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An Open Letter to the CFO of Goldman Sachs on Employee Compensation

Albert Meyer - Bastiat Capital

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Bastiat Capital has recently published several pieces of research on Goldman Sachs share-based compensation culture.

We compiled this research and forwarded it to the board of Goldman Sachs, to which we received a comprehensive response from R. Martin Chavez, Goldman Sachs' Chief Financial Officer. *Our initial letter and Chavez's response are linked in the index on the right hand of this page.*

We are not going to impose any further on the CFO's busy schedule with a formal rebuttal of his justifications of the company's compensation practices. Instead, we are summarizing our thoughts in this essay.

At the outset, we want to clarify that our quarrel is not with Goldman in particular. Share-based compensation is the norm, and very few companies rely solely on cash compensation. I've previously expounded on these views in interviews with the *New York Times* and several other media outlets.

Additionally, the CFO's defense is in no way unique to Goldman. Had we written to any other company, we would have expected a similar reply. Hence, we direct our divergent views at corporate America rather than at one specific company.

- Albert Meyer, BASTIAT CAPITAL

Bastiat Capital's Letter to Goldman Sachs -

'Share Based Compensation, Oh the Folly'

Response from Goldman Sachs -

'Dear Mr. Meyer... A Letter from the CFO'

About Bastiat Capital:

***Bastiat Capital** is a boutique asset management firm headquartered in Plano Texas (outside of Dallas). Bastiat has consistently outperformed the S&P 500 and has provided returns in excess of 200% (net of fees) since inception in 2006. Bastiat offers an actively managed, highly concentrated large-cap portfolio of companies with an average market cap of $90 billion. The fund's methodology is anchored in forensic accounting, rigorous research and disciplined investing.*

About Albert Meyer:

***Albert Meyer** is the Founder and Chief Portfolio Manager of Bastiat Capital. He founded Bastiat after having been awarded the American Accounting Association's 'Exemplar of the Year' award (previously awarded to the former Chairman of the SEC). Meyer is credited with uncovering high profile fraud and accounting issues (Tyco, Enron, New Era Philanthropy etc.) which resulted in significant accolades and global attention.*

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Excerpts from the CFO of Goldman Sachs, R. Martin Chavez's letter are highlighted in blue italics with our emphasis in bold throughout this piece:

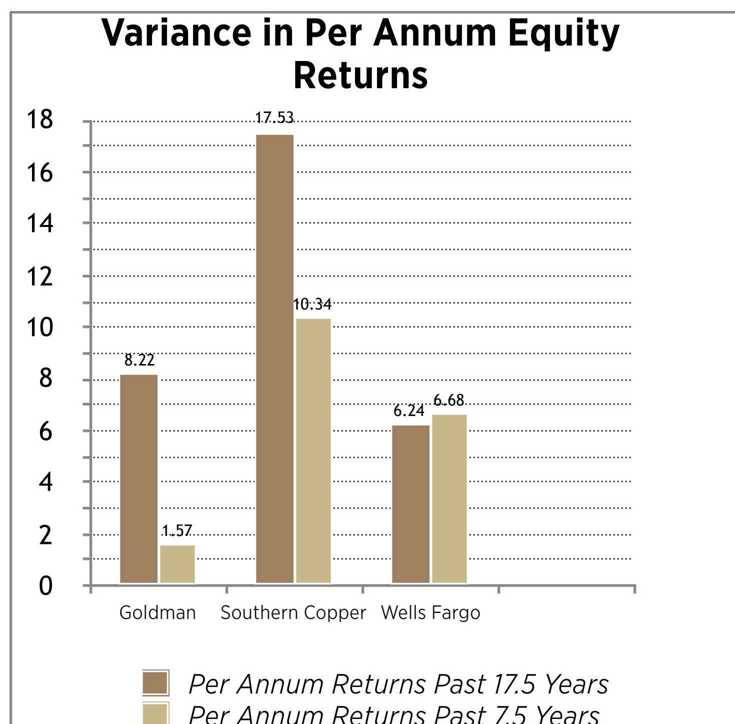
"We think equity-based compensation is an important component of an employee compensation program for several reasons. First, we believe it provides the strongest alignment between employees' interests and those of our shareholders and is an important component in discouraging employees from imprudent risk-taking."

