Activist Ownership
Senior Executive Retreat
April 17, 1997

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Nemocolin Woodlands
Farmington, PA

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Unimagined developments in the scope of institutional ownership have changed utterly the situation of Mellon Bank Corporation. Shareholder activism - in contrast to traditional passivity - is value adding and creates vast opportunity for profitable new business for a diversified financial company.

Historians can tell us what elements were responsible for the strength of particular countries in the past. A century ago, Alfred Thayer Mahan said that it was sea power that explained national hegemony; half a century ago nuclear power and guided missiles have been the source of our leadership. When the history of our times is written, it will be said that ultimate power is the existence of private capital available to be invested for the long term in enterprises all over the world. There are few restrictions on exchanging currencies and there are few prohibitions against investing in public companies in any country. By and large there is agreement that long term value maximization for owners is the objective of business and institutional convergence is proceeding rapidly among the OECD countries.

Which countries have the free capital and which do not is almost a matter of coincidence. It is a question of how different countries arranged to pay for their pension promises. Those countries who induced companies and individuals through tax subsidies to save for retirement now have huge sources of liquidity for investment. As it happens, the United States, the United Kingdom, Canada and the Netherlands are the big winners; France, Germany and - to an extent - Japan are the losers.

Institutional investors in the United States own close to 50% of all of the equity capital of public companies; they own over 60% of the equity of the largest 1000 companies.

The McKinsey Institute published in the summer of 1996 a magisterial study comparing the competitiveness of American, German and Japanese companies - their conclusion was that American preeminence was a function of insisting on the clear management goal of long term ownership value optimization. In turn, this was attributed to the existence of informed and effectively involved owners.

Mellon Bank Corporation is one of the largest "owners" in the world with $225 Billion under management and $1 Trillion under custody or administration. Like other large institutions, Mellon's ownership style has been a "passive" owner. I will suggest to you tonight that there are great opportunities for MBC in changing to an activist mode in the future.

The possession of assets on the scale of Mellon Bank Corporation gives you the opportunity - through - what I call proprietary activism - to reduce risk in many of your loans; protect and enlarge fee margins in your investment management businesses; and create a niche for a stream of new businesses.

The legendary Benjamin Graham - in the first 1932 edition of Security Analysis - made clear that the purchase of a stock was only the first step and that continuing involvement as owner was a necessary concomitant to assuring value. Nobody was listening and Graham gave up in subsequent editions. Ownership was too fragmented to permit effective collective action and stockholders were primarily concerned with the liquidity of their holdings at all times. This situation persisted for most of the next half century - long after it had become clear that many institutions would be "permanent" holders of the stock of prominent companies.

We were brought up short in the hostile takeover environment of the 1980s. Cash offers at above market prices demonstrated that control of virtually every American corporation could be bought. Boone Pickens came to Pittsburgh and carted Gulf Oil away, all the while complaining that the institutional investors were behaving improperly in holding back from tender. Peter Drucker warned that having large institutional ownership was the equivalent of having a ‘for sale’ sign over a corporation. He referred to the fact that the institutions with 60% of the stock had become so accustomed to passivity that their only alternative to Boone Pickens, Carl Icahn, the Belzbergs, Nelson Peltz and other Milkin creatures was to tender their stock. (At that time I was the head of the DOL ERISA agency and wrote Peter Drucker, privately and publicly, that fiduciaries were under no legal obligation to reach for the top buck in the short term. I agreed with him, that as a practical matter, almost all fiduciaries would succumb to the realities and would tender.) Rather than using their important ownership position by providing guidance for the trustees of their own pension plans, corporate America wanted to have it both ways - big gains in the pension plans diminishing the level of future contributions and entrenched control of their own enterprise. They turned to the government - efforts to get the federal government to illegalize takeovers failed, but the results at state capitals and in the Supreme Court of the United States were more availing. Possibly the most destructive response was that of the Commonwealth of Pennsylvania passing dreadful election year "stakeholder legislation" to save Bill Adams’ Armstrong from the hands of the Belzbergs.

By this time, many people had woken up to the new realities; institutions really do own control of corporate America; and companies do better when they were held to be accountable to somebody. The discipline of takeovers, much loved by economists, could very effectively and with much less disruption be provided by activist shareholders.

