Character – A Critical Element In Qualitative Investing

Fred Kiel, PhD
KRW International
April 29, 2016
Character:
How much does it really matter?
7-Year Return on Character (ROC) Research Study

• 2006 – 2013

• 121 enrolled CEOs with 84 CEOs/senior teams, ~8,500+ randomly selected employees, yielding nearly 1,000,000 data points.

• Duke Fuqua School of Management Accounting Department independently analyzed and verified results and cross-correlated with their own CEO Integrity study.

• Harvard Business Review Press cites ROC as the first and only data of its kind.
# Research Demographics

## Industrial Sectors

<table>
<thead>
<tr>
<th>Sector</th>
<th>Number</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer/Technology</td>
<td>7</td>
<td>8%</td>
</tr>
<tr>
<td>Entertainment/Media</td>
<td>7</td>
<td>8%</td>
</tr>
<tr>
<td>Financial Services</td>
<td>14</td>
<td>17%</td>
</tr>
<tr>
<td>Food and Beverage</td>
<td>7</td>
<td>8%</td>
</tr>
<tr>
<td>Government Agency</td>
<td>2</td>
<td>3%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>7</td>
<td>8%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>5</td>
<td>6%</td>
</tr>
<tr>
<td>Professional Services</td>
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<td>13%</td>
</tr>
<tr>
<td>Retail</td>
<td>12</td>
<td>14%</td>
</tr>
<tr>
<td>Social Services</td>
<td>2</td>
<td>3%</td>
</tr>
<tr>
<td>Transportation</td>
<td>2</td>
<td>3%</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
<td>9%</td>
</tr>
</tbody>
</table>
The Story Behind the Research
Moral Intelligence
## Universal Moral Principles

<table>
<thead>
<tr>
<th>Integrity</th>
<th>Responsibility</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Telling the truth</td>
<td>• Taking responsibility for personal choices</td>
</tr>
<tr>
<td>• Acting consistently with principles, values, and beliefs (walking the talk)</td>
<td>• Admitting mistakes and failures</td>
</tr>
<tr>
<td>• Standing up for what is right</td>
<td>• Embracing responsibility for serving others: “leave the world a better place”</td>
</tr>
<tr>
<td>• Keeping promises</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Forgiveness</th>
<th>Compassion</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Letting go of one’s mistakes</td>
<td>• Empathizing with others</td>
</tr>
<tr>
<td>• Letting go of others’ mistakes</td>
<td>• Asking for help</td>
</tr>
<tr>
<td>• Focusing on what’s right versus what’s wrong</td>
<td>• Empowering others</td>
</tr>
<tr>
<td></td>
<td>• Actively caring for others</td>
</tr>
<tr>
<td></td>
<td>• Commitment to others’ development</td>
</tr>
</tbody>
</table>
“The authors offer a timely, important, and practical personal guidance system that anyone in the business world would do well to adopt. The world of business would be vastly improved if Moral Intelligence became required reading.”

—Daniel Goleman, Author of Emotional Intelligence

Enhancing Business Performance & Leadership Success

Doug Lennick · Fred Kiel, Ph.D.

Foreword by Richard Boyatzis
Co-author of Primal Leadership

MORAL INTELLIGENCE 2.0

Enhancing Business Performance and Leadership Success in Turbulent Times

DOUG LENNICK | FRED KIEL

Foreword by Richard Boyatzis Co-author of Primal Leadership
Definitions:

- Character
- Business Results
Character Defined:

Your intentions

Your behavior
Behavioral Indicators of:

- Integrity
- Responsibility
- Forgiveness
- Compassion
Virtuoso Vs. Self-Focused Leaders
Character and Return on Assets

CEO Character Scores Ranked Lowest to Highest

Strong

Weak

VIRTUOSO

SELF-FOCUSED
Character and Return on Assets

CEO Character Scores Ranked Lowest to Highest

- Weak: SELF-FOCUSED (1.93%)
- Strong: VIRTUOSO (9.35%)
- 4.83%

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Major Findings: A Summary

Compared to Self-Focused leaders and teams, **Character-led and driven organizations** achieve:

