STOCK STRATEGIES

How to Vote Your Proxy Ballot

The proxy gives you as a shareholder your one chance to voice an opinion on how a company is being run.

BY JOHN DEYSHER, CFA

As the portfolio manager of a public mutual fund, one of my key responsibilities is to vote the proxy that accompanies the annual report for each of our holdings. Proxies are often tedious documents, but voting is important on a number of fronts: choosing directors, assessing management compensation/incentive plans, ratifying the auditor and deciding on shareholder proposals. It's your one chance to say how a company is run, so take advantage of it.

According to a ProxyPulse study conducted by Broadridge and PricewaterhouseCoopers last year, institutions owned 71% of public company shares while individuals owned 29%. Institutions voted 92% of the shares they owned while individuals voted only 28% of shares owned. Why are institutions over three times more likely to vote their shares than individuals?

There may be a few reasons:

- Institutions have a fiduciary duty to vote their proxies in the best interests of their clients. Publicly traded mutual funds like ours are required to file Form N-PX (Annual Report of Proxy Voting Record of Registered Investment Company) with the U.S. Securities and Exchange Commission (SEC) each year showing how they voted their shares. Many institutions have access to proxy advisory services like ISS and Glass Lewis, which provide proxy recommendations and make their job easier.
- Proxies are written by lawyers and consultants, often making them complex documents to decipher. The print is often small and single spaced. As a result, many investors throw up their arms in frustration. Feeling overwhelmed, many individuals just don't vote.
- Even individual investors who understand the proxy proposals often feel their votes don't matter since institutions often control the majority of shares. This is unfortunate since on many closely decided proposals, the individual votes can and do make a difference.

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Key Sections of a Proxy Statement

A walk through proxy land will help you better understand how to vote a proxy and why you should vote your shares. Consider a proxy and annual report for one of the companies that hit our desk last summer. I'll refer to it as ABC Company (ABC Co.). Flipping to the table of contents, we see that ABC Co. lays out its proxy in several sections:

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1. Notice of annual meeting and general information,
2. Election of directors,
3. Board structure & organization,
4. Advisory vote on executive compensation (say on pay),
5. Approval of various equity incentive plans and
6. Ratification of appointment of independent public accounting firm.

Let's review each of these separately, highlighting issues you should be aware of.

1. Notice of Annual Meeting and General Information

The proxy often starts with an invitation from the chairman or CEO announcing the annual meeting. This includes meeting details such as place, time and whether the meeting is in person, virtual or both. Instructions are provided on how to vote your shares (mail, phone or online) and how to sign on for virtual meetings. An agenda is set forth including the election of directors and the various proposals to be voted upon. The record date will be set; it indicates the date on which you must own shares to be able to vote. Make sure you own shares on that date if you intend to vote.

We always take note of the day and time of the annual meeting. Most are held on weekdays and start between the hours of 10 a.m. and 4 p.m. to encourage shareholders to show up and participate. If a company holds the annual meeting at 8 a.m. on the day after a major holiday, it's often a sign that maangement doesn't want shareholders to show up. We try to avoid these types of firms since it often indicates an insular board and management. We encourage you to attend the annual meeting—you'll learn a lot, meet management and directors, have the opportunity to ask questions and often meet like-minded shareholders.

2. Election of Directors

This section lists the directors up for election, both incumbents and new nominees. You will see their names, ages and a brief bio on each. ABC Co. has nine director nominees, including one insider (the CEO) and eight independent nominees. We like companies where the vast majority of nominees are independent. This is good governance and reduces potential conflicts of interest that arise when a large portion of the board is insiders. We are also pleased that all ABC Co. directors face reelection each year. Unfortunately, some firms have "staggered" boards where only a portion of the board stands for reelection each year, most often one-third of them each year. This may impede a potential change of control and protect incumbent directors from the will of the shareholders. Staggered boards with low insider ownership are especially noteworthy.

Ideally the independent nominees will each bring specific skills sets to the board that complement each other. We are pleased that nominee skill sets for the board seats on ABC Co. include senior leadership, industry specific expertise, M&A experience and risk management background, among others.

Where to Find Proxy Statements

Shareholders of publicly traded companies will be notified about proxy statements and upcoming shareholder meetings by their brokers. This notification will commonly be mailed or issued as an email, though an alert may also be displayed on the broker's website.

Often, the notice will include a link to a third-party website. These websites include Broadridge's ProxyVote.com. A control number will be given to vote your shares. If you are unsure about the legitimacy of the website, contact the company's investor relations department before entering any information.

Proxy statements for companies you are considering investing in can be found in two places. The first is the company's investor relations website. To find it, type in the company's name plus "investor relations" into a search engine such as Google. The second is the U.S. Securities and Exchange Commission's (SEC) EDGAR database (www.sec.gov/edgar/searchedgar/companysearch.html). Once on EDGAR, look for filings designated as "DEF 14A."

The nominees should have the expertise to stand up to management when required.

