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STRATEGY AND RISK
By Eleanor Bloxham

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STRATEGY AND RISK: Science and Technology: Opportunities and Threats: Employee, Customer and Community Impacts

In recent talks on governance, I've been emphasizing that *all strategic decisions - even those not to act - involve potential risks*. The question for boards is the definition of the parameters under which the company will operate.

Which strategies and thereby which risks is the board *not willing to approve* no matter the potential return? Which strategies will the board approve provided there is a sufficient return for the risk?

For example, where does your board stand on strategies involving new technologies and, more specifically, strategies involving nanotechnology and nanomaterials?

"According to the Project on Emerging Nanotechnologies, more than 1,000 consumer products containing nanomaterials are in the US, a number that is quickly growing"… but "like any new technology, nanomaterials carry with them potential for both good and for harm"… and "the most salient worries concern … [the] *likely possibility* that some of these novel materials may turn out to be *hazardous to our health or the environment.*" "In response to this uncertainty" the EPA has said it will launch a comprehensive research effort. In the meantime, some companies are waiting: Proctor & Gamble "is not pursuing nanotechnology because of the long-term risk". (Emphasis added, *Big Need for a Little Testing: EPA must act swiftly to evaluate the possible health risks of nanotechnology*, Editors, Scientific American, January 2010)

STRATEGY AND RISK: The Underemployed, Unemployed and Overemployed: Employee, Customer and Community Impacts

What are the mechanisms for assessing the risks of particular strategies? Is there a culture that encourages input from all quarters and taking action on that information?

According to a December survey of finance executives conducted by CFO Research Services and American Express, **40% of companies have seen their relationships with employees worsened** since the downturn. Despite the credit crunch and falling stock markets, this compares to worse relationships with creditors at 18% of firms, investors at 17%, suppliers at 13%, partners at 11%, and customers at 10%. (*The New Normal: A Spot Check*, Leibs, CFO Magazine, February 1, 2010)

The emerging case study which is Toyota suggests the importance of employee relations to the company's survival and the high risks of inaction. One worker, Uchino "routinely worked 14 hours a day. In his final month, his wife says, he worked 144 hours of unpaid overtime, *a common practice known as 'service to the company.'* In 2007, a Japanese court ruled Uchino had died from *karoshi* -- he had literally worked himself to death." At Toyota, "the union men had watched the company take what they believed were dangerous *safety and manpower shortcuts to lower costs and boost production*... 'Our responsibility as a labor union was to point out these problems that Toyota should have known about. People were overworked; some were committing suicide'… 'Of course, Toyota did nothing, but looking back we see how important this was. We just told them what we saw.'" (Emphasis added, *Toyota workers raised safety concerns with bosses in 2006 memo*, Glionna, LA Times, March 8, 2010)

The current TV show "Undercover Boss" has been a popular demonstration that there is much to be learned by executives about how the company works and the challenges employees face. Through the years, without the TV cameras in play, there have been respected executives that have taken time to stop and do the work of front line employees, in order to intelligently improve their operations for the better.

Given the deleterious impact on employee relations of the downturn and the cascading impact of poor employee relations on customers and communities, boards wishing to mitigate the risks could inquire: Are leaders in our organization trained to have the kind of open dialogue and investigatory practice (by deep diving into hands on practice)

that goes beyond management by walking around? Do we as a board encourage this? Do we, as a board, understand if we are placing short term unrealistic pressure on management either explicitly -- or implicitly in our compensation practices? Is the organization's culture part of the CEO performance review and how do we, as the board, ensure we fully understand the issues at stake? Solutions to the problem of the underemployed, unemployed and overemployed may begin with a re-evaluation of stakeholder interests, which boards are in a position to address.

In the US, a web-based mechanism for reporting fraud and misconduct has been developed by "a group of finance and accounting professionals" who are "asking employees of U.S. publicly traded companies and financial institutions to anonymously disclose information about the questionable business practices of their companies and those companies' executives on a new Website (www.zethics.com)." (Letters: Web-Based Whistle-Blowing?, Rome, CFO, March 1, 2010)

STRATEGY AND RISK: CAP(ital) and TRADE (s): Déjà vu all over Again 10 years later?

