Bird's Eye View of Proxy Statements

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Dave

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All right, folks, welcome to Investing for Beginners Podcast. Today, Andrew and I are going to do a bird's eye view, we're going to take a look at proxy statements for four different companies to give you an idea of how you can maybe assess management and kind of look through some important information from a financial statement that doesn't get talked a lot about but can provide some interesting information. So I guess, for us to start, why don't we just kind of talk through, like some of the things maybe that you look for in a proxy statement? And what I look for in a proxy statement, I guess I'll start, I like to look for things like,

Andrew

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how would you define a proxy statement? Because already there, I'm lost?

Dave

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Yeah. Okay. That's good point. Okay. So a proxy statement is also known as the DF 14 A. And it is a statement that they send out once a year to shareholders to announce a vote for different things that the company is voting on, whether it's things like the Board of Directors, the management pay, or any other incentives or objectives that they want shareholders to vote on. And so that's an announcement for us to vote on these particular, I guess, referendums, if you will. And it also provides us insider information about things going on with a company related to the management board, or the Board of Management, as well as the board of directors.

And so we can also see here where people are getting paid, how much they're getting paid, maybe who are some of the big insight ownership of the company, and anything related to that. So most people refer to it as a proxy statement. But the official SEC term is dF 14 A, I believe, cool. All right. So I guess maybe instead of like working through things we want to like when we just start digging in. So maybe we could take a look at Google as like, I guess our first example of a company that you would look at,

Andrew

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what are you trying to accomplish by Alexei looking at the proxy statement? Like what part of the business are you trying to analyze? By looking at this?

Dave

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I think the easy answer is management. I'm trying to assess management, what they get paid, and look for any incentives that drive their pay, which will in turn, affect how the business is run. I think that's the easiest way to describe it. And that's really the crux of the main question you want to answer when you look at this?

Andrew

2:27

Yeah, I think that's perfect. I mean, most companies are kind of run where you have management, which basically is talking about CEO usually stands at the top, and there can be a president, there can also be like a COO Chief Operating Officer, there can be a CFO, Chief Financial Officer. So everybody kind of has their different hats that they wear. Usually the CEO is at the top kind of directing things. But sometimes you have co CEOs to, like that insurance company, Markel, they had co CEOs for a while. So basically, the, you want to see what the management is doing.

And to your point, they and how they are compensated can can sometimes give you insight into what kind of things are they focusing on. So just as a big example, kind of very broadly, is a management going to be focused more on growing the business or making the business more profitable. Because if they're, if all their bonuses are tied to revenue growth, they might not focus as much as profitability, they might sacrifice profits to get more growth, and vice versa for profits and revenue growth. So I think that's where management incentives can be a great place to analyze, especially if you can give context to what's happening in the business. And then if you see it moving a certain way, maybe you say, Oh, well, that makes sense why?

Maybe profits are down or a company is going to grow in at all costs, while their management is compensated that way. So that would make sense. So you can start to avoid some of those aspects of a business and the way businesses are run without even needing to find that itself. You can almost like head it off up ahead instead of dealing with it down the road.

Dave

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Yeah, yeah, exactly. I think one of the things that I have used the proxies to help me with is trying to determine whether management is in it for us or in it for them. And kind of going back to that whole incentive idea what Charlie Munger always says, you know, show me the incentive, and I'll show you the result. And it really does go to everything that Andrew was saying. It's very, very evident.

And there's been in the past, there has been some bad actors that have used those incentives to try to grow the business for the wrong reasons. And it's basically just to line their pockets and not necessarily help shareholders out. And so those are some of the things that you can find within the proxy statement. I will warn people that the proxy statement by in and of itself is full of a lot of legal jargon. In a lot of legal language, and it can be overwhelming if you try to read it like a book, it's much better to pick and choose and kind of hunt for the things you're looking for, as opposed to trying to read it. And in some cases, you will find companies that will not make it obvious what the management is paid based on, for example, they they may be based on free cash flow, for example, and they get all kinds of bonuses and awards for that.

