HQAM

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CORPORATE EXCELLENCE INSIGHTS

We are a specialized provider of systematic Quality Investment Solutions and one of the few providers of Quality equity investment strategies worldwide. Corporate Excellence Insight is our monthly publication that includes a brief update on markets and our thoughts about major trends that are impacting the investment management industry.

MARKET UPDATE: SUPPORTIVE POLICIES AND SOLID EARNINGS

Trump's tax reforms continue to progress with the House passing the Senate's 2018 budget. This provided additional confidence that the US Federal Reserve will raise rates towards the end of this year. Business and consumer confidence remained buoyant in November.

129MWh

WORLD'S LARGEST BATTERY INSTALLED BY TESLA

Tesla has completed construction of the world's largest lithium ion battery in Australia, putting it on track to meet a 100-day deadline for switching the battery packs on.

3h15min

EXPECTED FLIGHT TIME FROM NEW YORK TO LONDON

Denver-based startup Boom Supersonic has won a $10 million investment from Japan Airlines Co Ltd in its push to build a supersonic passenger aircraft it claims will be faster, quieter and more affordable to fly than the Concorde.

$15.4bn

SUM THAT APPLE AGREES TO PAY IRELAND IN BACK TAXES

Apple reached an agreement with the European Union to begin depositing the $15.4 billion in back taxes it was ordered to pay Ireland last year, following the landmark decision to crackdown on tax shelter policies and profit offshoring.

MONTHLY TOPIC: PROBLEMATIC LEADERSHIP

Despite strong stock market performance, there is still plenty of bad news this year about CEOs leaving after poor results. The CEO of Avon quit this August after the company's stock lost 85% since she took the office in 2012. The CEO of AIG quit in March after the company failed to meet the turnaround plan targets and posted losses in four out of six quarters. The problem of stumbling CEOs seems to be always there. But how can we avoid selecting them in the investment portfolio?

Underperforming CEOs are more common within the Energy and Financial sectors, followed by Materials and Information technology sectors.

CEOs with technical backgrounds don't necessarily achieve higher shareholder returns than those without. But with rapidly changing technologies and consumer preferences, having the right specialist experience can help CEOs keep their companies and their offerings relevant.

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PROBLEMATIC LEADERSHIP: UNDERPERFORMANCE STARTS AT THE TOP

Quality companies should exhibit robust stock market performance even in difficult times. To find out what makes for strong performance, it is common to look at success stories to find out what they do right. It is less common but, if your concern is downside risk, perhaps more valuable to look at CEOs that performed poorly and see why they made mistakes. HQAM recently carried out a study with the Ashridge Strategic Management Centre (ASMC) at Hult International Business School of "stumbler" CEOs - CEOs that underperformed the market by 25% or more in the CEO's last two years in office. Nearly 10% of all CEOs of top 100 companies in the USA and Europe leaving office in the 10 years from 2007 to end 2016 were stumblers. Companies are often discrete about why the CEO is leaving. A few of these CEOs were not held to blame for company performance. For example, Patrick Thomas stepped down as CEO of Hermes after a substantial fall in the stock market price in his last two years in office. But Hermes price had been artificially inflated by speculation of a hostile takeover. And Thomas was the exception that proves the rule; most of these poor performing CEOS were fired and many more left under a cloud.

We looked at the statistics on all these 65 "stumbler" CEOs to understand their distribution by regional market and industry and then worked up case studies on 47 of them to get beneath the surface and understand how corporate strategies, top management background and Board composition were influencing performance.

Underperforming CEOs: regional and size differences

Fig 1. Regional differences

Company	USA	Europe
No. of CEOs analyzed	267	327
No. of underperforming CEOs (2 years)	23	42
Share of underperforming CEOs to total CEOs	8.6%	12.8%
Median CEO tenure (years)	5.8	5.2
Median underperforming CEO tenure (years)	5.7	5.8

Source: Hérens Quality Asset Management

Our sample consisted of 594 CEOs of top 100 US and European companies over the period from 2007 to 2016. We have found European CEOs in the sample to have a substantially greater propensity to stumble than US CEOs. This difference is largely explainable by differences in the average size and market capitalization of US and European companies. As shown in Exhibit 2, smaller companies are more likely to stumble than larger ones, which is particularly well-seen in the US, where the portion of underperforming CEOs to the total number of smaller companies' CEOs reaches over 30% rate.

