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Executive Riches

We begin with some unsolicited advice:

Forget about Occupy Wall Street. It's an activist movement of a mostly inactive, but definitely angry, mob. Exactly what they are angry about, nobody seems to know. Here's a guess. They are the true one-percent minority, and it makes them mad. The rest of us already have a life.

Ignore the White House, the ranting and raving about the wealthy not paying their fair share. We know who they are. They work hard, pay their taxes, contribute more than they take. Yes, we know. We just don't know how the big red target was placed on their backs.

In their own way, these are both feeble political ploys of little value. Occupy Wall Street is a not-very-popular populist movement. White House bashing of the wealthy is just another replay of class warfare. We've seen it all before. Neither one offers optimism, or a solution. Come to think of it, they don't even define the problem.

Here's a better one. It's a real issue, related to pay, and to a sliver of the wealthy. It's something that investors, people with their own money on the line, can be angry about: exorbitant pay at the executive office.

Today's leading example is the recently announced retirement package for the outgoing chief executive of Johnson & Johnson. We presume he is a fine man, upstanding member of his community, and a pretty decent chief executive. It's just that his gold watch contains too much gold.

Somewhere along the line, every business school student learns that the primary objective of management is to maximize shareholder value. This might seem cold-hearted, and certainly there are cases where the ends do not justify the means, so let's soften it up a bit. We'll suggest that there may be a handful of measures to assess an executive's performance. Nevertheless, one of those measures is enhancing shareholder value.

How has it worked out for Johnson & Johnson?
Not too well.

Since the newly-departed CEO took the helm in April 2002, the price of JNJ's stock has gone nowhere. Sure there were ups and downs, but after ten years the only thing showing for shareholders is a one dollar price gain and the dividend stream paid out over the decade. Trust us, nobody signed on just for the dividends.

JNJ April 2002 – April 2012

Okay, not every stock can be a winner, and it's not as if the company collapsed. Here's where we have a problem: According to the JNJ board, the performance displayed above is worth a retirement package valued at $144 million. This includes a $48 million pension benefit -- who says pension plans are passé? -- and $95 million in deferred compensation plans.

In fairness, managing JNJ may be no easy feat. The firm encompasses over 250 operating companies, organized into three major business segments, and conducts business in almost all countries of the world.

Furthermore, the company has not stood still these ten years. Aided by acquisitions, revenues have doubled to $65 billion. Net income has more than doubled, with earnings per share compounding at ten percent per annum over the decade. For a large-cap diversified healthcare company, these are good results. Maybe the stock was simply overvalued ten years ago, and no management genius could have overcome that initial hurdle. But still, $144 million?

To be sure, there are more egregious cases of corporate excess. Google's CEO-turned-Chairman was paid $100 million last year, the year in which he stepped away from day to day management. It's not as if he needed the money, or the incentive. His ownership stake already makes him a billionaire; and if watching over one's personal fortune is not incentive enough, what is?

Apple's new CEO was awarded one million shares of stock upon taking the helm. Sure, it vests over time, and one million shares of stock might seem modest in most cases. But when the stock is Apple, and it sells for close to $600 per share, this is a mighty nice welcome gift for an unproven CEO.

Where does it end? At Chesapeake Energy, it was disclosed that the Chairman & CEO owns a personal stake in all the company's drilling properties; and that he took personal loans in excess of one billion dollars, using his ownership interest as collateral. It leaves investors wondering why a Chief Executive needs to own a share of his company's properties, and why he needs a billion dollars. Isn't a paycheck, a bonus, and stock ownership enough compensation?

The truth of the matter is, it never ends. The corner office at public companies has become a "heads I win, tails you lose" proposition, where directors spend shareholder money to enrich their chosen one.

Finally, shareholder activism is pushing back. "Say on Pay" initiatives, while non-binding, are gaining traction. Last year some 40 companies were rebuked by shareholders on pay issues. A recent vote of Citigroup investors rejected the proposed compensation plan for senior executives. The biggest gripe: a disconnect between performance and pay. Since we started with advice, here's some for directors: Take heed.

And on second thought, by today's standards, maybe JNJ got itself a bargain.

Health Care and the Supremes

Constitutional law is not meant to be entertaining, but there was a certain sense of amusement in following the recent 'Obamacare' arguments at the Supreme Court. The common thread was an attempt by all parties to weave legal solutions into what are essentially economic problems. Let's not pretend this is off limits, that economics and regulation are at all times separate and distinct. Even in the most capitalistic society, that is a make-believe world.

Still, in the three days of oral arguments, something, or someone, was notably missing from the hearings -- a reasoned economist. Oh, sure, a supreme court justice or solicitor general probably has some grasp of economic concepts -- general principles of supply and demand, substitution, elasticity, and most important in this case, free-riders. It's just that, too often, a little knowledge can be a dangerous thing.

Case in point:
'Everybody uses health care eventually.'
True, but we do not all need insurance to pay for it. The wealthy can self-insure, even the not-so-wealthy. Ever visit the dentist or optometrist without insurance? Same here, because it is cheaper that way. Insurance companies do not set out to lose money, and their prices reflect both the cost of care and a built-in profit.