But you have to really look through the fine print to find that. And sometimes if they're trying to hide it from you or not make it super obvious. That can be I guess, a not so subtle hint that maybe they're not in it for you to sell that says something to kind of take away from it. Perfect.

Andrew

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So maybe before talking about like how somebody can be compensated, can you give us an example of a company where the compensation is really good? Where you feel like management is being paid in a way that's fair to shareholders?

Dave

5:57

Yeah, absolutely. I guess the first company that I would talk about would be Odgen. This is a Dutch payments company that I've been a big fan of for a little while now. And I've owned it for more than two years. And they are, I think they're one of the better examples of a company that's paid very well and aligned with the shareholders. And this company operates in Europe.

And so their discovery rules and the way that the documents that they write are different than they are going to be in the United States. So for example, for Argent, they don't have a specific proxy statement that they issue, they issue all this information in their annual report, which they write every six months. So they report numbers every six months. And so agenda includes all this information in that and the two pieces of data that you can pull from their annual report that can kind of give you a clue of where the how the companies aligned is the first thing and this is actually something that you will find in all the United States and all the US companies now as well, it's called the CE pay ratio, which is a formula that they figure out how much a CEO is paid, and then they figure out how much the average employee in the company is paid. And then they calculate a ratio of 100 to 110 to one you know, so and so on. So the CEO for Arjun right now, his pay ratio is seven to one.

And that in and of itself may sound like okay, you know, whatever. But when you put that compared to the pay ratio for Visa, MasterCard, and PayPal, those are range between 186 to one to 240, to one. So it shows you that those CEOs get paid a lot of money compared to the average employee for the company. And in and of itself, that may not mean anything. But depending on what the industry is, and also how much they increase their pay, those things can all be relative, now, the CEO for Arjun now keep in mind, this is a 50 to $54 billion company that does around four or five in annual sales a year, he is only paid $670,000 a year, and he has no other pay. Besides that they don't get stock options.

They don't get grants, they don't get bonuses, he just gets paid a flat salary for the year. And that's how he earns his income. And the rest of the management gets around 450 to 600,000 a year. Granted, that's a lot of money compared to, you know, peasants like us. But you know, that still, when you think about the annual salary for the says, Just his cash payment is around $14 million for the visa CEO. So he gets paid quite a bit less than the other people do. And that he does that for a reason. He wants to show shareholders that he's not in it to try to gouge shareholders for pay from the company. And he feels like getting paid when he gets paid is a fair amount of money for the work that he does. And they have, he owns he and his co owner own majority of the company, but that was all pre IPO.

And so it doesn't they've not issued any shares since the company has gone public. And that's one of the things that gets a lot of controversy stirred about CEO pay is the whole stock options and all that just, you know, avoids that completely and they just don't offer them to management or employees at all.

Andrew

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So would you say then that CEO of visa, for example, is gouging shareholders with his 14 million compared to Hodgins? 600 100,000?

Dave

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You could argue yes, I mean, I look at it more in relation to what the company is trying to do. And it makes me feel much more like Arjun is in it with us as shareholders, as opposed to the gentleman with Visa. And I'm not saying that visa is a bad company or that I hate visa or I love D says one of my biggest holdings.

But when you compare the pay ratio, it could, you know, if you start looking at the incentives and what drives visa and how this how the CEO gets paid, it could be Due to think that maybe they're not necessarily aligned with shareholders, it's not a deal breaker for me. But it, it certainly adds a not a questionable motive. But for me, it just makes me feel a little bit less. Like they're totally in it for the shareholders. I guess that's kind of the way I look at it.

Andrew

10:19

Are there rules of thumb for certain CEOs get compensated more versus others? Because you mentioned, you throw out big numbers 50 billion company 670,000? Those are some massive, right? Are there rules of thumb to kind of give context to some of these numbers?