Carolyn Brancato - who maintains the best statistical data base on worldwide institutional ownership as part of her work for the Conference Board - wrote on February 26th of this year (1997) in releasing the newest edition of institutional ownership statistics: "these data are important because they indicate changes in the balance of power between corporate managements and institutional shareholders." And so begins the modern iteration of shareholder activism. There were a number of false starts - the social activists filled up the annual proxies with a variety of wishes for a better world ranging from South Africa’s apartheid to North Ireland; the American version of yacuza [the gangsters who make a living out of disrupting the Japanese annual meetings] show up at annual meetings in their fanciful hats and colorful presence like Evelyn Davis; and the public pension funds like CalPERS were more concerned with headlines and appearance than with reality - see the current edition of Institutional Investor magazine for an article entitled "CalPERS Lite".

Reality lies in the recent edition of the Wall Street Journal - February 27th - with a section entitled SHAREHOLDERS’ SCORECARD. Here the 1000 largest companies are ranked according to total return to shareholders over 1, 3, 5 and 10 year periods. They are graded by quintile - just like they used to do in school - A through E. My firm - LENS - and others use this as a bible. We focus our attention on companies with persistent poor performance and problems that are susceptible to and suitable for shareholder remedy. We are very influenced by FORTUNE Magazine’s annual ratings of America’s most admired companies. We start from the bottom and work up. As LENS’ credibility has ripened with proven performance, we are most apt today to "focus" on companies that are brought to our attention by institutional clients - who appreciate the "value added" of activist shareholders.

Shareholders can not and should not run companies; they are perfect fools if they try to do so, because they are paying excellent money to have others do it. The trick is to make them do their job. Let me give you a few examples of what we have learned over the past ten years.

SEARS - We mounted a direct challenge through my candidacy for a seat of the board of directors in ’91. Much of what I was trying to accomplish from this dramatic and public confrontation came about in the 1992 extensive reform of the SEC rules regarding shareholder initiatives. Beyond this we learned some simple things: Lesson #1 - We find out a great deal about a management when confronting them with the unexpected and unpleasant. Anybody in business knows that the only thing that you can be sure of is that you will encounter the "unexpected and the unpleasant" - success comes from coping with them. I recall well being by a corporate officer of Sears on my way to meet with CEO Ed Brennan; we changed elevators at a kind of sky lobby on the 77th floor of the old Sears Building; he said - "This is the first time we’ve allowed bad news to get above the 77th floor."

Lesson #2 - The vote of more than 40% of the stock on any subject cannot be ignored;

Lesson #3 - LENS can ALWAYS get 40% of the vote. I had many acquaintances in the institutional investor world during a tour as Chairman of what is now your subsidiary The Boston Company; I made the acquaintance of many more when I served as the ERISA Administrator in the Department of Labor during the first administration of Ronald Regan; and I met many more in founding and building Institutional Shareholder Services ("ISS") as the primary analyst of ownership alternatives in the world today. During this entire period, our concern has been value for all the shareholders. I used to say "We aren’t always right, but we try".

STONE & WEBSTER - Even when the management controls 35% of the stock through an ESOP, shareholder activism can produce strongly affirmative results. S&W is our poster boy - I won’t go through the number of changes; 2 CEOs, 2 CFOs, eight out of 11 new directors, new accounting, and so forth. The company appears to be emerging today into a first class engineering and construction capability, worthy of its hundred year past. Lesson #4 - After a tyrant, it is very difficult to expect a satisfactory long term CEO from within the company. Patterns of pleasing are ingrained and are not satisfactory in a CEO.

Lesson #5 - Aggressive accounting to demonstrate profit usually connotes a weak management or a weak business, and usually both.

Lesson #6 - Some companies desperately need outsiders. Head Hunters are invaluable.

WMX - In moving to my third example, I must caution you that this is a work in process. The Annual Meeting of WMX is scheduled for May 9th and, while we have abandoned what appeared a very promising proxy contest, it will not be devoid of interest. Lesson # 7 - Look for the one or two people on the board who understand shame; we have consistently found at least one person on every board of a "focus" company who simply will not allow deterioration on "his" watch; look for the directors who have invested a significant portion of their net worth in the company.

Lesson #8 - When everyone knows that you have the votes, you don’t have to waste money on proxy contests, but in many situations you MUST keep alive the possibility of proxy confrontation in order to get management to deal with you in a realistic mode; and

Lesson #9 - There is an appropriate role for responsible ownership in the process of selecting directors and in choosing a CEO.

What have we learned? Today, governance can take place year round (management doesn’t push you off until the Annual Meeting); the institutional investor community is alert and responsive; directors are increasingly coming to understand that they "work for" the shareholders;

a lead investor like LENS can effect substantial change in virtually all companies notwithstanding a relatively small stock position.

