Shareholder Activism in the Last 100 Years

Even if you are a casual stock market observer you probably have noticed the preponderance of shareholder activism during the last few years. It seems that almost every week a hedge-fund manager is mentioned on CNBC or the Wall Street Journal waging a battle against some company. And no enterprise, no matter the size, is impervious to this type of attack.

One of the fiercest shareholder activist campaigns in recent years has been the feud between Bill Ackman and Herbalife. Bill Ackman is the founder and CEO of Pershing Square Capital Management, a hedge-fund management company managing more than $10 billion in assets. Herbalife is a multi-level marketing corporation that sells nutrition supplements, weight management, nutrition and personal care products, distributing its products through more than three million independent distributors worldwide.

Multi-level marketing is a controversial marketing strategy, where the sales force is compensated not only for the sales they generate, but also for the sales of the salespeople they recruit. Many pyramid schemes disguise themselves as multi-level marketing firms, and that is exactly what Bill Ackman accuses Herbalife of doing. Since 2012 Bill Ackman has waged a public relations campaign against Herbalife, while shorting around $1 billion of the company's stock.

Dear Chairman

While it may seem that shareholder activism is a 21st century phenomenon, it is nothing new. It has been going on for a century. In his new book *Dear Chairman: Boardroom Battles and the Rise of Shareholder Activism*, Jeff Gramm, a hedge-fund manager and adjunct professor at Columbia Business School, traces the skirmishes between management and activist investors from the 1920s to today. He does this by offering eight case studies of shareholder activism over the past 100 years. Additionally, and equally interesting, he shows the original activist shareholder letters, some of which have not been publicly revealed before.

The eight case studies that Gramm analyzes are:

- Benjamin Graham vs. Northern Pipeline (1927)
- Robert R. Young vs. the New York Central Railroad (1954)
- Warren Buffett and American Express (1964)
- Carl Icahn and Phillips Petroleum (1985)
- Ross Perot and General Motors (1985)
- Karla Scherer and R. P. Scherer (1988)
- Daniel Loeb and Star Gas Partners (2005), and
- J. Carlo Cannell, John A. Levin, and BKF Capital Group (2005)

Through these cases, Gramm shows us some of the inner workings of boards of directors work and what drives management teams to perform. He shows us how shareholder activism can be good, by challenging inefficient corporations, but can also be bad, by cultivating a culture that focuses on short-term results instead of one that manages for the long-term.

Let's explore a couple of these cases.

The Dean of Wall Street

Benjamin Graham, fittingly referred to as "the Dean of Wall Street," died almost 40 years ago, but he left a long-lasting legacy, due to his writings and the remarkable success of his students. *Security Analysis*, first written in 1934, is considered the bible of value investing and continues to sell today. Warren Buffett is Graham's most famous disciple, but other successful investors, such as Walter Schloss, Irving Kahn and Bill Ruane, owe their investing accomplishments to Graham.

Back in 1927 Graham was running a private investment account that worked very similar to the hedge funds of today. Graham's modus operandi was to look for undervalued securities, and he found one in the stock of Northern Pipeline. Northern Pipeline was one of eight pipeline companies created in 1911 when Standard Oil was broken apart after it was declared a monopoly.

In analyzing Northern Pipeline's financials, Graham found a company that generated over $6 per share in yearly earnings and owned investment securities worth $90 per share. Yet the stock was trading $65 per share, well below the true worth of the company. Graham had found a great bargain, and all he had to do was convince the company's management to share that wealth with its shareholders.

It turned out, though, that was easier said than done. Senior management at Northern Pipeline was adamantly opposed to giving away their cash hoard to shareholders. The company's cash gave its managers a huge cushion that protected their jobs, and they were not willing to let go of that protection.

Graham went to the annual meeting and was mostly dismissed; he wasn't even allowed to ask a question, because nobody was willing to second a motion that he made. He then decided to run a proxy fight for two seats on the board of directors and wrote a letter to the Rockefeller Foundation to try to gain their support. The Rockefeller Foundation was the largest holder of Northern Pipeline stock, owning 30% of shares. Even though Graham's idea of distributing Northern Pipeline's large amount of cash and securities would be beneficial to the Foundation, they were not interested, as they claimed never to interfere in the operations of their investment companies.