"… strongest alignment between employees' interests and those of our shareholders…"

We would argue that Goldman is unique among the world's great investment bankers. Goldman Sachs was founded in New York in 1869 by Marcus Goldman. In 1882, Goldman's son-in-law Samuel Sachs joined the firm. How many firms have an illustrious 150-year history like Goldman Sachs? Goldman recruits not only on the campuses of the world's greatest universities but also amongst the brightest graduates at these institutions.

It is a stretch to reason that a Goldman employee needs any incentive to align his or her interests with those of shareholders. Goldman would not hire in cases where it has any doubt about an employee's determination to sign onto management's goals and objectives. Employees walk through Goldman's door with great pride and honor. Have you ever heard of an employee at a prestigious institution like Goldman saying, "I wasn't motivated, but once I got stock options I got fired up to perform"?

Moreover, as we argue in our analysis, instead of issuing stock, a cash bonus equal to what stock options would have gained employees (equivalent to 9.1% of revenues over the past five years) would have provided enough surplus cash to start accumulating a decent holding in Goldman's stock. Shareholders put their after-tax earnings at risk when they buy Goldman's stock. If employees do the same, preferably voluntarily (although



employment contracts could stipulate a minimum) then the interests of employees and shareholders are aligned.

If stock awards are a prerequisite to align employee interests with those of shareholders, the largest shareholder at

Berkshire Hathaway, Warren Buffett, has a massive problem with 377,000 employees who are only paid in cash. The long- and short-term returns that the two stocks offered investors do not support the case for stock awards.

Since 2000 and 2007, Berkshire has rewarded shareholders with compounded annual returns of +10.95% p.a. and +15.25% p.a., respectively. On the other hand, Goldman and its highly incentivized employees with their boatloads of stock awards delivered +8.22% p.a. and +1.57% p.a. over the past 17.5 and 7.5 years, respectively. Southern Copper ($33 billion market cap), another company that pays employees in cash only, delivered +17.53% p.a. and +10.34% p.a., respectively. King of the stock option hill, Wells Fargo's comparative returns were +6.24% p.a. and +6.68% p.a., respectively.

We would also argue that stock awards undermine employee morale. Let's see what happened at Dell. If we examine the realized stock option gains for the period 1995 to 2005, employees picked up 72% of these gains in the period 1998 to 2001, which equated to 13.1% of revenues generated during the same period. The other 28% of the gains represented only 2.3% of total revenue during this 10-year period.

The average ratio of gains to revenues was 6.0%, boosted by the outsized gains of 1998 to 2001. In other words, the lucky few made out like bandits during 1998 to 2001, but in the preceding and ensuing years, the pickings were slim. Perhaps most employees who joined the company after 1995 benefited from the largesse in the 1998 to 2001 years, but employees who were still waiting for their options to vest were disappointed. The gains realized from 2002 to 2005 only equaled 1.7% of total revenues. In 2001, employees still had unrealized gains of more than a billion dollars in their unvested options. A year later, that number cratered to less than $300 million. What does this kind of wealth destruction do for employee morale? Stock awards are fine and dandy when the stock price motors on, but when the fortunes reverse, employees find themselves holding the bag.

If Dell had paid employees a cash bonus equal to 3% of revenues from 1995 to 2005 and used the remaining free cash flow to buy back stock, a 1.0% owner in 2005 would have become a 1.69% owner, purely as a consequence of the shrinkage in the share count. Instead of earning $0.88 per share in 2005, the company would have reported $1.38. At a 34.0 P/E at the time, the stock price would have been $46.90, instead of the $29.92 ($0.88 times 34.0). We all know what happened with Dell after that, and we suspect Dell had trouble recruiting the very best talent following the disillusionment that employees must have felt when their options-related expectations evaporated.

Goldman employees received 21.8 million stock awards in 2007 at a weighted average strike price of $224.13. They were presumably still waiting for the restricted stock units (RSUs) to vest when the stock hit a high of $247.92 in October 2008. From

then onwards, the RSUs were under-water until November 2016. At a current price of $240, the return on the 2007 RSU grant is less than one percent per year. Not be discouraged, employees received 21 million RSUs priced at $67.59 in 2008. Shareholders got nailed with another 5% dilution, with the prospects of hard-earned cash flows being allocated to stock buybacks to mitigate dilution.

"... And is an important component encouraging employees from imprudent risk-taking..."