We always like it when nominees own shares, as it increases the likelihood of their interests being aligned with outside shareholders. The nominee share ownership for ABC Co. is mixed; only three of nine nominees have significant holdings, including the CEO. Five have limited holdings and one (a new nominee) owns no shares. Normally we vote against nominees who own no shares but, in this case, the new nominee will hopefully own more shares next year.

We believe strongly that the presence of insiders on the board should be commensurate with their shareholdings. For example, if a nine-person board has three insiders (33%), we expect the insiders to represent 33% of the shares outstanding—including founding family shares for example. Unfortunately, with some small companies, the insiders have board seats with no corresponding share ownership. This results in an "insider board." We will normally vote against insider nominees in these cases as we prefer such seats be held by independent directors.

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Finally, we feel the independent directors should be paid a fair amount for their services, with some of this compensation being paid in stock grants or options. ABC Co. independent nominees are paid reasonable amounts for their services: 45% in cash and 55% in stock awards. It's important for the independent directors to have some skin in the game. Structuring their compensation to include an equity component helps accomplish this. Any executives who are board members should not be paid for their board service; their salaries are enough.

3. Board Structure and Organization

We feel strongly that the roles of the chair and CEO should always be separated in order to prevent a concentration of power. Separating the positions allows the CEO to focus on the full-time job of running the firm while allowing the chair to lead the board in its fundamental role of providing advice to and maintaining independent oversight of management. Many firms have moved in this direction over the years, recognizing the importance of good governance. The ABC Co. board is overseen by an independent non-executive chair, who runs all meetings.

One potential red flag is the presence of an executive chair who remains on the payroll and is still an insider. This is often a former CEO who, upon relinquishing that title stays on as executive chair. Of course, a former CEO has a wealth of knowledge and should remain on the board if so inclined. However, it raises the question of how a chair who is still on the payroll can properly maintain the independence required to represent the outside shareholders. We prefer that former CEOs leave the payroll before continuing to serve on the board.

4. Advisory Vote on Compensation (Say on Pay)

While this vote is nonbinding, it can send a powerful signal to boards and management about how shareholders view the reasonableness of compensation packages. American executives of public companies are often criticized for compensation that goes up no matter how the shareholders do. Board compensation committees rely much more heavily on compensation consultants than they used to, resulting in increasingly complex compensation packages. Reading this section of the proxy can be a mind-numbing experience but here are some points:

Virtually every company will start off this section with statements indicating the hope of aligning management incentives with shareholder interests. The goals listed by ABC Co. include the following:

A. Substantial portion of compensation should be variable and directly linked to performance.
B. Compensation should be attractive to attract, maintain and motivate talented employees.
C. Compensation should balance incentives for delivering long-term sustainable performance against the potential to encourage inappropriate risk-taking.
D. Executive financial interests should be aligned with long-term shareholder interests.

In addition, ABC Co. specifically states that no executives have employment agreements, there are no bonus guarantees, no repricing of options and no significant perquisites. All good.

Like many firms, ABC Co. compensates their named executive officers (NEOs) via four basic ways: salary, bonus, short-term incentive plan (STIP) and long-term incentive plan (LTIP).

Let's take a look at each.

Base salary: Salary is usually driven by an individual's experience, background, knowledge and the level of salaries in the marketplace. Often a list of other public firms is presented as an "executive compensation peer group," which is used by the consultants to help frame salaries required to help attract qualified candidates. ABC Co. lists several firms, all of which are in the same or similar industries and serve as a baseline for determining salary levels. Unlike other components of compensation, which are often described in detail, the specifics on salary determination remain a "black box" known only to the consultants and board.

Bonus: This is usually a cash award, sometimes tied to achieving specific performance objectives. Like many firms, ABC Co. provides no clue on what bonuses are tied to, which is unfortunate. Some firms will say bonuses are paid at the board's discretion, which is also disappointing. Sometimes "retention" bonuses are paid to keep key executives from jumping ship during times of turmoil. As with salaries, the thought process and factors that determine executive bonuses often remain a mystery.

Short-term incentive plan: These are awards (cash, stock grants or options) issued for achieving short-term performance metrics, usually over the past year. For ABC Co., the two key metrics are adjusted earnings before interest, taxes, depreciation and amortization (EBITDA) and individual performance metrics designed to foster the achievement of corporate goals and priorities. While we agree with the latter, we have an issue with adjusted EBITDA.

Often presented as a measure of cash flow, adjusted EBITDA, as usually calculated, often excludes several items that we view as real expenses in running a business. These often include depreciation and amortization, stock-based compensation and currency gains and losses. All of these are legitimate expenses and are included to calculate operating income (or EBIT), which we view as a better metric on which to base incentive compensation. If cash flow is the chosen metric, the appropriate measure is net cash flow, calculated as cash flow from operations less net capital expenditures.

Long-term incentive plan: These awards (cash, stock grants or options) are used for achieving longer-term performance metrics often calculated over a rolling three-year performance period.

