BOOK REVIEW:

THE OUTSIDERS:
EIGHT UNCONVENTIONAL CEOs AND THEIR RADICALLY RATIONAL BLUEPRINT FOR SUCCESS

In his 2012 letter to Berkshire Hathaway shareholders, Warren Buffett casually recommended a book, *The Outsiders: Eight Unconventional CEOs and Their Radically Rational Blueprint for Success*, by William N. Thorndike, Jr., calling it “an outstanding book about CEOs who excelled at capital allocation.” In 2013, the book quickly became a hit and won public praise from a range of CEOs and star investors. In a Forbes interview, Thorndike himself said: “The reaction to the book has dramatically exceeded any expectations I had … .” While the book has generated discussion in many areas, possibly the most important contribution is that Thorndike, as well as many of “the outsiders,” are collectively responsible for putting the previously obscure term “capital allocation” into the business lexicon. So what was so special about this book?

The book, which began as a research project that wound up spanning eight years, starts with the premise that a CEO’s performance should be judged objectively by the long-term returns he or she earns for shareholders relative to the broad market. Thorndike was looking for CEOs whose stock returns exceeded two performance hurdles. They had to beat the relative performance (vs. the S&P 500) that Jack Welch earned during his tenure at GE and also meaningfully exceed their industry peer group. At a certain point, he realized the CEOs who met these criteria had several things in common – among those were a preference for independent thinking, a focus on cash flow over reported earnings and, perhaps most importantly, an understanding of how astute capital allocation can increase a firm’s per share business value. In Thorndike’s words: “CEOs need to do two things well to be successful: run their operations efficiently and deploy the cash generated by those operations.” The latter of those two tasks, capital allocation, is often overlooked by CEOs, yet is a critical driver of long-term returns. Thorndike says it best:

Basically, CEOs have five essential choices for deploying capital – investing in existing operations, acquiring other businesses, issuing dividends, paying down debt, or repurchasing stock – and three alternatives for raising it – tapping internal cash flow, issuing debt, or raising equity. Think of these options collectively as a tool kit. Over the long term, returns for shareholders will be determined largely by the decisions a CEO makes in choosing which tools to use (and which to avoid) among these various options. Stated simply, two companies with identical operating results and different approaches to allocating capital will derive two very different long-term outcomes for shareholders.
Henry Singleton, the original outsider, provides an interesting case study. Singleton earned bachelor’s, master’s and PhD degrees in electrical engineering from MIT, had no formal business training and was described as somewhat of a recluse. In the 1960s, Singleton’s conglomerate Teledyne refused to pay dividends, a decision that stuck out much more then it does now. When there was a bubble in conglomerate stocks during that decade (which Buffett writes about in his 2014 letter), Singleton used this overvalued currency – Teledyne stock – to make 130 acquisitions. In contrast to other conglomerates of the day, though, Teledyne emphasized a decentralized operating model, with limited staff at headquarters. Eventually, Singleton largely removed himself from what little centralized operations there were in the firm and focused on capital allocation for the business. In 1969, as the honeymoon with conglomerates came to a crashing end, Singleton stopped acquiring. As Teledyne stock plunged with the rest of the market, between 1972 and 1984 Singleton tendered for an unprecedented 90% of Teledyne’s outstanding shares (at a time when repurchases were “unpopular and controversial”), earning a compound return of 42% on these purchases. The result was that while net income increased sevenfold during this period, per share earnings increased by more than 40 times. The combined results of paying for quality businesses with overpriced stock and then repurchasing undervalued shares in the 1970s led to a 20% compound return over the span of 27 years – more than nine times that of peers and 12 times that of the S&P 500.

As Thorndike points out, these CEOs were constantly aware of the full range of opportunities they had for deploying capital. They were continually aware of both the price and the value of their own stock, as well as the price of potential acquisitions and internal reinvestment opportunities.

At BBH, an emphasis on capital allocation has long been a part of our investment process, as it goes hand in hand with value investing. Among other things, we look for both management teams and investment managers who are good stewards of capital. Many company management teams today are incentivized to grow earnings per share (EPS) at all costs; however, this can often be in conflict with the principles of good capital allocation. Good management teams realize that there should be a high bar for growing a business through acquisitions or reinvestment and that sometimes the best investment is your own stock. Simply knowing these facts, however, still doesn’t make the execution any easier. In fact, the data indicates that most companies have poor buyback records. Anecdotally, it appears companies do share buybacks when they have extra cash on hand or as a short-term EPS management tool, as opposed to when their stock is cheap.

*The Outsiders* does a masterful job at bringing the obscure and misunderstood practice of capital allocation into the foreground. In addition, it sheds light on the idiosyncratic personalities of some of the most successful CEOs of all time. The management techniques espoused in the book are compelling and highly rational, and we think any student of the business world would benefit from reading it.