COMMENTARY

March 17, 2017

Dear clients and colleagues,

We have been very busy since the beginning of the year, attending conferences in Japan, Hong Kong, Europe, the US and Canada.

In recent commentaries, we detailed the positive outlook that the majority of companies we met are discussing for this year and next. So far this year, economic data from around the globe support that optimistic outlook. Global growth should be strong in 2017 unless a policy mistake or geopolitical incident takes place.

During our meetings with over 200 companies since the beginning of the year, what struck us was the significant difference in executive compensation between North America and the rest of the world. American CEOs, for similar size companies in similar industries, make two to three times the compensation of European CEOs and four to five the compensation of their Japanese counterparts.

An example: the CEO of Toyota, Akio Toyoda, received the equivalent of US$3.1M in 2016, composed of a salary of US$890K and a bonus of US$2,210K. He received no stock award or options. In Germany, the president of Daimler (Mercedes) earned US$8M, including about US$3M from stock awards. In the US, the Presidents of General Motors and Ford each made over US$15M in 2015.

We could go on and detail the compensation of almost every CEO in the US compared to their counterparts around the world and find a similar picture.

In a weekly commentary last June we discussed how executive compensation in the US was out of control. It has already started to have perverse effects on the competitiveness of the US economy. Employees at all levels, from the shop floor to middle and even senior management, are feeling disenfranchised by the greed at the top.

Will the situation improve? Not in the short term. Last week, Bloomberg reported that of the 42 companies that had filed proxy statements for 2016, compensation for the CEO of each had increased by approximately 5.5% compared to 2015. That compares to a 2.8% increase in average hourly earnings for private non-farm employees, according to data from the U.S. Bureau of Labor Statistics.

US companies have been buying back shares aggressively. However, a look at the share count of many companies reveals that the total number of shares did not go down at all. In other words, the share purchases barely covered the dilution from option and stock awards to management. Yet management excludes these awards from earnings and reports adjusted earnings. This is clearly wrong and unfair.

Warren Buffett discussed this situation at length again in his latest letter to shareholders. A beacon of hope, he received an annual salary of $100 000 in 2016, the same salary he has received for the past 25 years.

In our portfolio, we have a number of companies where the CEO takes a very modest salary. Sam Kolias, Chairman and CEO of Boardwalk Real Estate Investment Trust, elected once again to forgo any compensation for his services on behalf of Boardwalk Equities, a company he co-founded with his brother Van Kolias in 1984. In 2015 Sam Kolias drew **no salary, no bonus, no long-term incentive payouts and no other compensation**. Another example is Mr. Gabriel Escarrer Julia, the founder and Chairman of Melia Hotels, another of our holdings, who receives an annual salary of €265,000.

It is difficult to find studies linking modest compensation to superior long-term shareholder returns, but our 20 years of experience in portfolio management leads us to believe in a link between the two.

Will the situation change?

We are not optimistic. The inherent conflict of interest of board members agreeing to these compensation packages suggests a status quo. Boards are often composed of CEOs or senior executives of other companies who would want to see the favour returned.

The rise of ETFs and passive investing combined with ever-shorter holding periods for stocks creates no incentive for portfolio managers to take a role in better governance.

However, there is some hope. Norway's $905 billion oil fund opposed 6,700 resolutions last year at annual meetings. It actually voted against resolutions of over half of its top 50 holdings, including companies such as Apple, Amazon, Facebook, Samsung and Petrobras. It opposed combining the roles of CEO and chairman at companies including ExxonMobil, Johnson & Johnson, JPMorgan, General Electric and Procter & Gamble. It also opposed executive compensation packages at many companies. The oil fund's CEO earned less than US$1M in 2015.

Blackrock also revealed it voted against resolutions of 14% of the companies it held in 2015.

Global Alpha is a strong proponent of good governance.

We became a signatory to the UN Principles of Responsible Investment (PRI) in 2012 and have integrated ESG considerations into our investment process.

There is increasing evidence that ESG factors have an impact on financial performance. The UK, Australia, France and Germany now require that investment decision makers, both money management firms and pension funds' in-house asset managers, disclose the extent to which they take these factors into account. A recent amendment to the Ontario Pension Benefits Act also requires pension plan administrators to establish a statement of investment policies and procedures that contains "information about whether environmental, social, and governance factors are incorporated into the plan's investment policies and procedures and, if so, how those factors are incorporated." Such legislation will certainly help PRI adoptions worldwide. Research done by Credit Suisse revealed that family-owned companies demonstrate superior performance characteristics, providing a return as much as 8% higher over the long term. Long-term management focus and better alignment of management and shareholder interests are just a few reasons explaining the higher returns and profitability. Both Warren Buffett and Sam Kolias are the founders and significant shareholders of the companies they lead. Most people know of the extraordinary wealth created by Berkshire Hathaway, and in the case of Boardwalk, its shares have returned a compounded 22.7% since its IPO in 1994 compared to 7.6% for the S&P/TSX.

Besides ESG integration into the investment process, engagement is also very important. We actively communicate with our companies on ESG matters and inform management of our values and best practices. Executive compensation is one of the subjects at the top of our agenda.

What would we propose?

- The elimination of stock options and restricted share units.
- A large portion of any bonus should be in shares. Such shares would be restricted for a number of years.
- Bonuses could be clawed back.
- The salary of any CEO should not exceed 50 times the median salary of all the company's employees.
- Bonus formulas should be well detailed in the proxy and include such criteria as sales growth, profitability and EPS growth.
- If a portion of the bonus is related to stock price, it should be in comparison to the indices and industry competitors.

We will report on our progress next year during proxy season.

Have a great weekend.

The Global Alpha Team