Dave

10:37

I would say, it's a little bit all over the board. From what I've looked at, I've looked at some smaller companies, as well as some really big companies, and it's the PE ratio tends to be for the most part, they tend to fall in line with other companies, because one of the things that companies will do is they will base their PE ratios on what other companies are paying. And so they will kind of try to all stay within the same general area, depending depending on the industry, and what they're doing, you know, you would think automatically, that maybe just like tech ones are going to be higher than other ones. But I noticed a few months ago, I was investigating John Deere, which you don't think of as like a big tech company.

And their CEO pay ratio was actually quite high, it was in the, I think over 200 to one. And that surprised me, because it's not a tech company that maybe their PE ratio was would have been lower. So I've seen it, I've seen it kind of all over the map, I haven't really seen any rules of thumb that say that, hey, just because this company is smaller than this one, some of it has to do with how much the employees are paid. I think an interesting one to look at would be Walmart, for reference for that. Okay.

Andrew

11:49

So the so you're talking about PE ratio, or like the actual number that the CEO is getting paid?

Dave

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The first part is, I guess, really, the thing I focus more on is the actual PE ratio. And then I'll look at the individual numbers to kind of see how that lines up.

Andrew

12:03

So when, like a tech company whose employees aren't making 100 grand a year, have a much lower pay ratio than like you said, Walmart who has minimum wage workers,

Dave

12:14

right? Yeah, so the disparity is going to be a lot bigger, you know, in some of those companies, so it's really more about, like, what the CEO is getting paid, you know, kind of compared to other competitors, and then also in comparison to what industry it is that they're doing, and whatnot. But it's all I guess, I try to look at it as it's all part of the information to assess whether the management is aligned with us. It's not necessarily strictly just based on the numbers, but it's also kind of what drives those stock incentives, for example, or any sort of cash bonuses that the company might

Andrew

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make. Yeah, and I guess it's helpful to know that every company is different. And, to your point about is management aligned with the shareholders, I think that's the most important thing. So you know, when you hear big news articles of, you know, journalists like to throw a big number out there, because it sounds really nasty. But some of that can be a base pay, and some of it can be stock options.

So you could argue that stock options could actually be a really good thing. If those if the way they're earning those stock options are helping the shareholders, the owners of the company, to also have good growth and up into the future. So my biggest takeaway from that kind of whole discussion is is management aligned, or getting about what the actual numbers are? Is management aligned with shareholders.

And if they are aligned with shareholders, then it makes sense for them to treat all these billions of dollars other moving around to treat it like they are stewards of the capital, serving the shareholders versus just being a way for them to line their own pockets. Is that fair? Oh, yeah, that's totally fair. So I guess what would be some examples of stock option alignment, where the way a CEO is being paid, aligns with shareholders,

Dave

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some of the things that I've seen that I've liked have been when they are paying them bonuses for things that move the needle for the company to be better and also how they spread them out. Sometimes they'll award stock options to accompany I'll give you an example of Novo Nordisk, which is a company I've looked at a little bit here recently. One of the things that they do is they award stock options, but they have three to five years for those to vest before they can actually liquidate them. And they can only liquidate them if they meet certain targets.

And so they set the targets up based on returns on capital free cash flow and I think it was market cap moving. So they're trying to drive the stock price. price higher, but they're trying to do it by returns on capital and generating free cash flow which they can use to reinvest in the business. And so when you combine those two ideas together, I'm okay, you know, if they're driving the stock price higher, because they're creating more growth from the products that they're generating, creating, I think that's a good thing for the company. And it's a good thing for me as a shareholder.

So I'm okay with the CEO, being rewarded for that productivity, and the fact that it's based on a three or five year period, and if they don't hit those targets, then that I'm okay with that. And the targets are also set. It's not like, so let's use for example, it's if they're going to use ROIC return on invested capital as a metric, they're not setting it at like, hey, the company has to achieve a 5% ROI see, when historically they have 25%, you know, it's, it's, they actually set it at a level that makes them stretch or is least comparable to what they've been doing.