One reason Bastiat escaped the carnage in the financial sector in 2008 (caused by imprudent risk-taking) was because we avoided companies with large stock option overhangs. We recall that Merrill Lynch had an overhang of 28% in 2008. Goldman's stock overhang (outstanding restricted stock units and stock options divided by outstanding shares) was 33.0% and 20.8% in 2008 and 2009, respectively. Stock options were very much in fashion. Stock awards did nothing to lower the risk profile of these institutions as taxpayers who bailed them out would attest. Bank of America's new CEO Brian Moynihan, immediately on taking office dispensed with stock options and switched to restricted stock units (RSUs). We will say more about RSUs, but Moynihan's dislike for stock options resonates with us.

For a more recent example, stock awards did not curtail risk-taking at Wells Fargo, as we know only too well. We chose the company's 2014 10K to see if perhaps a lack of stock awards could account for the reckless conduct of executives that followed. On the contrary, one could argue that the prospects of a rising stock price juiced by improper decisions to reap outsized stock award gains were the impetus to open fake accounts that created the perception of growth. At the end of 2014, the company had 5.170 billion shares in issue. Stock options and stock awards totaled 160.9 million, or 3.1% of the share count. Although not excessively high, it still represents significant shareholder dilution – more about this later.

A company's penchant for share-based compensation often goes hand-in-hand with extreme levels of remuneration. Even though Warren Buffet owned 9% of Wells Fargo's stock, we balked at the CEO's salary. For example, CEO John G. Stumpf's compensation in 2012, 2013, and 2014 was $22.8 million, $19.3 million, and $21.4 million, respectively. In 2014, the value realized on vested stock and option exercises amounted to $67 million. He also had $4.1 million in a deferred compensation plan, $20.8 million (present value) in pension benefits, and $24.3 million in potential post-employment payments not included in any of the above amounts. The proxy also tables 2013 and 2014 Performance Shares with an estimated value of $29.5 million. Goldman's overhang was 4.6% at the end of 2014. Goldman's CEO, Lloyd C Blankfein, earned $13.3 million, $19.69 million and $22.1 million in 2012, 2013, and 2014, respectively.

As for aligning interests, a former investment banker called us after reading the Forbes (June 14, 2018) interview to say

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he speaks on behalf of the majority of employees on Wall Street that they don't like stock, they want cash. Of course, upon vesting and exercise, employees turn around and sell because stock is not legal tender at the car dealership or Louis Vuitton.

Consider Wells Fargo again. At the end of 2014, 160.9 million stock awards were outstanding, and yet all directors and executives (the insiders) as a group (28 persons) only owned 4.482 million shares, of which the CEO Stumpf owned 1.333 million. The insiders also held 12.8 million options and stock awards, of which the CEO held 3.9 million.

CEO Stumpf received 678,170 stocks awards and options in 2014. If this was the annual run rate, his outright ownership of 1.333 million shares represents a mere 1.97 years of stock grants. He served as an executive since 2002, during which time one must assume he received equity awards. Without analyzing 12 years of proxies, let's assume that his average stock award was at least half the number granted in 2014. Over the ensuing 12 years, he added on average every year 111,000 Wells Fargo shares (16% of the total number of stock awards in 2014 alone) to his stock portfolio. If so, then he must have cashed out at least two-thirds of his stock awards over the preceding 12 years.

Contrast this to Warren Buffet's commitment to the company as a shareholder. The proxy lists Buffett as a shareholder because he is deemed to be the controlling shareholder of Berkshire Hathaway Inc. in whose name the shares are registered.

At the end of 2009, Warren Buffett owned 344.4 million (6.7% of total) of Wells Fargo stock. All directors and executive officers as a group held 4.195 shares (0.082% of total). CEO Stumpf held 795,185. Stumpf's total compensation in 2009 was $21.3 million.

By 2014, Warren Buffett held 490.0 million shares (9.5%) of the company's stock. All directors and executives owned 4.482 million shares (0.087%).

CEO Stumpf was replaced in 2017, which makes 2016 the last proxy in which his stock holdings were listed. As of February 24, 2016, Stumpf owned 1.618 million shares and all insiders in the aggregate 5.11 million shares (0.10% of total). Warren Buffet held 506.3 million (9.9%). So, from 2009 to 2016, Buffett increased his share count by +47%, not quite matched by a +22% increase for insiders.

The most recent 2018 proxy tells a different story. All insiders now own only 2.716 million shares (0.05%). Warren Buffett holds 484.5 million (9.8%) shares. There is no alignment here of the interests of the recipients of copious amounts of stock awards and shareholders, as represented by Buffett. Since 2009, Buffett increased his shareholdings by +41% compared to a -35% decline by insiders.

