

THE NEW CAPITALISTS

How citizen investors are reshaping the corporate agenda

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I have read many great books in my life that I would describe as inspiring, educational and motivating. The New Capitalists has added a new dimension to my life. This book is **empowering** and provides a roadmap for citizen activism. The authors point out that globally, accountability is improving greatly. However, there is still much to be done, hence the need for more investor activism. “Work and struggle and never accept an evil that you can change” - Andre Gide.

“Can one person can make a difference”. Yes. However, how many people really believe this? History books are full of individuals that made this leap of faith and changed the course of history of nations and people. Still don’t believe it? Email wayne@ethicaladvisor.com and request his article on **Trim Tabs.**

This book along with a few of my own tips will demonstrate how you can start making a difference in the corporate world that manages your money. Most of the principles outlined in this book are common sense. All that is needed is for investors and our leaders to act on it. This is a book about ethics and social responsibility.

One of my goals in life is to see Canada as a leader in the world of corporate responsibility. Can you imagine the benefits we would receive if we achieve this goal?

- Corporations with the most reliable and accountable accounting procedures in the world

- Corporations who are leaders in corporate governance
- Corporations with high environmental standards
- Regulators that are pro-active in dealing with corruption instead of being reactive.

As a financial advisor, I was very distressed by the actions of Corporate North America during the crash of 2000 to March 2003. From approximately 1995 to 2000 corporations and investors large and small invested like there was no end in sight. Bubble, what bubble? The media did report from time to time that the share prices of companies were going through the ceiling and had no true value. High debt, low sales, yet the share price kept being pushed up higher. Only the occasional voice from the wilderness such as Al Rosen, the forensic accountant or Hal Jackman and some pension funds “blew the whistle” on the corporate excesses in the market.

Where was the accountability from the rest of the market place? I do not recall any one organization or financial institution that stepped up to the plate to speak out for the investor. So who were the players that could have reined in this rush to push stock prices well above their true value and expose the corrupt practices being used?

1. Mutual Fund companies buying stocks on our behalf
2. CFO's, CEO's leading the corporation
3. Banks & Insurance Companies buying stocks on behalf of citizen investors
4. The accounting and legal profession
5. Financial analysts
6. Auditors
7. Government regulators. (They did change some of the laws after the crash)
8. Financial advisors
9. The media could have written more stories behind the faulty accounting practices like they did after the crash. Expose the crime before it occurs
10. The employee who discovers corrupt practices

Here is my fundamental belief. I believe that the rational self interest of the market is not in line with the rational self interest of the individual investor in the short term. However, I do believe that the rational self interest of the investor and the corporation in the long term is in line.

This means that we cannot know what the government, corporations or stock pickers have in mind when they buy investments for a portfolio on a day to day basis. Markets rise and fall on a regular basis and timing the market is very difficult.

The solution for the investor is to think long term and protect your downside using basic financial planning strategies:

- Have ample cash reserves to fall back on
- Manageable debt
- Use insurance to manage risk
- Have a plan for buying and selling
- Choose investments that are focused on your goals and not the corporation or money managers
- Use an advisor that has the same self interest as you do
- Monitor your progress on a regular basis

This book clearly outlines how you as an individual investor can make a difference in the way corporations and money managers manage your money. I will also provide you with direction how you can become an active citizen investor. Bob Hooey once said “You cannot succeed in isolation but you can fail in isolation” If you join the SIO (Social Investment Organization, \$45 a year as an individual) you will not be alone. SIO has over 400 members to date.

The role of the citizen investor:

1. Be an observer
2. Study and read up on this emerging issue
3. Become an activist – Chapter 9 of the book outlines “action memos” for the new capitalist to follow.
4. Ensure that your own ethical house is in order before pointing fingers at corporations.

This book has two main goals:

1. Expose the mechanisms that have historically driven corporations and citizen investors apart.
2. Support the concept of the civil economy: a population of new capitalists that are seizing influence over the corporate agenda.

Corporate power used to be wielded by either wealthy tycoons or by the state. Increasingly, around the world the owners of multinational corporations are the tens of millions of working people who have their

pensions and other life savings through mutual funds and shares of the world's largest companies. From Telus to the Bank of America, you can own a piece of prosperity. Of course these citizen investors have neither known nor acted the part of being an "owner". In this book the authors track the present awakening of a consciousness of civil ownership of new capitalists that promises to make those traditional power brokers accountable, or kick them out of the way.

The motivation for this civil ownership action started with the Enron, Parmalat, Worldcom, scandals that ravaged the accounts and future dreams of millions of middle and working-class savers. Regulators took aim and fired at the likes of Martha Stewart and a number of major Canadian banks to bring a new level of accountability to the market place. To date, the following major players are serving time. Jeffrey Skilling the former CEO of Enron, John Rigas of Adelphia, Enron's Andrew Fastow, Tyco's Dennis Kozlowski and WorldCom's Bernard Ebbers.

The circle of accountability:

New capitalists are beginning to compel radical change across the globe as they build a civil economy. We find evidence, first, in a circle of accountability.