Without the support of the Rockefeller Foundation, Graham was forced to obtain the proxies of a large number of minority shareholders. By the beginning of 1928, he had enough votes to gain two board seats at Northern Pipeline. At that year's annual meeting Graham and his lawyer became the first outsiders to ever be elected to the board of a Standard Oil affiliate. Soon thereafter, Northern Pipeline decided to distribute its cash to shareholders.

The Great Salad Oil Swindle

In 1960, much like today, American Express was a respected company with a well-known and cherished brand. The company's main operations were its dominant traveler checks business, and its new, rapidly-growing credit card division. It also had a small field warehousing business that most people had never heard of. It was that small business that almost caused the company to collapse.

Anthony "Tino" De Angelis was the owner of Allied Crude Vegetable Oil Refining Corporation. He was also a con man who had repeatedly defrauded the U.S. government. De Angelis needed some money, but no bank would ever lend him any without independently verifying collateral. He discovered, though, that he could obtain loans based upon the company's supposed inventory of salad oil. And that is where American Express' field warehousing operation came in.

Ships apparently full of salad oil would arrive at the docks, and American Express inspectors would confirm that the ships were indeed full of oil. American Express issued warehouse receipts certifying Allied's ownership of millions of pounds of soybean oil. This collateral allowed Allied to obtain millions of dollars of loans.

The problem arose when an anonymous tipster called American Express and exposed a fraud at Allied. He explained how the ships were mostly filled with water, with only a few feet of oil at the top. In the end, Allied claimed to have 1.8 billion pounds of soybean oil, when it actually only had 110 million pounds. American Express was on the hook, as it had guaranteed all that salad oil. The stock reacted immediately, plummeting more than 50% in the months following the scandal. It was this drop that caught the attention of a young hedge fund manager named Warren E. Buffett.

Warren Buffett is now one of the world's richest persons and the well-known CEO of Berkshire Hathaway, one of America's largest and most-admired corporations. Back in the 1960s, however, Buffett was a 30-something investor managing a few million dollars through his investment partnership. He was always on the lookout for bargains, and he saw one in American Express stock after its massive drop. Buffett, never shy about pouncing when he saw a great opportunity, bought a significant position in American Express stock for his partnership. At one point, Am Ex accounted for almost a third of his portfolio.

American Express eventually reached a settlement with salad oil claimants that would cost the company $32 million net of taxes. But that settlement was delayed when the company's own shareholders filed suit to block any settlement, arguing that American Express had no legal obligation to pay the subsidiary's liabilities. It was at this point that Buffett wrote a letter to Howard L. Clark, the President of American Express.

Warren Buffett's activism was unlike most, as he didn't demand board representation or question management's performance. Instead, he praised management and, convinced that the strength of American Express was its reputation, he urged the company to use its capital liberally to reward those that were defrauded in the swindle. Buffett wrote: "*…it is our judgment that American Express by making a fair and perhaps even generous offer is an enterprise that is worth very substantially more than American Express disclaiming responsibility for its subsidiaries' acts.*"

In the end, American Express settled its claims and the company emerged, as Buffett suspected, with a better reputation. The handling of the crisis strengthened the company's business and its management team. And Buffett, as has been the norm now for more than half a century, scored huge profits in his investment.

Conclusion

In *Dear Chairman*, Jeff Gramm turns the dry topic of shareholder activism into an intriguing, informative, and entertaining tale of investors morphing from passive onlookers to passionate owners. Experienced and novice investors alike will do well in reading this book, not only for its historical context but also for its lessons in how to effectively bring change to mismanaged companies.

FELIPE

Felipe Garcia, CFA
Chief Investment Officer
INKWELL CAPITAL LLC

Aaron

Aaron Byrd, CFA
President
INKWELL CAPITAL LLC