And so that helps make it more aligned. I've seen some companies where they set you know, a fast growing company, and they set the revenue growth at 5% a year when they're growing at 25% Every year, and well, that's, that's too easy of a hurdle to step over. And they don't have to moderate the work at it, they earn the money. So I guess that's one of the ways I look

Andrew

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at it, I'll take the opposite side and be less optimistic. So I'll talk about a company who, when I saw this in their proxy statement, it literally made me not want to buy this company. So I'm not going to actually say the name of it. Okay, so don't hop over my screen and read the proxy statement I'm looking at. But so when you use the proxy statement, not only can you find out about management, but you can also find out who owns the company. And when certain group of individuals or a single person owns a majority stake in the company, they can basically decide whatever they want happens with the company, which includes who the CEO is.

And so I ran across a company like this, it's a great company. It's been growing for a while, it's got super strong brands that everybody knows, but the way that management was compensated were things like, and I'm just gonna read it right now. From their proxy statement, net sales, adjusted earnings per share diluted margin, EBIT, margin, free cash flow, growth rate and adjusted earnings per share, and shareholder return. Those are just some of the examples.

So when I read those incentives, I don't necessarily see them as aligned as a company like Novo Nordisk that you use in your example, because something that I think is not always obvious for beginner is that a lot of companies can grow their earnings per share really, really fast, by wasting a lot of money. So you can have companies that, you know, I'm thinking that like GE 20 years ago, where the CEO, not only were they lining their own pockets, agreed, honestly, some of the examples are, are absolutely ridiculous. Like, I've read this in the book, once I wish I could remember he would have a gym, like his own private gym set up every hotel, he went to like the gym, wherever he went, wasn't good enough, they had to like outfit his whole suite, you know, with the gym, whatever.

But what they ended up doing was they would buy a lot of businesses and pay huge prices for them. So that profit number is growing every year. But at what cost? It became unsustainable for GE, because they just burned through all this cash. So in a similar way, if I look at a company where it is majority owned by somebody else, it's not owned by all the shareholders.

And management could be compensated with high bonuses for just doing growth, without it being balanced by something where the way capital is being used as evaluated like return on invested capital, then that's pretty much a red flag for me. And if I see return on invested capital going the wrong way. Then you look at all those factors and you say maybe this investment isn't for me. So I guess that would be an example on my end of where the incentives don't seem to be aligned. And I don't like the way the company is going with their ROIC and some of their growth. So it's a pass.

Dave

19:23

Yeah, I've seen those kinds of things. McDonald's, Boeing, and I think Caterpillar a few years ago, all three of their CEOs were let go, because they were kind of gaming the system, they were kind of doing exactly what you're talking about. They were getting compensated on earnings per share growth, even though the company's earnings, like the actual number wasn't growing, but they're spending all their free cash flow on reducing the shares outstanding.

And so even though the company's revenues were flat, and their earnings were flat, their earnings were growing, and they were getting their bonuses. And so and people discovered they finally caught on that that's what they were doing, because they were manipulating the numbers to allow them to get their bonuses in all three of them were like, oh, for doing that kind of shady kind of stuff. So, you know, show me the incentive. And I'll show you the result. Right. I have probably

Andrew

20:13

one of the worst memories. So take that, for what it's worth advice. I feel like you had mentioned that on our show, like, three, four years ago. Yeah, talking about at least Boeing and McDonald's.

Dave

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Yeah, I remember reading article, I think it was in Forbes or somebody that they were talking about that all three of those CEOs were in a lot of hot water, because of people that discovered that they were doing that. So that's, you know, those are all great ways you can determine whether management is aligned with us or not, maybe we could talk a little bit about like, ownership of the company. I know, you have a couple of companies that you wanted to kind of talk about, maybe we could talk a little bit about how you look for who owns the company, and maybe how that can impact the decisions that are made with the company,

Andrew

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certainly. So I would say the vast majority of companies are owned by the collective public, think of like all of Wall Street. And that's everybody 401 K's, you know, pension funds, really rich people, whatever it is. It's funny, one of the pet peeves I have is when you see something going around on Instagram, where I guess I don't know, people are discovering the proxy statement, and not understanding how they analyze it. So they're like, Who is this BlackRock?

