

Exclusive Outlook

WEST COAST ASSET MANAGEMENT, INC.

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I Pledge Allegiance to My Career

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Whenever we visit New York, it galls us to see the expensive restaurants packed at lunchtime. Those fine meals are being eaten by executives, and paid for by shareholders. The concept of good stewardship, often discussed among the stakeholders of non-profit organizations, deserves greater attention in the corporate world as well.

Along with the occasional corruption and frequent incompetence that have always bedeviled organizations, a new and growing problem seems to be gnawing at many of the businesses we study. Simply put, the problem is selfishness; many workers are far more dedicated to managing their careers than to managing their business.

Don't get us wrong: we expect ambitious and talented people to take responsibility for their own professional advancement, but there is a line too often crossed, where the goals of the organization are compromised for the goals of the individual.

TWO SIDES OF A COSTLY COIN

The blatantly corrupt or incompetent "me-firsters" are beyond the scope of this article. We want to call attention to the other two primary types of selfish worker, which we call the mercenary and the ballast-barnacle.

The mercenary is completely obsessed with status, and calculates his or her every action toward advancements in title, power, and income. These people tend toward reckless self-promotion, and typically job-hop every 2-3 years, effectively escaping accountability for the long-term consequences of their actions. These are the braggarts, full of big promises and ready excuses.

"Ballast," in this case, does not refer to a stabilizing force. Rather, we refer to the other type of selfish worker as ballast-barnacles because they are the opposite of "boat-rockers," and

because they attach themselves to an organization and will not let go. These people let fear dictate their actions, or more accurately, their inaction. They try to protect their careers through excess of caution, avoiding risky assignments and bold decisions.

WHY THEY FLOURISH

In cubicles all over America, coworkers post a photocopied list of "The Five Stages of A Project." The five stages are:

1. Wild Enthusiasm
2. Hopeless Despair
3. Search for the Guilty
4. Punishment of the Innocent
5. Promotion of the Non-Participants

Sadly, the humor of this list springs from its universal truth: this is the way most companies behave. Mercenaries and ballast-barnacles thrive in such environments, especially where poor examples are set at the top.

In his outstanding book "Good To Great," Jim Collins opens the chapter on Level 5 Leadership by quoting Harry S. Truman: "You can accomplish anything in life, provided that you do not mind who gets the credit."

Collins goes on to explain that "Level 5 leaders channel their ego needs away from themselves and into the larger goal of building a great company. It's not that Level 5 leaders have no ego or self-interest. Indeed, they are incredibly ambitious - but their ambition is first and foremost for the institution, not themselves."

Although mercenaries and ballast-barnacles are not driven by ego per se, they know how to please those who are. The mercenary is an excellent flatterer, and the ballast-barnacle specializes in non-threatening behaviors. Together with a peacock CEO, they create companies that look good but perform poorly over time.



A FISH STINKS FROM THE HEAD DOWN

Although ballast-barnacles slow a company's progress and drain vitality, mercenaries are far worse. Single-minded and ambitious, mercenaries often reach their goals and end up as CEOs. To secure their position, they build organizations of ballast-barnacles. In other words, having secured status, they consolidate power.

Unfortunately, having never held a position long enough to understand the consequences of their actions, they have not developed the judgment apropos to the top job, and inevitably fail.

When we study a company for possible investment, we always try to meet its co-workers, but the ubiquity of mercenaries and barnacles requires different criteria for judging their influence in the organization. We want to understand which values the leaders model, and whether the culture rewards, tolerates, or punishes mercenary or barnacle behaviors.

As Jim Collins points out, the best leaders are "workhorses, not showhorses," and they build "enduring greatness through a paradoxical blend of personal humility and professional will."

LOYALTY AND FREE AGENCY

We believe in free agency, and the need to actively manage one's career. But we also believe that an agent's value must be properly measured. Only now are companies with executive teams of job-hoppers coming to truly appreciate the value of loyalty. Only companies that actively encourage risk-taking and open-communication will uncover the hidden treasures in tenured coworkers' brains.

Nowadays, it is difficult to discuss complex ideas like "loyalty," but loyalty is exactly what mercenaries and barnacles each lack. Because of misplaced loyalties, each denies a company his or her best judgment and full talent.

THE HONOR OF THE STEWARD

Along with "loyalty," ideas like "service" and "stewardship" need to be codified as important values in an organization. The world's best companies, like Johnson & Johnson, do so. In life and in business, only people who commit to a vision beyond themselves create works of lasting value.

Public companies have fiduciary responsibility: stewardship for other people's money. We invest in companies that understand the concept.

Ultimately, a company is just a bunch of people. Companies thrive when all of these people share common

SEEING IS BELIEVING

COUNTING CARBS

Krispy Kreme Doughnuts (KKD) and American Italian Pasta Company (PLB) each recently lowered sales and profit estimates, citing rising consumer concerns about carbohydrates. The stocks have dropped 30% and 25% respectively since the announcement. Big Surprise!

SAY CHEESE

Investors were recently surprised when new data came out showing that sales of traditional film and cameras are declining faster than expected. Who would have thought?