Some people easily remember what they were doing when a certain event unfolded: a natural disaster, an assassination or a hijacking. I remember I was reading a popular US business magazine - but not which one - when I first knew that Enron was potentially in serious trouble. At the time Jeff Skilling, according to the article, was battling it out with Rebecca Mark for the presidency of Enron. In the article, as I recall, Mr. Skilling said the trading business was a much better business than investments in physical plant because *trading didn't require capital*. I remember then thinking that if Mr. Skilling thinks that, Enron is in big trouble.

In trying to locate the original article I read, I found an article written *after* Ms. Mark's departure and Mr. Skilling had won the presidency and confidence of Ken Lay: "Today, Mr. Skilling, 47 years old, stands triumphant at Enron as its president and heir apparent to Chairman Kenneth Lay. Ms. Mark, 46, is gone. Their respective fates stand as testimony to the effectiveness of their competing business strategies"…. "the company always is looking for ways to create what Mr. Skilling calls 'high-velocity capital'"… "Daniel Rappaport, chairman of the New York Mercantile Exchange, where Enron is one of the biggest customers", says " 'Enron is the consummate trader'"… " 'They know the cardinal rule of trading, which is cut your losses.'" (http://bodurtha.georgetown.edu/enron/summary.htm, *Rebecca Mark's Exit Leaves Azurix Treading Deep Water*, Smith and Lucchetti, WSJ, August 28, 2000)

Now, ten years later, following the financial crisis, international regulators are setting out to determine how risky trading is and how much capital banks should hold for that risk: "international bank regulators, with the blessing of national overseers, are readying rule changes that could further increase the amount of capital banks hold, especially in their trading operations."… "A dearth of capital was one of the reasons banks were so shaky going into the financial crisis"… Although "Basel II's revamped capital requirements" … "might be the best way to reduce risk in the system", "the banks will try hard to push back against these changes". (*Expect a Fight on Bank Capital*, Eavis, WSJ, March 7, 2010)

The salient question, for bank boards, and all boards is: "**How much capital do we need for the risk we are taking on?"**

"In a highly theoretical scenario, Goldman said Morgan Stanley might need to hold $269 billion of regulatory capital against its credit derivatives book, BofA $108 billion and J.P. Morgan $21 billion. Applying Goldman's approach to itself suggests the firm would need around $100 billion against its credit derivatives"... Currently, "Goldman has $65 billion of Tier 1 regulatory capital". (*Expect a Fight on Bank Capital*, Eavis, WSJ, March 7, 2010)

"In choosing what the organization is and is not, what activities it will engage in and how, executive management and the board of directors determine the risk level of their organizations. This process is conscious in some organizations and less so in others." (Economic Value Management: Applications and Techniques, Bloxham, 2002, Wiley, p. 234)

In some ways, traditional finance had encouraged less thinking about specific risk than was appropriate. "While risks that are specific are often discussed as irrelevant to investors [i.e. they can be diversified away], there are ways in which we can understand their relevance to investors and to other constituents as well. In deciding whether to purchase Enron [stock], for example, understanding these specific risks were very relevant to prospective investors" … "What investors were exposed to if they invested in Enron, for example, were the ways in which Enron chose to manage their risks. Enron is an example of a firm that most would say in 2000 and 2001 held less capital than most investors and creditors in hindsight would consider adequate vis-à-vis the risks they had taken on. Those who invested in Enron were subject to returns for that stock based, in part, on Enron's decision to hold less capital than 'required' to avoid bankruptcy court and to handle a given change in markets or energy prices, or to cushion the specific risk effects that are generally called 'reputation risk'. Because of the specific choices made by Enron, and their level of disclosure, investors and third parties, such as rating agencies and analysts, did not adequately understand the risks. **If, however, all had been performing *risk capital analyses*, they would have been better positioned to forecast potential problems**." (Economic Value Management: Applications and Techniques, Bloxham, 2002, Wiley, p. 234 - 235)

STRATEGY AND RISK: Lessons for Boards from Successful Shareholder Activists

The March PRI Digest summarized recent academic research on shareholder activism, citing the value of activism to shareholders.