There may be specific time periods or price levels at which the stock and option grants vest.

ABC Co. uses the following three long-term performance metrics:

1. Absolute stock appreciation,
2. Stock appreciation relative to a specific industry benchmark and
3. Cash return on invested capital. This is normally calculated as net cash flow ÷ (gross debt − cash + shareholder's equity). We like this metric since it is return-based and measures how well management is earning a return on the capital it deploys.

At the end of the compensation discussion, you'll find the executive total compensation table for the named executive officers, including the CEO, CFO, executive vice presidents (EVPs) and senior vice presidents (SVPs). We always look at the table relative to the financial results and are disappointed when total compensation rises in the face of falling or flat financial results. When this

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occurs, we will vote no on pay and will sometimes vote against the board compensation committee members who helped craft the pay package.

Like many firms, ABC Co. has a requirement that the NEOs own shares worth a multiple of their base salaries. For example, the CEO should own shares worth 5x their base salary, an EVP should own shares worth 3x their base salary and an SVP should own shares worth 2x their base salary. Unfortunately, only three of the five ABC Co. named executive officers meet the minimum ownership threshold.

5. Approval of Various Equity (Stock) Incentive Plans

These plans are designed to foster share ownership by the directors, management and employees. While this a noble goal, we always evaluate the specific terms—especially the dilution such plans place on existing shareholders. We also take note of how many shares are left in any existing plans before supporting plans for additional shares.

While we view stock grants and options as important to attracting and retaining talented employees, we want to limit dilution and encourage insiders to buy shares on the open market just as we do.

6. Ratification of Appointment of Independent Public Accounting Firm

This is normally straightforward but it's worth noting how frequently a firm changes auditors.

Firms change auditors for a variety of reasons, but one that changes auditors every few years should be examined carefully—especially if the financial statements are complex.

TABLE 1

Ownership of Shares by Key Insiders and Large Investors

The proxy statement will include a list of share ownership by executives, directors and large investors. This table shows both the number of shares held and the percentage of total shares outstanding the position represents. The exact name assigned to the table will vary by firm but it will generally be something like "Security Ownership of Beneficial Owners and Leadership." Displayed below is a truncated example of the type of information you might find in such tables.

Name	# of Shares	% of Outstanding Shares Owned
Chairman and CEO	7,430,158	27.9
Investment Firm A	2,926,118	13.9
Investment Firm B	1,768,655	8.4
Investment Firm C	1,489,911	7.1
Investment Firm D	1,253,645	6.0
Director A	45,802	<1.0
Director B	10,459	<1.0
Director C	435,243	2.0
Chief Operating Officer	255,758	1.2
Director E	204,726	1.0

Other Proxy Disclosures Worth Noting

Related Party Transactions

These arise when a company does business with another firm where a member of the board or management has a vested interest. An example would be the provision of legal or accounting services by a firm where a director has a financial interest. Alternatively, the company may lease real estate from or buy supplies from an executive-owned firm. While not illegal, such transactions should always be arms-length and kept to a minimum.

We are also skeptical when an executive has significant dealings away from the employer. We once passed on investing in a well-known retailer when we learned the CEO had ownership in several other retailing ventures. While none were direct competitors, we viewed these ventures as possible distractions that should be eliminated.

Another red flag is large personal loans to executives or directors. Although the interest rate may be competitive, we think company cash should be put to better use in growing the business, buying back stock or paying dividends. For stock buybacks, we are not fans of companies buying back stock directly from directors or executives. We have seen too many cases where such shares are repurchased at "sweetheart" prices that probably wouldn't exist in the open market.

Shareholder Proposals

While rare, shareholder proposals are always worth noting. One we see occasionally is a proposal to declassify a staggered board or eliminate a dual-class share structure, both of which we support. Or there might be a proxy fight where a shareholder seeks to replace part or all of the board with its own slate of nominees. Proxy fights are expensive and are generally not undertaken until all other initiatives have been exhausted.

5% Owner Table

In addition to disclosing insider ownership, proxies also contain a table showing shareholders owning 5% or more of outstanding shares. Are any of these significant shareholders considered activists who might be agitating for a higher share price? Have they disclosed their ownership interest via SEC Form 13G (passive) or 13D (activist)?

Are any of the 5% owners exchange-traded funds (ETFs) that might be forced to sell to meet redemptions at the first sign of trouble?

ABC Co. has several large owners including two that could be considered ETFs and one large owner who sits on the board, a very positive sign.

Table 1 shows an example of a proxy table detailing the ownership of shares by key insiders and large investors.

Conclusion

Just as voting in a political election is the responsibility of every citizen, voting your proxy is a core duty of an informed shareholder. An indifferent shareholder base that cares little about board members or executive compensation often leads to abuses and a lower share price. Often an activist will emerge to set things right, but by then significant shareholder value may have been destroyed. Hopefully this can be avoided by taking the time to understand your proxy and voting your shares. Remember, your vote counts so use it wisely, your net worth may depend upon it. ■

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