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Field trips. We've all done them. My favorite from long ago-third grade I think-was a trip to Los Angeles. We visited the Continental Baking factory. Sound boring? Not for this third-grader. Continental was the home of an all-star lineup of kid's favorites: Twinkies, Ding Dongs, Ho-Ho's, Sno-Balls, Zingers, Suzy Q's. Yes, junk food!

A recent New York Times article about Twinkies owner Hostess Brands got me reminiscing about my long-ago field trip. No, I didn't go out and buy a 10 pack of them. But it got me thinking about corporate management and the so-called "**agency**" problem.

As most of us know, an "**agent**" is a person hired to act on behalf of another, usually called the "**principal**". In the world of public investing, corporate executives (the agents) serve the company's owners (the principals). These agents are paid a salary but often don't have significant ownership. We've found in these cases the executives don't think like owners because they aren't substantial owners, they're just hired guns.

But back to the Twinkie. In the case of Hostess, the company has a bit of a checkered past. The company filed for bankruptcy not once, but twice, due to poor management decisions, poor union leadership, and changing food consumption patterns. Production even shut down in November 2012 for nine months. Twinkie addicts were suffering withdrawal symptoms for months. Some fans feared that Twinkies would be gone-forever.

The carcass of Hostess was dragged through bankruptcy court by a private equity firm. The firm chose which assets to keep and which liabilities to shed. It trimmed the payrolls, closed facilities, shed union contracts and pension liabilities, rejuvenated marketing, and (most importantly) brought back Twinkies. They were a hit, again. The customer loyalty never left. It just required a different set of owners to create a financially viable business.



In the end the private equity firm (acting as an owner, since....they were the owner) made hundreds of millions of dollars of profit by resuscitating Hostess. Who lost out? Clearly, some of the unionized employees who lost their jobs in the process. And the previous public shareholders who saw their investment wiped out in bankruptcy. It's possible an owner would have worked harder to prevent financial collapse than the agents running Hostess.

If this were just an isolated example of poor public company management it wouldn't merit much mention. But it's not. In our work, we see frequent examples of the lack of alignment between public company shareholders and management. Why does it persist?

Public company shareholders are generally dispersed and poorly organized. Big shareholders with the resources to fight, such as pension funds, often vote with their feet and sell the shares rather than create conflict. Information flows in one direction, from company agent to owner principal. No surprise, "agent" managers have an incentive to promote good news, and hide bad news. It's a "heads I win, tails I don't lose much" mentality, as managers can walk away from an underperforming business with attractive compensation on the way to their next gig.

Meanwhile, the private equity buyout crowd feasts on the leftovers. Their usual playbook: take an underperforming business private, load it up with debt, improve the operations out of the glare of public ownership, then sell it back to the same public shareholders, but at much higher valuations. Since much of their capital is borrowed, the return on investment for the private equity buyers can be astronomically high.

It's a lot like buying a fixer-upper home with mostly borrowed money, doing a remodel and flipping it. Except it costs public shareholders billions in lost value.

What this demonstrates to us is the importance of investing in businesses where the managers act like owners. One of the best ways to ensure this is to invest with managers who ARE owners. We've found that a significant personal financial commitment is a good sign that management is sitting on the same side of the table as shareholders. And it wouldn't hurt if there were a Twinkie or two on that table.