Second case:
'The young and healthy, in opting out of insurance, are distorting the market.'
As a group, young adults are not distorting the market. They are acting rationally, and rational behavior is a basic premise of economic analysis. If this creates a high-risk pool of older adults buying insurance, the industry has a solution: risk-based pricing. It's not much different from the way auto insurers price their products -- adjusting for age, miles driven and safety record of each policy-holder. Pricing is a great arbiter, and the health insurance industry is alive and well and highly profitable.

Third case:
'Free riders create a burden on the entire system.'
Free riders -- those who game the system, using it without paying -- shift the burden to actual providers of care. Hospitals are the primary victims of free riders, and this is a real problem. But the health insurance mandate provides exceptions to numerous companies and to the poor -- and the poor are the most likely group of free riders, so this problem will continue in any event.

Fourth case:
'If nothing else, the health care law will reduce costs.'
Really? Then why did it include a cut in Medicare funding?
If every American is insured, presumably the demand for health care services will increase. With no commensurate rise in the supply of health care, prices will increase. Or do the rules of supply and demand not apply here?

The Supreme Court ruling on Obamacare is expected in June. Regardless of the outcome, certain truths will remain: The US maintains a complex, inefficient patchwork of health care. We spend more than necessary, with results that are good but not great. Nobody starting with a blank sheet of paper would design such a wasteful system. At the same time, we are the world's leader in medical innovation, we manage to provide care to most of our needy, and we have justifiably resisted the most fiscally efficient and morally cruel practice -- outright rationing of care. The system is flawed, yet most ideas to fix it would only make it worse. Obamacare, a poorly designed reform bill, rushed through Congress and expanding government's reach, does not answer the challenge.

In the end, there are two well-kept secrets about health care:
1) we are gradually moving toward a nationalized system, but nobody wants to own up to it, and
2) the enormous financial burden facing America is the unfunded liability known as Medicare.

Everything else is just a side-show.
For three days at the Supreme Court, at least it was entertaining.

Silly Season

A long time ago, there was a television show named 'Can You Top This?'. While the title is memorable, exactly what the show entailed is beyond all recollection. Presumably it was light-hearted entertainment, which is what television is still best at delivering.

Years later, the catch phrase has somehow evolved into a stock-market game of one-upmanship, and nowhere is it more apparent than in the coverage of Apple, Inc. To be clear, as owners of Apple we are thrilled at the success of the company and its stock; and if analysts want to play cheer-leader, go right ahead. Still, when the posturing gets silly, somebody needs to say so.

Specifically, this may be the first-ever 'bidding war' on analyst price targets, which are silly in their own right. Just in the past month a little-known analyst made some noise by raising his price target on Apple to $740 per share, while the stock traded near $600. Next up was a more reputable analyst, a long-time Apple bull, who raised his target to $1000 per share. A third contestant chose numeric symmetry, setting a target of $1111. Perhaps he was making fun of it all. But don't blink, the bar was raised yet again by another contestant, who felt the price of $1200 was within reach.

Did we say contestant? Sorry. Honest mistake.

As for us, we are investors, not promoters, and do not set price targets. Call us party-poopers. Still, with 56 Wall Street analysts covering Apple -- all vying for attention, with little cost in missing their targets -- something tells us we have not heard the last of it.

Do we hear $2000?

Sources:
1. Bloomberg
2. Wall Street Journal
3. Johnson & Johnson corporate filings

Tidbits..

White House proposes eliminating tax breaks for big oil.
Among the largest tax payers already, but it makes for good sound-bites.

Federal Reserve stress test gives passing grade to 15 of 19 large banks.
Results spark dividend hikes, share repurchases, increase confidence in banking system.

Kraft Foods snack business to be re-named "Mondelez".
Is there an award for worst name ever?

Exxon Valdez tanker, name changed but infamy retained, is sold for scrap 23 years after oil spill.
And after 23 years, the lawsuits continue.

Chairman Bernanke says Fed's easy credit policy did not fuel housing bubble.
No, it just kept re-filling the punch bowl.

European economy shrinks 0.3% in fourth quarter 2011, seemingly worsens in early 2012.
The start of a Euro-recession, and possibly a severe one.

S&P/Case-Shiller Home Price Index falls to nine year low.
Anecdotal signs of housing recovery are not matched by pricing moves.

Group led by Magic Johnson buys Los Angeles Dodgers for $2.2 billion.
A milestone price for any team.

Corporate bond issuance in first quarter reaches record level at $427 billion.
Borrow money when money is cheap.

Best Buy to close 50 stores in start of restructuring program, CEO is ousted.
For specialty retailers, big box storefront equals big overhead costs.

White House, claiming manipulation, seeks tighter regulation of domestic oil markets.
Next ploy: open strategic petroleum reserves.

Apartment vacancies drop below 5%, lowest since 2001; home ownership falls to 15 year low.

Data reveals Federal Reserve bought majority of US debt issuance in 2011.
A nice trick -- offsetting high deficits with low interest rates -- for as long as it lasts.

Natural Gas spot prices briefly fall below $2 per mmbtu, lowest in over a decade.

Argentina moves to nationalize oil company YPF, majority owned by Spain's Repsol.
Capitalism, rule of law, are victims of populist government.

E.F. Hutton name resurrected as new brokerage firm picks venerable moniker.