And why do they control every corporation? Like no, BlackRock and Vanguard, they're actually like holding the shares for everybody else who owns them, right. So you can look at the ownership, it's sometimes labeled like stock ownership or beneficial ownership, you look for a section like that in the proxy statement, and that will tell you who owns what, how much they own, does the CEO own a lot of stock does some founder own a lot of stock is a lot of it held by the general public. Those are all things you can find out from the stock ownership section of our proxy statement. So as an example, one of the companies I own watsco they are majority owned by basically the family that founded the company.

So you have Blackrock owns four and a half percent Vanguard 3.6. Remember, those are shares that BlackRock and Vanguard are owning on behalf of so many other people. And then you have over 50%, owned by the NOMID family, which is related to the founder. So you can use, you can use that information to tell you if shareholders have a say in the company, and the way the direction it's going or if they don't, because if you don't have a say, then you basically the only power you have is to walk away. So you could look at a company like Disney from a couple years ago, where investors were kind of getting impatient with the way they were choosing to strategize the company, whether that's through streaming or the parks or wherever it was. So you had basically voting proposals, that that are made on behalf of how to change what the company is doing.

When a company is owned by all of Wall Street, like everybody in the world owns a piece, then you can start to have voting where kind of the power of the crowd comes in. But a company like watsco, you don't have that because it's family owned, essentially. So if people who owned watsco did not like how the company is spending their money, for example, they can't necessarily drive a vote to have the company change, because the votes not going to matter, because they have been during the ownership. So when you find a company where there's majority ownership, you have to look at management, their actions, how they're compensated, those things need to have like a double, triple, quadruple look, with a really, really big magnifying glass because you really don't have as much power versus there was another company.

I won't say the name, but they used to own them, where there was like a huge fit, and they're actually voting materials sent out and, you know, shareholders were voting and that kind of influenced what the company was deciding to do and how are they are deciding to move forward. So not saying that, like you can just turn a blind eye if it's not family owned, but you can kind of hope that the crowds gonna push for change, when it's not family owned versus if it is family owned or founder owned. You you won't have that same recourse so you do have to be a little more careful as an investor.

Dave

24:52

You absolutely do a kind of on the flip side of that I know Intel just recently they had a vote for the CEO pay And kinda to your point, there was all these news articles about how much he was going to get paid and was considering the company was on a big time is on this big time struggle bus, it just seemed really outrageous. And so there was a big push back. And they actually, the shareholders actually got together and voted and, you know, it did not pass.

And so he wasn't able to get his bonuses that he, you know, had been, you know, told he was going to get just based on the performance of the company. So, it's interesting to kind of think about, like, a lot of people think about, you know, I want to own founder LED or family owned businesses, because it makes it simpler. But to your point, if you don't like the direction, or that's going, you don't really have much say other than to sell and go on to the next company. Yeah, so

Andrew

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that kind of, there's a level of oversight that's kind of gone there. So it's that extra level of trust that you're putting on another company,

Dave

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you really, you really have to like the people that are running the company, if they're in that much, and that much control, because like you said, you don't like it, there's not much you can do about it. And it's not

Andrew

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even necessarily a 51% ownership that necessarily drives that. Berkshire Hathaway, for example, Warren Buffett owns 33% 35%, which isn't the entire thing. So he can't completely vote, sway the votes, but he basically has had basic ownership from his 30% stake. So just having a significant stake can really sway how different big picture decisions are made at a company. Right?