- **Individual investors** – the new capitalists – are awakening to citizen investor power around the world, spurring
- **Institutional investors** to adopt responsible portfolio and activist strategies, which prompt
- **Boards of directors** to embrace sweeping reform making them accountable to shareowners, creating an agenda for
- **Corporations and corporate executives**, who are turning to a new "capitalists manifesto" path to corporate success, which in turn, hands
- **The new capitalists** unprecedented clout

A recent study was published in the Futurist issue of November/December 2006 on the happiness of nations. Canada ranked # 10 out of 178 as the happiest nation in the world. The USA ranked # 23. The data analyzed was for wealth, access to education and health levels. Citizens of successful capitalistic countries can be expected to be generally happier. One can only hope that if a nation that works towards having a more civil economy, can only give that nation a higher score.

If we focus too much on accountability of boards, we risk diluting their prime function, to provide effective leadership. There must be a balance between being overly legalistic and providing value to the shareowners.

The civil economy – In political life, we refer to a **civil society**. In the business world it is the civil economy. It is a process to develop accountability to shareowners. The transformation from conventional to civil economy is happening today.

New capitalists are fiercely bent on scrutiny that ensures that corporate profits are real, not a result of accounting tricks. The focus is shifting to sustainable, long – term corporate performance and away from short term highs. The end result is increased public trust.

The really big question one should ask is “whose money is this that they are managing”? To whom are these financial institutions accountable to? We as investors pay fees to financial intermediaries to manage our money. The end result is to have the investors financial goals achieved. When the “gatekeepers” of our civil economy fail the investor such as in the crash of 2000, where was the accountability? It appears the pendulum is starting to swing in favour of the investor.

Now let’s ask why stock ownership has spread from elites to broad populations:

- An ever expanding world population
- An ever expanding working and middle class. India and China are only two prime examples that will impact the world in the next decade
- Advances in health care, quality of life issues
- The tidal wave of workers reaching retirement. They will need stable and predictable income to enjoy their retirement years.

The result: expansion of stock ownership and an equity culture. A key reason citizen investors may be numb to a sense of power is that they have shifted ownership functions to others. When savers don’t feel like owners, corporations and money managers are free to behave as if they were unaccountable. Without accountability, the inevitable result is abuse of power.

Extreme examples of late are:

- Enron, Worldcom, Tyco & Parmalat

When accountability breaks down on a market wide scale, the cost is staggering. Harvard’s Michael Jensen reported that remaking boards so that

the companies were indeed run in shareowners' best interests could produce enormous paybacks. Page 12 of book refers to other studies to support this statement worldwide.

Page 14 refers to an important question. To whom does the stock – traded company board report? The authors outline a process of reporting:

1. Corporate executives report to the board
2. Which reports to shareowners, who are represented by fund managers who may be hired by pension trustees
3. These decision makers, in turn, are responsible to the individual investor or employee in a pension plan

In a civil society, we talk of voters. Most people recognize how they can “fight city hall” when things go wrong. In a civil economy, we address share owners. We need to encourage more investor activists' whether they be individuals or mutual fund managers to “fight corporations” on the investors behalf. Please refer to the page 9 copy of “case in point: citizen investors move a nation” as an example of investor activism in action.

The barriers are coming down that will allow citizen investors to compel corporate change in favour of the investor. Part three of the book outlines the process.

Monitoring the market: the information moguls – As the civil economy takes hold, the information moguls traditionally fed information to analysts, auditors, credit rating agencies, and the press to monitor the markets fairly. As we have seen, fair is in the eye of the beholder. The crash of 2000 demonstrated the weakness of “information” being fed from the top/down. Now these sellers of information are targeting the New Capitalists.

Civil economy and financial reporting – We expect our political leaders to present a budget that is correct in a civil society. What about the market place? The methods of measuring shareholder value in a civil economy are far too complex to measure accurately.

What are the consequences if we the citizen investor do not take action?

- The power brokers will continue to do what they wish
- Corporate board members will continue to support the corporation instead of the investor. “Boards of directors are just like sub-atomic particles”, says governance expert Nell Mino. “They behave differently when they are observed”.
- Government will not impose regulations that jeopardize the individual investor/pensioner unless we speak out as in a civil society

- Money managers both small and large will continue to be accountable to the corporation instead of the citizen investor
- Corporations that make short term profitable decisions at the expense of the long term profit. The investor/pensioner is in most situations, a long term investor. Buy and hold for the long term. However, the burn and churn strategy is not in line with the long term game plan. Ask your money manager which game are they playing? If their rational self interest is not in line with yours, change players.