What did shareholder activists do to create the most value in these cases? With proxy access a possibility on the horizon, can boards replicate their

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actions? Looking deeper into the research, are there potential lessons for boards?

Hermes has a good track record of producing benefits. Two areas where their activism provides the best return?

"The largest excess returns, 6.6% [seven day window], are associated with *restructuring activities*, including sales of assets and divisions. *Changes of CEO and chairmen* also give rise to large and positive excess returns, 6.0%. These are often accompanied by prospective restructurings. Cumulative abnormal returns for changes of nonexecutive directors are negative and insignificant." (Emphasis added, http://ssrn.com/abstract= 934712, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund, Becht, Franks, Mayer and Rossi, European Corporate Governance Institute (ECGI) ECGI Finance Working Paper No. 138/ London Business School Finance Working Paper Series Number – FIN 462, November/December 2006)

This suggests thoughtful boards can pre-empt actions by
(1) Ensuring agendas fully review *restructuring* and *succession planning* as important governance practices and strategic options on a regular basis and
(2) Taking decisive action as needed.

A study of hedge fund activism shows that *hedge fund activism can add significant sustainable value*.

"Hedge funds seldom seek control and in most cases are nonconfrontational. The abnormal return around the announcement of activism is *approximately 7%, with no reversal during the subsequent year.* Target firms experience *increases in payout, operating performance, and higher CEO turnover* after activism."… "Activism that targets the *sale of the company or changes in business strategy*, such as refocusing and spinning-off noncore assets, is associated with the largest positive abnormal partial effects… This evidence suggests that hedge funds are able to create value when they see large allocative inefficiencies"… "During the year after the announcement of activism, average *CEO pay* declines by about $1 million dollars, and the *CEO turnover* rate increases by almost 10 percentage points, controlling for the normal turnover rates in the same industry, and for firms of similar size and stock valuation." "Managerial opposition to hedge fund activism may stem from its negative impact on CEO pay and turnover even if it ultimately creates value for shareholders." (Emphasis added, http://www.columbia.edu/~wj2006/HFActivism.pdf, Hedge Fund Activism, Corporate Governance, and Firm Performance, Brav, Jiang, Partnoy, and Thomas, The Journal of Finance, Vol. LXIII, No. 4, August 2008)

This study suggests thoughtful boards can pre-empt actions by
(1) Ensuring agendas fully review *sales of the company, spin-offs, changes in business strategy, dividend payouts, succession planning* and *CEO pay* on a regular basis and
(2) Taking decisive action as needed.

Similar to the Hermes study, both *capital allocation* and *CEO oversight* matter.

Here's another study: "firms with high cash flows but low dividend payouts tend to become the targets" of switchers [investors who switch investment purpose from passive to active]… In this sample in the Korean market, "target price reaction is significantly positive around the time of the switch disclosure and this effect is more pronounced when the switcher is foreign or declares to use a wider scope of activist measures" … "switched firms tend to exhibit higher dividend payouts compared to a sample of control group following the switch." (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1078782, Value of shareholder activism: evidence from the switchers, Kim, Kim and Kwon, University of Texas School of Law: Law and Economics Working Paper No. 128, KDI School Working Paper Series**:** Working Paper No. 08-09, December 2007)

This study suggests thoughtful boards can pre-empt actions by
(1) Being active -- taking decisive action as needed and
(2) Ensuring agendas fully review dividend payout.

Similar to the hedge fund study, *dividend payouts* matter.

Of course, all research is subject to issues and limitations associated with data collection and measurement. The areas highlighted above may not, in fact, represent the most value creating possibilities because other equally important issues may not be addressed by activists or may create less value because, although activists request them, they are never fully implemented. And similar to the "consultant said it – it must be true" versus the "employee said it – it must be false" phenomenon, markets may react differently, finding activists more credible than boards taking the same actions, thus boosting stock prices more when they act.

Nevertheless, the lessons don't seem to go against intuition and certainly can't hurt boards wishing to ameliorate management agency costs and stay a step ahead of value-creating activists.

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