SIGMA INVESTMENT COUNSELORS

Sigma Summaries

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Why should you care about corporate governance?

It's been said the best way to be boring is to leave nothing out. There is definitely a lot to leave out when writing about corporate governance. Trying to write about it in an interesting and compelling way is a bit like adding color commentary and a half time show to C-SPAN. Then again, people would definitely pay more attention if Fox Sports covered Senate hearings and Britney Spears performed during the breaks. I decided to try and keep this as simple as possible and answer one main question: Why should you care about corporate governance?

The bottom line is good corporate governance makes it harder for corrupt managers to steal from shareholders. Companies can put in place policies and guidelines to help prevent the fiascos that happened at Enron and Tyco. This is what good corporate governance is about. It can ensure management is working in the best interest of shareholders, instead of only their own.

If you owned a restaurant, you could hire and oversee a manager to run your business. If your restaurant was being mismanaged, you could hire a different manager. As shareholders of a company we elect a board of directors, who then hire and oversee management. If shareholders believe a company would be better off with different management, they have two choices - sell the stock, or hold it and use proxy votes to send a message to the board.

We recently used proxy votes to send a message to the board at Walt Disney. We believe management of the Disney theme parks, movie library, and television networks could be improved. Therefore, when Chairman and CEO Michael Eisner came up for reelection, we withheld our support. This year, an unprecedented 45% of shareholders withheld support for the reelection of Eisner.

Disney's board of directors responded by removing the Chairman responsibilities from Eisner. He remains as CEO of the company. As Chairman, Eisner was running the board that oversees his job as CEO. We believe in this case, separating the positions is a step in the right direction.

After the Disney shareholder vote, the board issued a statement. The following is an excerpt:
"While there appear to have been a number of different forces at work in the shareholder vote, a significant message conveyed in the vote was in the area of governance, as evidenced by governance-driven withhold recommendations by two influential proxy recommendation groups and the public and private statements by a number of other shareholders. In particular, there was substantial focus on the question of whether the Chair and CEO functions at the Company should be split... We believe the action we have taken today is in the best long-term interest of the shareholders of the company."

Acting in the best long-term interest of the shareholders of the company is the basis of good corporate governance. A recent Wall Street Journal editorial defined corporate governance as "ensuring that managers serve the shareholders and not themselves." How can we as shareholders evaluate whether management is serving us?

Sigma's investment committee developed and maintains proxy voting policy guidelines. The "best interest of the shareholder" is the key tenet underlying the committee's decisions and judgments. Using these proxy guidelines, we actively vote our clients' proxies, unless the clients prefer to vote themselves.

The reasons we decided to withhold support from Eisner had to do with board independence, lack of a clear succession plan, and what we consider to be excessive pay packages. While recent changes to

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Disney's board appear to have increased the quality of corporate governance, we believed additional changes needed to be made.

In January 2004, Disney published corporate governance guidelines. Included in these guidelines is a policy that a substantial majority of the board be considered independent, or outsiders. Usually, directors not employed by the company are considered outsiders, and those employed by the company, or who have significant business relationships with the company, are considered insiders. If insiders dominate the board it would seem difficult for them to fairly evaluate the person who is also their boss on a day-to-day basis. But, insiders can also be effective contributors to boards because of their superior knowledge of the company.

Disney's corporate governance guidelines also cover management succession, but an actual plan has not been made public. According to the guidelines, Disney's CEO is required to meet once a year with non-management directors to discuss potential successors. Eisner is supposed to have a confidential written procedure in place at all times for someone to take over the company, if something were to happen to him. Disney may have a brilliant succession plan for Eisner, but since it is not public information, it leaves an uncertainty when evaluating the company's future.

The compensation committee on Disney's board of directors states their objectives as *"to obtain and retain management and creative talent while ensuring that executive officers are compensated in a way that advances both the short and long-term interests of shareholders."* Eisner's current contract went into effect in January of 1997. Through the end of 2003, Eisner's compensation including salary, cash bonus, and stock options has totaled $285 million. Shareholders have not been rewarded nearly as well. During the same time period, Disney shareholders earned a total of 1.4% on their investment while the benchmark S&P 500 index returned approximately 56%. Eisner's compensation does not appear to be aligned with shareholders' interests.

The shareholder revolt at Disney sent a signal not only to the Disney board of directors but also to the thousands of directors serving on corporate boards across the country. The main responsibility of a board of directors is to evaluate management and reward, punish, or replace as they see fit. If shareholders do not believe a board is doing their job, they should vote their proxies accordingly.

There are a number of issues to consider when evaluating corporate governance and how to vote proxies. They all boil down to acting in the best interest of shareholders. As investors, we need to constantly review the governance procedures and policies corporations put in place and evaluate their impact on shareholders. Voting our proxies can send a message to the board to remain diligent and active in their evaluation of management. Having strong corporate governance policies in place will hopefully provide a deterrent to management from acting only in their own best interest and instead putting shareholders first.

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.

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