Dave

26:33

Yeah, exactly. Exactly. You know, Google, kind of to your point, Google is not family owned, but it is majority owned by the two founders, they have two classes of shares. And they have a Class B shares, and a Class A shares. And the Class B shares are owned, and majority of them are owned by Larry Page, and Sergey Brin, who are the founders of the company.

And so they really control any decisions we make. And if you're a shareholder of Google, for example, and you don't like the direction the company's going, or you don't like the CEO, you don't really have much choice in whether or not that decision gets made. I mean, we can all buy a shares. And like you said, Vanguard and BlackRock hold almost 900 million shares for investors in that company. And there's about 5.9 billion outstanding. So it's only, I think, seven or 8% of the companies all those shareholders own. And so, you know, to your point, it's, you really have to check and see if everything that's going on at Google, meet your approval, as far as the incentives, the pay, you know, the any of the motions that they file for the company and just the direction that they're trying to go?

Because if you don't, you can always just walk away. Is there anything else about the proxy statement, kind of beyond? Maybe the management pay, and some of the incentives, ownership that you may look at as well?

Andrew

27:58

I don't really have much, how about you, the only other thing

Dave

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that I look at it for, besides those important areas is who they consider their peers. Because a lot of times when you read through the 10k, they may or may not list out specific companies. And so you may not know I mean, if you read Walmart's you know that Amazon is going to be competitors is that, you know that, but it's also helpful to look through that section to see who they consider as competitors.

And then I use that as a way of either measuring, like, what kind of total market maybe they think they're going after. And I also will look at it as a way of investigating other companies, because sometimes you may be looking at Company A, and you find that they have these 10 other competitors, and you read through those and you find one that you like better than the one you originally started with. And it's just, it also gives you a kind of a good idea of the whole overall market as well. So that's, I guess the other place that I look for with stuff,

Andrew

28:58

you can also you can go so deep down the rabbit hole, you can you can see how the different direct board of directors is constructed. So you have a board of directors might be 510 people who kind of make other decisions, and they're kind of the balance of power against the CEO, and when they are voted in and how they are voted in is all in the proxy statement. And sometimes the way these committees are constructed I've seen at least one instance where even though the person didn't have majority ownership, they had really tight control over everything because of the way the Board of Directors was structured.

So in especially with those smaller companies, if you do some digging, you might find stuff that really stinks when that can be well worth it if you're investing a lot of capital so you can go down the rabbit hole, or most investors buying big Companies in the s&p, I think, thinking over the things that we talked about is helpful, I would not make a decision solely on a certain number or ratio I saw, I would take it in context with everything else. And also with how the company is moving in general, and more use the proxy statement to try to understand where management's coming from and how things are structured. That's kind of how I would look at it.

Dave

30:26

Yeah, that's a very good point. I think the last thing that I would kind of relay is, if you're unsure about what the company's growth metrics, or whatever their compensation metrics are, really whatever their goals are, and where they're trying to go. If you listen to an earnings call, the topics that they talk about the most in the earnings call, especially in a management presentation, those generally are going to align with either the compensation or the stated goals for the company, whether that's revenue growth, or earnings growth, or things of that nature.

And so that can be a bit of a cheat code, to help you figure out what it is that is important to the company. Because there usually be three or four things that are like super important to the company. And I'll talk about those a lot. And then when you read through the proxy statement, you may find out that those are the things that the management is compensated on, or that's those are the incentives driving the company forward. And that can be a kind of a cheat code to help you figure out some of that stuff. That's something I learned. All right. Well, everyone that's gonna wrap up our show for this week.

Don't forget to subscribe to the show on your preferred podcast app if you enjoyed our little show. If you would kindly consider giving us a review. It greatly helps the show. And don't forget to browse the incredible materials we've created for you at investing for beginners.com. Last week, consider growing your knowledge as an investing for beginners insider with insights and educational tips delivered right to your inbox for free sign up today. And with that, I will go ahead and wrap us up you guys go out there and invest with a margin of safety emphasis on the safety. Have a great week, and we'll talk to you all next week.