BEWARE OF "COUNTRY RISK"

The Arbitration Court of Moscow recently handed Russian oil giant YUKOS a decision calling for additional profit tax (including penalties and fines) for the year 2000 in the amount of US\$3.4 billion, based on a claim filed by Russia's Tax Ministry. Yukos and auditor PriceWaterhouseCoopers claim they have reviewed YUKOS' taxpaying practice during 2000 and did not find anything wrong. In fact, YUKOS was Russia's third largest taxpaying company in 2000, paying a total of US\$1.922 billion. During 2000, YUKOS' taxes to revenues ratio was approximately 30%, in line with the industry average. According to Russian claims, YUKOS should have paid 59% of its sales revenues or 107% of its profit in taxes during 2000.

Interestingly, Yukos chief Mikhail Khodorkovsky was arrested by the Russian Government in late 2003 for alleged fraud and tax evasion. Critics say the arrest is an attempt by the Kremlin to assert its power over business tycoons and keep them out of Russian politics. Mr. Khodorkovsky was believed to be Russia's richest man, with an estimated net worth of US\$8 billion.

Although West Coast Asset Management has no opinion on the subject, we believe it serves as an excellent example of "country risk." From our point of view, any country lacking a great history of foreign investment and political stability represents a certain degree of country risk, including China and India.

goals, and enthusiastically share their time and talents to achieve those goals. Building such an environment requires commitment to an ideal beyond one's own advancement, and courage to rock the boat now and then. ▲

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Corporate Governance: A Matter of Duty

While the press has done a good job exposing the wrongdoings of specific executives in the spate of recent corporate scandals, we think they missed an opportunity for some extremely valuable investigation and reporting. In nearly every instance of corporate malfeasance heading to the courts, the board of directors behaved shamefully, if not criminally. They too should face the harsh glare of the public spotlight.

In our system, a public company's board of directors plays a critical role. A directorship carries a duty to the shareholders and to the integrity of the stock market itself. And we do not use the word "duty" lightly: we mean a moral and legal obligation.

To fulfill this duty, a board must be tough, thorough, transparent, and true to their mission: advancing the shareholders' interests. Government agencies have done a good job effecting change in corporate governance during the past few years, but it is still only the tip of the iceberg.

HALL OF SHAME

In late 2002, Corporate Board Member magazine detailed examples of boards that shirked their duty, and we think these are good illustrations of our point.

A board shirks its duty when it grants huge stock options for short-term performance enhancements, as the board at Computer Associates did for three key executives. The three were granted more than one billion dollars in stock for keeping the stock price over a certain level for 60 days. Never mind that the stock dropped by 25% a month later.

A board shirks its duty when it turns a blind eye to accounting irregularities. Need we mention Enron, the nation's biggest bankruptcy thanks in part to questionable "off the books" partnerships, and WorldCom, who misrepresented billions of expense dollars as income? Whether these boards were spectacularly ignorant or criminally involved, they managed to harm the entire world economy.

A board shirks its duty when it excessively rewards management in a failing company, like they did at WorldCom and Enron, but also at Kodak, a company that underperformed against the major indices between 1986 and 2001! When CEO Daniel Carp complained about his half-million-dollar-plus bonus for 2000, the compensation committee at Kodak created a more flexible reward system. In related news, Kodak

announced 15,000 layoffs in January of 2004.

A board shirks its duty when it takes no role in directing a company lost at sea, which brings us back to Kodak. How does the board explain decades of poor performance from a company with one of the top three recognized brands in the world? Where was the board when Fuji stormed the film market? Where was the board when everyone else got into digital photography? Why are they called "directors?"

A board shirks its duty when it accepts generous gifts, excessive compensation, and lucrative business deals from the company it is supposed to be challenging. The examples at Enron and WorldCom are numerous. Some board members accept large contributions for their favorite charities; others accept large contracts for their own business. Still others, like those at Enron, simply get paid too much, although a cynic might say that depends on what they're really getting paid for.

TOUGH, THOROUGH, TRANSPARENT, AND TRUE

The boards mentioned above are egregious examples, to be sure. But they teach us how to find a board that does its duty. For one thing, boards clearly need greater distance from management. Boards must be able to meet regularly without executives present. Corporate Board Member cited Colgate-Palmolive's as a champion board; its audit committee (all outsiders) actually meets privately with the company's independent accountants.

Dutiful board members ask tough questions, and not just of management. They meet customers, co-workers and investors. They actually make corporate governance a priority, and staff the board with true experts. We've heard of famous athletes serving on audit committees for public companies, and the practice disgusts us, unless of course these superstars also hold degrees in accounting.

A board that does its homework, asks tough questions, keeps the company's dealings open and simple, and stays true to the mission of shareholder value, can also be bold in fulfilling its primary function: directing the company to a profitable future. A board of directors should not be a rubber stamp for management or a social club for wealthy cronies. The board must be the seat of accountability. This is their duty, not just to the customers, coworkers, and other stakeholders of an individual company, but to the integrity of capitalism itself. ▲

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