We would be remiss not to cite Goldman's comparatives. In 2009, CEO Blankfein held 2.005 million Goldman shares (0.41% of total). By 2017, he held 2.300 million (0.58% of total), for an increase of 295,000

shares, or 42,000 per year. One could argue that this represents an alignment of the CEO's interest with those of long-term Goldman shareholders. However, in 2009, he also held 1.350 million restricted stock units and stock options to which he had the right to acquire within 60 days. Had he held onto these stock awards as and when they vested or were exercised, he would have owned at least 3.650 million shares (0.92% of total) by 2017, not counting all the other vested stock awards that fell due in the ensuing seven years. It would not have been any different if the board had increased his cash compensation considerably and granted only 42,000 shares every year with the stipulation that he may not sell these until retirement, with the result being minimal shareholder dilution and the alignment of interests.

Now for the kicker, there are two parties to a stock grant transaction, the employees, and the shareholders. One would be hard-pressed to find shareholders who think ownership dilution of any kind is something to cherish. The fact is, shareholders do not want to be diluted, and the market rewards companies that protect shareholders' ownership interests. In short, there is no alignment of interests here.

In 2004, Kenneth F. Broad published an insightful essay "Hi-Tech Option Myths," which we found archived on the FASB website. "Options do not directly align the interests of management with shareholders. Those who perpetuate this fallacy ignore the asymmetric return profile of options, which is akin to that of a lottery ticket. Returns are leveraged on the upside and 100% on the downside. As a result, options can incentivize imprudent risk-taking, especially when combined with short vesting periods. Restricted stock grants with long vesting periods provide a much tighter alignment of interests as Brian Hall, of Harvard Business School, argues in his study, 'Incentive Strategy II: Executive Compensation and Ownership Structure.' He details the myriad of problems attendant with options use and explains why plain-old stock is a 'more efficient' equity motivator…

"Options often do not promote outright stock ownership. Most companies grant options annually to their employees and, according to the book 'In the Company of Owners,' the vast majority – an estimated 90% – sell their stock immediately after exercise. This is typically for diversification reasons, which defeats the purported purpose of building a direct ownership stake. Many firms even offer a 'cashless exercise,' which allows employees to receive their net option gains without ever having to open their own checkbook. Proxy statements detail the 'amount and nature of beneficial ownership,' but if you subtract 'shares subject to purchase options exercisable within sixty days,' the real underlying share ownership of executives is usually pathetically low-especially for tech firms. Restricted stock grants more efficiently promote outright stock ownership, but are underutilized due to their less favorable accounting treatment."

"We also ***believe that deferred equity compensation encourages employees*** *to think and act like long-term owners*

of the business. This results in more effective risk management, which is core to generating superior long-term returns."

Failure to manage risk at Well Fargo has led to the 2017 proxy spelling out at length the company's renewed efforts at risk management. The proxy does not blame past failures on a lack of stock awards. Neither does it refer to the future role that stock awards will play in minimizing risk, other than to intimate that incentive compensation arrangements failed and, hence, it now has a new goal, i.e., to "manage incentive compensation risk." For example (**our emphasis in bold**):

*"For our executive officers, our **compensation risk-mitigation features** include multi-year, performance-based vesting, claw back policies and forfeiture provisions, consideration of **qualitative aspects** of performance, and management's and the HRC's **discretionary ability to adjust downward or eliminate long-term and annual incentive awards**... The design and risk management features of our Company's executive compensation program provided our Board the discretion **to forfeit and adjust unpaid equity and annual incentive awards**."*

*"In September 2016, our Board took the following actions in response to our **unacceptable retail banking sales practices**: Our Board and Mr. Stumpf agreed that **he would forfeit all of his unvested equity awards**, forgo his salary during our Board's independent investigation, and not receive a 2016 annual incentive award. Our Board caused Ms. Tolstedt **to forfeit all of her unvested equity awards**, not receive a 2016 annual incentive award, and agree not to exercise her fully vested stock options during our Board's independent investigation."*

We believe that the expectations of cashing in on significant stock gains might well have encouraged the improper sales practices which lead to the forfeiture and elimination of $91.3 million in incentive awards granted to these two individuals. French novelist, Honoré de Balzac, once wrote that "Behind every great fortune there lies a crime." He was onto something.

Furthermore, long-term returns at both Goldman and Wells Fargo have gone AWOL despite the best efforts to the achieve this through the means of equity compensation – returns quoted above.