The McKinsey Quarterly 1996 number 4 provides the first quantification of the value of governance. Relying on a survey of CEOs and institutional investors, they conclude that good governance makes a company worth 11% more than otherwise. The editors conclude: "believing in the value of corporate governance should no longer be a question of faith. Some investors will pay a significant premium for good governance. … given that many investors do care about board governance, what action can companies take to improve their own practices."

What does this mean for Mellon Bank Corporation with its 225 billion dollars of assets under management and over one trillion dollars of assets under custody or administration.

We will first talk about "risk".

You should know that shareholder activism assumed its modern guise in the Bank of England. Lord Henry Benson - formerly the managing partner of Coopers & Lybrand - became concerned that the Bank only became involved with companies when it was too late and after member banks had suffered huge losses. He figured that there must be a way for banks to anticipate trouble and to take appropriate steps to minimize its impact. Benson's work at the Bank was followed up by (Sir) David Walker and particularly Sir Adrian Cadbury. The so-called Cadbury Code - setting forth rather common sense guidelines for board membership and practices is now widely followed by managements. We are now awaiting the Hampel (for Sir Ronald) code and a Labor Government. The UK experience has demonstrated that to the extent owners monitored effectively the management of companies, the risk of their failing to repay debts was reduced.

Turning to investment management - think of that style known as "value investing". The premise is that a company possesses real value that the market does not recognize for some or many reasons; the bet in buying the stock is that in time events will occur that will cause this value to be manifest. Involved shareholders can enhance value in this situation. First of all, they can reduce the risk that the value enhancing event does occur and, secondly, they can assure that it happens earlier rather than later. So shareholder activism materially improves the intrinsic characteristics of value investing.

We will next talk about adding value. It should be clear that an investment product combining activism and value investing is a new niche that should have great appeal - particularly in the mutual fund area. By purchasing stocks that are poorly valued in the market, down side risk is reduced; by ensuring activism, the timing and probability of upside movement is increased. This is a new niche product and is an important arrow in an investment quiver, as it were. At a time when it is difficult for managers to achieve performance at the level of well known indices and when traditional management styles are being commoditized, it is important to note that those areas like venture capital and buy-outs where significant manager involvement is required, substantially higher fees are charged and paid. An "activist" capability would enable MBC to characterize its own management style at the "hands-on" high fee side of the spectrum.

Will functioning as an activist shareholder threaten Mellon's other businesses and its position in the commercial community. Over the past decade, it has become clear that activism is in aid of shareholder values. As activism has emerged from its half century somnolence and confusing iterations, its appropriateness as an indispensable tool to reduce risk and add value is becoming widely accepted. The management of corporate America today is willing to accept the challenge of competition. I tell CEOs what I really feel to be true. Being a CEO is extremely difficult. The CEO is where the buck stops. The CEO is the one person who must reconcile the interests of all manner of competing complaints. I say simply - I am here as an owner, nothing more, nothing less. I know nothing except what is publicly available information. I bring to you the perspective of a shareholder. I do so out of the sense that this is a viewpoint that is very important to you and YOU ARE UNLIKELY TO HAVE A CLEAR PRESENTATION OF IT FROM ANY OTHER

SOURCE. In my experience CEOs and top management respect the entitlement of owners to hold them accountable. It needs be done carefully, discretely and respectfully.

One of the great advantages that Mellon's aggressive policy of expanding beyond a conventional commercial and trust bank confers is the ability to take a competency like "activist ownership" and apply it across a whole spectrum of businesses. The capacity to function as an activist would be invaluable in many situations where the Bank finds itself trustee of an ESOP or other instrument for the benefit of company employees; occasionally the Bank is designated executor or trustee of holdings in businesses where an active presence would be value enhancing. Master trust is a highly competitive business. Suppose Mellon is in a unique position to offer a valuable service that none of its competitors can. If Mellon is making the commitment to activism on account of its managed equity accounts, it can also use this added value as an additional and unique component in its indexed and master trust product. This should create a favorable selling and pricing opportunity.

This is a uniquely favorable time for Mellon Bank Corporation to develop an effective ownership activist competency. By reducing risks in the banking segment, enhancing returns in investments through new proprietary products and improving competitiveness in the custody and master trust area, Mellon Bank should be able to increase profits - the old fashioned way - by adding value through creating niches, adding value and earning higher fee income.