July 2013

"No One Washes a Rented Car[1]"

Warren Buffett has often addressed the issue of his acquisition criteria in the Berkshire Hathaway annual letter to shareholders. The following quote highlights one factor that Buffett finds important: significant ownership by the managers of the business.

> *"Our favorite form of purchase is one fitting the pattern through which we acquired Nebraska Furniture Mart, Fechheimer's and Borsheim's. In cases like these, the company's owner-managers wish to generate significant amounts of cash, sometimes for themselves, but often for their families or inactive shareholders. At the same time, these managers wish to remain significant owners who continue to run their companies just as they have in the past."*

1991 Berkshire Hathaway Annual Letter to Shareholders

What Mr. Buffett is describing in the above quote is companies run by owner operators whose interests are well aligned with shareholders. This is critically linked to another important topic that Warren and his partner Charlie Munger have spoken about in the past, and that is incentives. An incentive is defined as "a thing that motivates or encourages one to do something." In fact, Charlie Munger once said the following about the importance of incentives:

> *"I've been in the top 5% of my age cohort all my life in understanding the power of incentives, and all my life I've underestimated it. And never a year passes but I get some surprise that pushes my limit a little farther."*

If these types of business – ones where management has a significant ownership stake and, consequently, their incentives aligned with shareholders – are Buffett's favourite form of purchase, then surely the average investor can also benefit from similar types of investments, albeit on a much smaller scale.

So what are the incentives for the management of the typical company? And how do they compare to the incentives for managers of owner-operated businesses?

Typical Management Structure Incentives

In the typical corporation, shareholders are represented by a Board of Directors. This group oversees the hiring of professional managers that are compensated primarily through salary, bonus and stock options. In a technical sense, these managers are agents of the shareholders - people who are supposed to run the business and increase the value of the enterprise over the long run. Quite often, however, the incentives for these managers do not perfectly align their interests. Professional managers often wish to increase the **size** of the business because a larger business leads to more prestige, and often a larger pay package. In our experience, this desire to grow often leads to value-destroying acquisitions that lead to future write-downs.

The Appeal of Owner Operators

These agent/principal issues do not impact all companies equally. This is why we, at Sionna, spend a lot of time evaluating the track record of management, and their capital allocation policies to ensure that they think, and act, like owners. We assess their ability to focus on the long-term, increase value on a per-share basis and conservatively manage the business. Although it is possible to find professional managers who “get it”, they are most likely to be found in businesses where the current CEO or Chair of the Board has a significant amount of personal wealth invested in the company. Often, these individuals are the original founders and have demonstrated their managerial acumen by building a successful business. More importantly, they also still tend to manage the business as if it were private: shunning short-term thinking, focusing on growing pershare value, and making opportunistic investments that will increase the value of the firm over the long-run.

Academic Evidence

There is a growing collection of academic research that supports the argument that the better alignment of incentives of owner operators does in fact lead to behaviours that benefit all shareholders of the company. A 2012 study[2] by Babson professors Joel Shulman and Erik Noyes examined the historical stock price performance of companies managed by the world’s billionaires. For the 10-year period ending March 2011, they found that an index of billionaire-led companies outperformed the S&P 500 Index by over 750 basis points annually.

Conclusion

Sionna is fond of owner-operated businesses. In fact, one feature that we look for in our qualitative analysis is the extent to which management has insider ownership. Fortunately, we have identified many companies that are owner operated and also meet our other qualitative and valuation criteria. Some of these companies across our various portfolios include Power Corporation, Empire, Brookfield Asset Management, Home Capital and FirstService – among many others. In each of these cases, management has a significant personal stake and a long-term focus on building value. It is no surprise to us that these businesses have impressive long-term track records and are managed in a conservative manner. We believe that owning these types of businesses supports our goal of providing downside protection and long-term outperformance for our clients.

[1] Prem Watsa, 2012, Fairfax Financial Annual Report

[2] Shulman, J.M. and Noyes, E. "The Rich Get Richer and So Can You: *Investing in a Billionaires' Index" The Journal of Index Investing*, Spring 2012, pp. 12-32