

## Skin in The Game, Part II

By Mariko Gordon

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**I have 26 of these newsletters under my belt.** Thanks to all this practice - not to mention learning how to write on deadline for the school paper - I've gotten to the point where I knock these out without too much fuss.

**It used to be that I began with the "So what?" - the key point - and then scrambled backward for a hook that would set up an intriguing segue.** Now I tend to go the

other way, beginning with a story about what's happening in my life and looking for an investment lesson worthy of being shared.

Either way, the fun part of writing this sucker is the feedback I get, even if it's not always fan mail. It means I don't have to brood like B.B. King when he sings, "[Nobody loves me but my mother, and she could be jivin' too.](#)" It's nice to know that people (you) are reading the damned thing.

In response to [my last newsletter](#), and speaking of "not always fan mail," **one reader - John - took me to task:**

*"I couldn't disagree with you more... do you make it a habit to invest in companies where management has very little "skin in the game"... I don't... it's one of the major things I look at before investing... one of my first checks is the proxy to see what management and the directors own... yes, it's not perfect, like many things in life, and there are always exceptions to the rule, but this is a game of probabilities, and with this one, it pays to bet on the guy or gal with a fair amount of [skin in the game]."*

To reiterate my position, **I think skin in the game is important, but it's only one data point and it doesn't tell the entire story.**

But what about John's observation re "management?" Last month's newsletter was focused exclusively on money managers, but **how about the people on the inside, the ones running the company in question day-to-day?** Does the "more skin the better" rule apply to these folks?



Alas no. Here too, there are plenty of exceptions to such a tidy correlation and it's more like "Goldilocks and the Three Bears." **The trick is in telling what amount is juuuuuuuust right - attitude can sometimes trump ownership.**

At first glance, it may seem that degree of management ownership would be a pretty good predictor of what you're looking for as an investor. After all, if you had to choose between a go-go momentum guy "investing" in a stock for a week or two while badgering management to lever up and buy back stock, vs. an insider who is managing the business for the long-term, I'm willing to bet you'd go for the latter.

Me too. Ensuring healthy profits in the future by investing a little more (and tempering results) in the present can lead to better long-term stock performance than running the business for short-term results.

**But there's such a thing as *too much* ownership and there is a dark side to a private owner's mindset**, especially if they own enough to control the fate of the company. We once owned a venerable (now dead) regional department store during a time of industry consolidation. The family owned a boatload of stock and was willing to sell ... provided it maximized its after-tax proceeds. The deal, as finally structured, screwed public shareholders, most of whom were tax-exempt.

**Sometimes a controlling interest is spread among many descendants, and they can be more concerned with their dividend checks** than in taking cash flow and reinvesting in the health of the business or, when times are tough, shoring up the balance sheet.

**Other times, a family uses its stock as collateral** and when the world comes to an end, as it likes to do every so often, decisions for the business are not made independently of the consequences for the family's personal financial situation.

**Even in those seemingly balanced circumstances where a founder and/or descendants own enough stock to have skin in the game but not so much as to ignore the little people**, it doesn't always mean investing utopia. We used to own a lighting company whose founder still owned a nice chunk of stock. He decided to take the company private and fleeced public shareholders, paying a small premium to a depressed stock price at a market bottom. The board was stuffed with his cronies, and though there was a proxy fight, public shareholders lost. (He was the Louis XIV of corporate America: "The company, c'est moi.")



Finally, with **management teams that are not to the manor born but are hired mercenaries** with generous options packages, there can be difficulties of another sort. Indeed, they have a lot of skin in the game, but only if they jack up the stock price meaningfully, and short-term tactics can be detrimental to the long-term health of a company. (Can you say "[Chainsaw AI?](#)") Needless to say, incentives must be structured such that the pot of gold at the end of the rainbow does not encourage management to indulge in high-risk, high-reward, bet-the-farm tactics, even if they aren't fraudulent.

**In practice, exceptions will always exist, whether due to context, conflicts of interest or other fuzzy human motives ...** none of which can be reduced to a simple metric.

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