We see merit in deferred compensation programs. Granting stock appreciation rights settled in cash would achieve the same outcomes, but without any associated ownership dilution – but accounting rules add complexities discussed below.

"... our global regulators also either encourage or require equity-based compensation..."

"For these same reasons, our global regulators also either encourage or require equity-based compensation as a

component of our compensation practices. For example, the Federal Reserve Board and the US and the Prudential Regulation Authority in the UK expect or require a substantial portion of variable compensation to be in the form of equity-based award."

Knowing our jaundiced view of regulators and bureaucrats, it does not surprise us that these august bodies find it expedient to interfere in matters so way beyond the scope of their mandated functions. We can imagine them trying to foist any such ridiculous prescriptions on the likes of Warren Buffett. It goes beyond the pale. This reminds us of American comedian Flip Wilson who won a Grammy with his 1970 Album "The Devil Made Me Buy this Dress," which spawned the Devil Made Me Do It song - to quote a line: "The devil made me do it, oh, oh, oh, oh Your honor I am innocent."

*"There are several incremental reasons we are supportive of granting equity-based compensation awards including that they **naturally build shareholders' equity over time…**"*

We have already pointed out that cash bonuses can accomplish the same effect, again without shareholder dilution coming into play. Most public companies offer employees an opportunity to purchase shares at some discount, and at the lowest price at the beginning or end of a quarter.

*"… are **less expensive** than granting cash awards given the discount on equity-based awards resulting from our 5-year transfer restrictions and are consistent with peer-benchmarking."*

Stock appreciation rights would achieve the same goal *sans* dilution, subject to tax and accounting considerations. When the stock price goes nowhere, as has been the case at Goldman the past seven-and-a-half years, employees might want to chime in and bemoan their lack of wealth accumulation and their employer's unsuccessful attempts at making their compensation "less expensive." "Per benchmarking" is just a way of rationalizing a lot of dubious actions, as we did when we told our mothers, "But, Mom, everybody does it."

"We are continually reviewing and re-evaluating ways to enhance our approach to employee compensation and have outlined below several of the pros and cons we have considered over time with the options you recommend."

– Terrific.

*"We appreciate that the alternative cash compensation program you suggest could potentially limit shareholder dilution but still accomplish an alignment with shareholders by allowing employees to utilize cash compensation to purchase stock of their own. In practice, we believe that **implementing such a program presents a few challenges**. For example, it would require a trade-off to achieve, the same level of long-term employee/ shareholder alignment. In a*

hypothetical deferred cash program, employees would not participate as beneficial owners until the cash award was vested and received, and until after they paid taxes and used the remaining amount to purchases shares, reducing alignment and long-term focus."

Employee stock ownership, though to be encouraged is not a *sine qua non* for business success, as Berkshire Hathaway would confirm. Insider buying that flows from option exercises provides far less confirmation of employee commitment than actual open-market purchases with after-tax income. Employee stock purchase plans are a perfect vehicle for achieving this goal. An employer could mandate that executives and senior managers allocate a certain percentage of their stock portfolio to the company's stock within defined parameters, including a stipulated holding period.

In a hypothetical deferred cash program, the company could place, say, $4,000 in a deferred compensation account on behalf of an employee and use the money to pay $40 per call option to buy Goldman stock for $220 on January 17, 2020 (current quote as we write). This would be just as effective as any stock award arrangement but without diluting shareholders.

"The use of "cash-settled equity-based awards," which in theory could correct for this issue, poses another challenge. This option would require replacing equity-based awards with cash-settled awards, indexed to our stock price. ***Under current accounting rules, we would be required to mark-to-market any cash-settled awards to the value of our common stock.*** *This approach would increase the volatility of our reported earnings and could result in a lower valuation multiple for the firm. In addition, if our stock price were to appreciate in conjunction with strong operating performance, it would increase the negative consequences of increasing reported employee compensation expense for previously undelivered awards. This would result in a reduction in net earnings and lower book value growth."*

Concerning volatility in earnings, one needs to point out that the business models of financial institutions are already heavily impacted by mark-to-market accounting. In the case of Goldman, the impact of cash-settled equity-based awards could be minimal. Also, as the stock has done very little over the past seven and a half years, volatility would not have been an issue. When the stock price declines, a reversal of negative mark-to-market adjustments that initially increased the compensation expense would be a most welcome boost to earnings when needed most and grow book value. It works both ways.

