the things that really matter in life and of just how thin is the line separating us from each other and from eternity. The column I intended to write on the issues of corporate governance and business integrity raised by the conduct of Enron and others took an unexpected turn this past week with the peaceable passing of my father.

That I am motivated to address these issues I owe to his diligence and character, to his love of learning and to his dedication to the principles of freedom and free markets. My father taught me how to think, what to take seriously and what, too, shall pass, and how at all times we must stand for what we believe is right, and to be a *mensch*, a man of honor. In the end, our memory is all we can leave to others. If at any time in the course of all my scribbling I have touched any of you at a level deeper than a trading idea, I have helped carry on the teachings of my father in the manner described so eloquently by Keynes. It is to his memory that I dedicate myself below.

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The Law of Unintended Consequences

I began my career in 1978 as a public policy economist with the Standard Oil Company (Indiana), now a part of BP. One of my group's tasks was to track what we classified as emerging issues, and one of these was corporate governance. The whole issue smacked of an effort by various corporate gadflies to acquire control over a range of corporate policies via the modus operandi of buying a few shares and turning themselves into gigantic pains in the derriere. Or so it seemed. After all, if you owned the shares and were really unhappy with management, why didn't you just sell and get on with your life?

One idea these folks had that made sense was aligning the interests of corporate management with shareholders. By 1978, the stock market was twelve years into a trading range, and many corporate managers seemed insulated from the pain. It was easy to pull out a proxy statement at random and be shocked at how little exposure senior executives had to their company's stock. The solution seemed simple: Pay corporate managers in stock options to provide them with a real incentive to reward shareholders.

Once the massive bull market of 1982-2000 took off, it was pretty hard to sit in the corner office and not collect a huge bonus. Yes, shareholders were being rewarded, and yes, like most traders I don't begrudge anyone their wealth: Chances are they earned it somewhere in their life.

But some of the options rewards were simply from the tailwind of a bull market. During the 1998 Russian/LTCM downturn, many options were re-priced to a lower strike, effectively making the devices a heads-I-win tails-you-lose deal between management and shareholders. By the end of the tech bubble's wretched excess, many of these rewards were ephemeral transfers of wealth from naive investors to equally starry-eyed managers and employees who exchanged a current pay envelope for a risky promise on the future.

A Car Without Brakes

Sharks don't like just a little blood and greedy people don't like just a little money. Wealth should be accompanied by a diminishing return on income – what can you do with $1 billion that you couldn't have done with $990 million? – but that doesn't seem to be the case. On a personal level, I cannot fathom what I would do with the sort of options packages that Disney's Michael Eisner or Citigroup's Sanford Weill have received. When I read about Worldcom's Bernie Ebbers taking out a $183.7 million loan against shares, the only thing I could think is "What does anyone need to borrow $183.7 million for?" In fairness, I'm willing to bet this trio couldn't understand my befuddlement: Of course I want more!

All traders take losses. Only good traders take small losses early. On this basis we can declare our friends at Enron to be bad traders. The purpose of all those partnerships was to hide losses, to pretend they didn't exist. The one outcome not permitted was endangering the share price. Was this out of concern for outside shareholders or for the protection of their own lavish lifestyles? Former Enron vice-chairman John Clifford Baxter bought a new yacht every year on the profits he made on your dreams. Then he blew his brains out.

Back To The Future

Remove the incentive to lie, cheat and dissemble, and you'll get a lot less of it. Our demands as investors for ever-higher share prices and our willingness to not ask questions on how earnings are calculated are part of the problem. Did anyone's personal bank account rise as smoothly as General Electric's earnings, and would someone please tell me why smoothness per se in a volatile market is important? Pro-forma earnings should be consigned to the fiction section of the library, and "beating expectations" is a game best left to political consultants and other charlatans.

By all means, let's pay managers for taking risk and rewarding shareholders. But let's make it a two-way street, and let's have someone independent on the board determine whether the gains in share price were at all related to anything produced by the executives. As an investor, recognize that dangling a colossal reward in front of people who will do anything to capture it is an open invitation to theft. This problem gets worse if the recipients have gotten huge rewards in the past. Demand that analysts, many of whom pretend to recognize good management, inform you of these incentives. And remember that those who have been amply rewarded in the past will have a tendency to push for more, and to never accept less. Mrs. Kenneth Lay considers herself destitute now, and doesn't that tell you everything you need to know about human behavior in this situation?

Harold Williams, Chairman of the SEC in 1978, proposed that corporate boards contain only one manager, the CEO, and service providers such as investment bankers be excluded from board membership. At the time, I thought this proposal would have excluded too many people who had a working knowledge of the firm from the board. But, one thing I learned at home was there would never be a penalty for admitting error, and I now think we ought to revisit some of the corporate governance proposals from that era.

They'll work real well until the next bull market.