Fig 2. Underperforming CEOs in % of total

Market Capitalisation	US	Europe
0-20 billion	35%	18%
>20-50 billion	12%	18%
>50-100 billion	5%	8%
>100 billion	4%	7%

Source: Hérens Quality Asset Management

Underperforming CEOs: allocation by industry

More interesting are the differences by industry. Locating the underperforming CEOs on the industry chart, one can clearly see that the largest contribution in the US is provided by the Energy and Financial sectors, followed by Materials and Information technology sectors. In Europe Financials are also in the lead, while IT, Materials and Utilities also have significant numbers of poor performing CEOs.

On the same chart we have also plotted the relative exposure to the industries in the Herens Quality portfolio. The Herens Quality portfolio is underrepresented in Energy, Financials or Utilities sectors. So, investing in the Quality style does indeed help reduce the risk of selecting stumblers.

The exception is information technology industry, which also supplies a significant number of the underperforming CEOs. So, the selection in this sector would be the key to success to avoid the severe undeperformance cases.

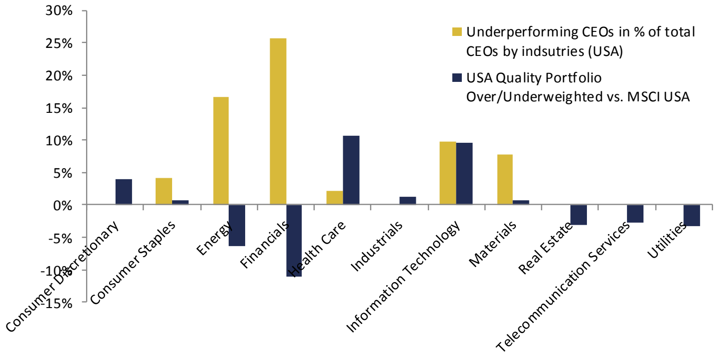

Figure 3: USA Industry sectors: Share of underperforming CEOs to total number of CEOs, relative exposure of USA Quality Portfolio (Source: HQAM)

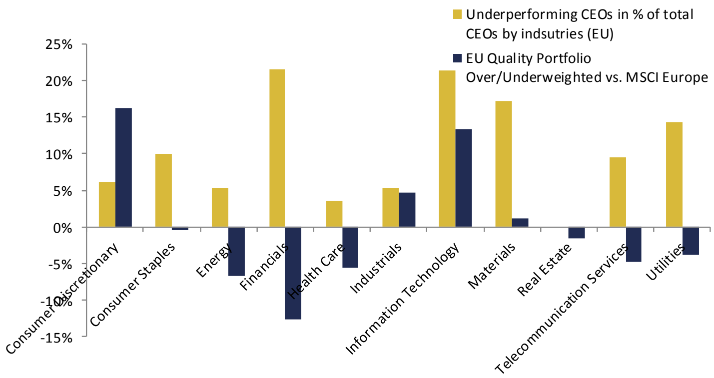

Figure 4: EU Industry sectors: Share of underperforming CEOs to total number of CEOs, relative exposure of EU Quality Portfolio (Source: HQAM)

A richer picture appears if instead of classifying Consumer companies into Consumer discretionary and Consumer Staples, we classify them into consumer goods producers and retailers. Both consumer goods producers and retailers are favoured industries for the HQAM quality portfolio. But retailers have a much higher propensity to stumble than consumer goods producers.

Conclusion

The industry mix in the HQAM quality portfolio, with a much lower share of financial services, energy and materials companies, substantially reduces the probability of selecting stumbler CEOs with marked underperformance. But all sectors have some stumbler CEOs. In an upcoming white paper, written together with ASMC, we look in detail at stumbler CEOs and their track records to identify "markers" that make it possible to reduce the risk of selecting stumbler CEOs regardless of industry.

For HQAM corporate governance and CEO assessment is an important aspect in the investment process. It is not only the business model, which influences the corporate performance, but it is also the personality of CEO, the person in the lead (more can be read on CEO inluence on stock price in our previous article (link to article)).