Evidence coming from diverse markets already shows that being ethical and socially responsible is working:

- Companies with active long-term shareholders introduce more responsive governance and are more likely to produce higher returns.
- Investors with a long term buy and hold loyal attitude will benefit
- There are fewer conflict of interest issues referred as addressed in the book
- Real value issues are compared between corporations as apposed to the “fantasyland” accounting that is currently being used.
- Corporations that are ethical are able to access to capital at a lower cost. The banker sees this as a lower risk and charges a lower premium to borrow.
- **Accountability in all parties, in short, is surfacing as one of the most effective keys to unlocking sustainable value.**
- Accountability to the shareholder is the core of what we mean by a civil economy
- New capitalists are becoming a powerful force driving long-term value so that corporations work for social benefit

There is still much to do. Only a fraction of the world’s listed companies have what we might indemnify as hallmarks of the civil economy enterprise:

- A professional independent board
- A culture of disclosure
- Executives skilled at recognizing and drawing value from management of corporate responsibility.
- Chapter 9 offers solutions to this challenge

The goal of the corporation is to serve its shareholders and maximize profit. Corporate misconduct remains the exception, not the rule. This is because of at least three important constraints:

1. The market

2. Government
3. and the societies within which they operate

Destroying shareholder value – Study after study has shown that the majority of acquisitions fail to make a proper return for the acquiring company, losing their investors billions of dollars. Page 55

New capitalists need the entire economic system to be healthy, not just a single company in which they are invested, to be successful over the long term.

Historically, millions of investors have acted like renters of corporate shareholdings instead of owners. Things go deeply amiss when investor passivity is chronic. If the money managers feel the citizen investor does not care or feels powerless, management may not feel the need to be accountable to the real owner.

A sample accountability chain:

1. The pension plan and its trustees
2. Board members and managers
3. Proxy agents who influence voting outcomes at corporate AGM's
4. Monitors that need to be independent. I.e. ISO 9001 auditors
5. The advisors to the pension plan that are hired by the pension plan
6. The mutual fund or portfolio of investments (portfolio manager' pick the stocks)
7. The portfolio manager rely on the analyst
8. The financial advisor chooses the fund company or portfolio manager
9. The client, customer, pensioner and shareowner relies on this chain of accountabilitycc

A weak link with any part of this chain can compromise the investment of the citizen investor:

1. Conflict of interest between any of these players. Incentives, kickbacks etc
2. Lack of accountability to each other and the citizen investor. Directors often have little connection with minority shareowners
3. Undue influence
4. Managers acting for the corporation instead of the citizen investor (the owner)
5. Bonuses paid to portfolio managers that are computed based on quarterly or annual results instead of vigilant long-term ownership. Today, the average annual turnover at mutual funds is no less than

110%. Billions are wasted each year on excessive commissions and badly executed trades according to Liquidnet. A money manager that is not going to hold a stock for long is not interested in the long term quality of the stock.

In every corporate scandal, directors have failed to protect the shareowners. The question begs to be asked: what is it that allowed boards of directors to look on as corporate scandal, greed, and incompetence have engulfed their companies? Chapter 5 deals with this issue and gives hope to citizen investors.

The three “I’s” of impotent boards (page 101)

- Insufficient information
- Improper influence
- And incompetence

What are boards for?

1. Leadership for the organization
2. Be able to form judgements that meet the needs of the shareowners
3. Apply their expertise

Web sites and organizations to assist the citizen investor to become more engaged in the process:

1. The International Corporate Governance Network
2. Euroshareholders Organization
3. Committee on Workers Capital. A trade union organization
4. www.pensionriskmatters.com
5. The Investment Protection Principles
6. Enhanced Analytics Initiative (EAI)
7. Fund Democracy
8. AccountAbility
9. Fairtrade Labelling Organizations International (FLO)
10. Social Accountability International (SAI)
11. Transparency International offers business principles for countering bribery
12. Global Reporting Initiative (GRI) nearly 800 global blue-chip corporations report according to GRI standards to some extent. GRI is stakeholder focused not shareholder focused.
13. CorpGov.net – a free web site devoted exclusively to news and analysis of corporate governance.
14. FairPension
15. People & Planet

16. Investor network on climate risk
17. Friends of the earth's guide to shareowner activism
18. Executive Paywatch.org
19. The Corporate library
20. GovernanceMetrics International
21. Institutional Shareholder Services
22. BoardEx
23. Investorside
24. Independent Research Think Tank
25. Global Compact, a voluntary, principles – based network, a flagship for sustainability standards. By early 2006, more than 2300 companies were participating.

Accounting standards -Traditional accounting methods, which boast a five hundred year history, have not kept pace with the new capitalists of the world. There is far more intrinsic value that cannot be uncovered with traditional accounting methods.

- Intellectual property
- Detecting corporate diseases that sap or destroy its growth
- Environmental issues that carry real financial risks. Ie. The Valdez oil spill. \$15 billion in market value lost.
- Value – added processes – How much profit is created per unit of input?
- EVA (Economic Value Added) comes close to measuring how a corporation creates value. Page 157
- Auditors that work for the corporation not the shareowner

I strongly recommend that you read this book. If you would like to learn how to become an active citizen investor, call Wayne Taylor and he would welcome the opportunity to coach you through the process.

Harvard Business Review published an article that may be of interest to you as well. “Strategy and Society: the link between competitive advantage and Corporate Social Responsibility (CSR) by Michael Porter & Mark Kramer. December 2006. If you wish, I can email you my three page summary of this article.

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