- **5x** greater Return on Assets (ROA)
- **26%** higher workforce engagement
- **Lower levels of risk** measured by audit fees and legal events
- **20%** greater advantage in the strength of leadership skills
Definitions:

- Character
- Business Results
Where Business Results Come From

Macro-Economic Factors + Business Model + The Leadership Effect = Business Results

Common for all competitors within market sectors + Relatively consistent within market sectors + Source of unique competitive advantage

~70% + ~30%
Dr. Shane Dikolli — Duke University Accounting Professor

Dr. Thomas Keusch - Erasmus University Rotterdam and The Harvard Law School Program on Corporate Governance

Using Shareholder Letters to Measure CEO Integrity
CEO Integrity

- Can we define it?
  - “honesty and fairness”
- Can we measure it?
  - fraction of abnormal ‘causation words’ in shareholder letters
CEO Integrity

• Why “causation words”? -
  – “Faced with the messes resulting from out-of-integrity behavior, people and organizations regularly avoid confronting the role of their out-of-integrity behavior as cause in the matter. Instead, they supply explanations, rationalizations, justifications and excuses that masquerade as causes for the messes actually created by out-of-integrity behavior”
  Erhard et al. (2009)
Some “causation words” –

- Because
- Consequence
- Therefore
- Attributed
- Based
- Effect
- Affect
Examples in large sample – Low Integrity

- Joseph Nacchio, Qwest CEO

<table>
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<tr>
<th>datadate</th>
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<th>masterCEOfullname</th>
<th>pctRES_NEW</th>
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<td>31 Dec 98</td>
<td>QWEST COMMUNICATION INTL INC</td>
<td>NACCHIO, JOSEPH P.</td>
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</table>

- Richard Scrushy, HealthSouth CEO
  - Convicted of money laundering, extortion, obstruction of justice, racketeering and bribery in 2006.

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<th>masterCEOfullname</th>
<th>pctRES~W</th>
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<td>RICHARD M. SCRUSHY</td>
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<td>HEALTHSOUTH CORP</td>
<td>SCRUSHY, RICHARD M.</td>
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</table>
Example in large sample – High Integrity

- Jim Sinegal, Costco CEO, Morningstar CEO of the Year (2011)

<table>
<thead>
<tr>
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<tbody>
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<td>31 Aug 01</td>
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<td>31 Aug 10</td>
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<tr>
<td>31 Aug 11</td>
<td>JIM SINEGAL</td>
<td>11</td>
</tr>
</tbody>
</table>
New Measures of “Off-the-job” Behavior


Evidence of Legal Infractions

Conjecture: more likely to perpetuate fraud

CEO Ownership of Luxury Goods i.e., ”abnormal” levels of real estate, boats, & vehicles

Conjecture: CEO more likely to develop a loose control culture

Conjecture: other insiders more likely to perpetuate fraud

Outcomes: Increased Likelihood of Future Misstated Financial Statements
A New Measure of Accounting Quality

Hribar, Kraver, and Wilson (2014), Review of Accounting Studies

• Unexplained audit fees
  – Contain information about accounting quality
  – Measured by regressing audit fees on known explanations.
  – May also proxy for management behaving badly
  – Predictive of:
    • Fraud
    • Restatements
    • SEC comment letters
Does CEO Integrity matter?

We show that low-integrity CEOs are associated with:

- unfavorable employee ratings
- negative employee sentiment
- higher likelihood of “weak tone at the top”
- higher audit fees
- backdated stock options
- more lawsuits
- worse accounting quality prior to SOX.
The importance of integrity

Warren Buffett said in one of his shareholder letters:

“When hiring people, look for three qualities: **integrity**, intelligence, and energy. And if you don’t have the first, the other two will kill you.”
What’s in the Black Box?

- Personality?
- Education?
- Experience?
Questions?

kiel@krw-intl.com
Find out your team’s character score:

http://bit.ly/1PQGQCZ

Only 25 questions—5 minutes

We’ll send you a PDF report in a day or two.
Positive proof of global warming.