Marcellus: The Traits of an Effective CEO

Rather than being a corporate Superwoman, the effective CEO is an honest, industrious, well informed executive who is aware of her limitations and understands that her conduct and her incentive structure sets the tone for the rest of the firm.

"Buffett manages his CEOs just like he manages his stock purchases. He carefully choses them and doesn't ask them to do anything different as a result of his ownership. He is loyal to his CEOs, and they are loyal in return…Each CEO is expected to manage his or her enterprise as if it were not part of a larger organisation…Outside of a simple monthly financial report, there are no required reports, meetings or phone calls and no need to consolidate job functions…No time is spent on the ongoing valuation of the enterprise, earnings forecasts or media relations." **– Robert P.Miles in "The Warren Buffett CEO – Secrets from the Berkshire Hathaway Managers" (2001)**

Neither a liar, nor a hero. So what should a CEO be?

Since our previous two pieces have been about how we tend to get deluded by heroic leaders and especially by those who lie, several of you have asked us what qualities do we expect a CEO to have. In a low trust society like India, it is obviously untenable for the CEO to a liar but what are the positive qualities that investors should expect in a CEO?

A good place to start understanding the characteristics of an effective CEO is the late Peter Drucker's work. Drucker lived in an era where market for management gurus wasn't as crowded as it is today. So he could write about the art of management in a rational, measured manner. In contrast, modern day gurus need to write "Hardy Boys" style case studies/books for people who go to business school.

In his 1967 classic "The Effective Executive" (a book which has never gone out print) Drucker identifies the behavioural traits required of an effective CEO:

"An effective executive does not need to be a leader in the sense that the term is now most commonly used…some of the best…CEOs I have worked with over a 65-year old consulting career were not stereotypical leaders. They were all over the map in terms of their personalities, attitudes, values, strengths and weaknesses…What made them all effective is that they followed the same eight practices:

- *They asked, 'What needs to be done?'*
- *They asked, 'What is right for the enterprise?'*
- *They developed action plans.*
- *They took responsibility for decisions.*
- *They took responsibility for communicating.*
- *They were focused on opportunities rather than problems.*
- *They ran productive meetings.*
- *They thought and said "we" rather than "I".*

The first two practices gave them the knowledge they needed. The next four helped them convert this knowledge into effective action. The last two ensured that the whole organisation felt responsible and accountable."

Taking a cue from Drucker, we have sought to list the most desirable traits in a CEO.

The six qualities of an effective CEO

1. **Relevant experience**: Running a listed company in a country with weak institutions like India is a demanding job. As stewards of our clients' monies, we have to assess that the man or woman in charge has credible, relevant experience of having managed such an enterprise before. If the CEO happens to be the promoter's son or daughter, we check whether he/she has been groomed for the job properly as opposed to being parachuted into the Boardroom by dint of his/her DNA.
2. **Awake & alive to commercial realities**: Paying attention to the latest fads in Finance or trends in Management appears to be a futile activity. An effective CEO instead keeps his ear close to the ground to assess: (a) changes in the cost structure of the industry; (b) changes to the relevant market size either due to customers' tastes changing or due to macroeconomic factors; and (c) innovation in the product/service itself or innovation in the process used to bring the product to the market. CEOs who are good at this tend to be naturally inquisitive and that in turn makes them voracious readers.
3. **Decentralised authority**: No CEO can have all the skillsets to manage the whole firm even if the firm is a small company. If she is good at Marketing & Business Development then we would expect her to centralise authority for that specific domain whilst decentralising authority for HR, Finance and Operations. If she has formerly been the CFO and wants to continue exerting control on that function then we would expect her to decentralise authority for Marketing & Business Development to a capable lieutenant. What we want to avoid are companies where the CEO is the all singing, all dancing superman with disempowered underlings reporting into him.
4. **Rational capital allocation**: Whilst assessing a firm's capital allocation track record is an important job for us, we believe it is even more important to assess the process via which a company allocates monies to projects/ventures. Indeed the most useful part of meeting a CEO is the

discussion around this subject – we ask her to lay out the business case for the Rs 100 crore investment that has been commissioned in south India; we ask her what the IRR for the project is; when the project is expected to hit cashflow breakeven; what will be the impact of the project on the firm's ROCE. We have heard CEOs say that they "forgotten the IRR" or that "the project will breakeven in about 3-4 years". Those sorts of answers worry us.

5. **Integrity**: Whilst it is unrealistic to expect CEOs to be paragons of virtue, what the CEO has to have is the moral integrity to set the right example for her managers. The CEO of a textile company with a 5% PAT margin who visits the factory in a new BMW 7-Series will find it difficult to carry her team with him. On the other hand, the CEO of a jewellery company with 45% ROCE and a three-year old Honda Accord is more likely to be able to set the cultural tone for the firm. The CEO of a smallcap Pharma company who flies Economy is sending a more eloquent message to his Sales executives than the charismatic CEO who waxes lyrical in the Boardroom. The CEO can't party in London and expect his team to slog it out in a factory in Ludhiana.
6. **Skin in the game**: In a country where management talent is in short supply, the CEO acts an anchor for the rest of the management team – they are less likely to run away to greener pastures if the CEO is financially committed and locked-into the firm. Promoters of family owned companies are by definition locked-into their companies. Study after study in India shows that family owned companies produce better financial results & superior shareholder returns than companies where there is no promoter. This suggests that hired CEOs should also be incented like promoters! As Warren Buffett discovered in America, the "owner CEO" method is the best way to align the interests of the of the shareholder with those of the manager.

In short, the effective CEO is an honest, industrious, well informed executive who is aware of her limitations and self-aware enough to understand that her conduct and her incentive structure sets the tone for the rest of the firm. Truth be told, we have not met more than 40 such CEOs in India over the past decade. These 40 companies form the spine of the portfolios that we are building for our clients.

Our thanks to Nitin Bhasin of Ambit Capital for pointing us towards “The Warren Buffett CEO” by Robert P.Miles.

Note: the above material is neither investment research, nor investment advice. Marcellus does not seek payment for or business from this email in any shape or form.

Saurabh Mukherjea is the author of “The Unusual Billionaires and “Coffee Can Investing: the Low Risk Route to Stupendous Wealth”. He’s also the Founder of Marcellus Investment Managers.

Saurabh Mukherjea can be reached on Saurabh@marcellus.in