We agree that the accounting rules favor the perpetuation of equity-based compensation. FASB accommodates executives with accounting rules that treat their favorite cookie jar with kid gloves. Corporations bankroll FASB's budget.

Under FASB rules, a company can issue stock options with a strike price of $30 (and a compensation "guesstimate" of $10), and if some years later, an employee garners $300 in gains, there are no mark-to-market adjustments of the initial $10 expense recognition. In all other instances where management uses its judgment to put a number to an estimate (for example, provision for doubtful accounts), subsequent adjustments are made to true-up the initial estimate, but not so with equity-based compensation. However, when management uses cash-settled equity-based awards, market-to-market is suddenly a requirement.

The accounting rules relating to stock-based compensation are so bizarre that when Deloitte decided to publish a handbook on the topic, entitled "A Roadmap to Accounting for Share-Based Payment Awards," it required a 648-page document. As a former auditor at Deloitte and Touche, it is relatively easy to vouch for and verify a compensation expense when paid in cash. However, it requires extensive and costly audit procedures to comply with the rules related to stock-based compensation. In specific instances, cash-based compensation may not be as tax effective as equity-based compensation, but spare a thought for the costs associated with auditors working their way through 648-pages of compliance.

Goldman paid professional fees to its auditors in 2017 that amounted to $64.6 million, of which $2.1 million related to tax matters. Goldman has a market capitalization of $90 billion and trailing 12-month revenues up to Q2 2018 of $35.6 billion. The company's proxy statement devotes 44 pages to explain to shareholders the in and outs of executive compensation.

According to the 2017 proxy, in the paragraph that follows the disclosure of the $64.6 million audit fee, we find this: "PwC also provides audit and tax services to certain merchant banking, asset management and similar funds, managed by our subsidiaries. Fees paid to PwC by these funds for these services were $70.1 million in 2017…"

Berkshire Hathaway, a company that compensates employees only with greenbacks, paid Deloitte $47.8 million in professional fees in 2017, of which $0.8 million related to tax matters. Berkshire is a $520 billion company with revenues of $242 billion in 2017. The company's proxy consumes less than two pages to discuss executive compensation.

Paying an employee in cash and then requiring them to purchase the company's stock outright, or buy call options, or some similar arrangement would avoid the mark-to-market issues raised by the CFO. Also, an informal agreement with employees could base annual bonuses on some criteria, including the performance of the company's stock price to avoid any accounting complexities.

"On a separate note, another issue you raise in your letter is an estimation of the cumulative EPS benefit of ~$17 over the past 5 years if we had granted cash instead of equity, you assume that our

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*buybacks during that period would have occurred in the absence of an ongoing employee stock issuance program. This assumption may not be accurate, given that **our equity-based compensation created equity, which was the determining factor in sizing our buybacks.** As a result of regulatory capital requirements, our buyback would likely not have been as robust without this equity creation."*

We concur, but it confirms the logic of our analytical process whereby we always adjust free cash flow for the cost incurred to buy back stock issued to employees during the year. These buybacks are just an obfuscated way of paying compensation at the back door. If FASB were ever to mandate (they never would), that companies report the cash effects of buybacks related to equity-based compensation in the operating section of the cash flow statement instead of the financing section, it would seriously undermine corporations' enthusiasm for this form of remuneration.

Although we favor cash compensation above all else, we concede that restricted stock unit grants are preferable to stock option grants. The accounting rules related to the calculation of compensation expenses under stock option grants are too subjective. Because of the risk that some options might expire out-of-the-money, option grants are often much more substantial than grants of restricted stock.

On this score, Goldman has not issued any stock options since 2008. However, in 2004 and 2008 the company granted 22.5 million and 35.9 million options, respectively. The company expeditiously timed these grants. In 2003, the company granted 903K options at a strike price of $96.08, and in 2005, the grant was for 3.3 million options at a strike of $131.64. The 22.5 million options granted in 2004 had a strike price of $96.08, a mere 0.28% above the previous year's strike price. It got a lot better in 2008. In 2007, the company granted 3.5 million options at a strike price of $204.16 and in 2009, there were no option grants. The 35.9 million stock options awarded (ten times the previous year's grant) in 2008 had a strike of $78.78, a discount of 61% compared to the prior year's strike price.

From the first quarter of 2003 to the third quarter of 2004, the company's stock price was in a bit of a trough. It broke through the $110 per share barrier in 2005 and then reached a high of $250.70 in the 4th quarter of 2007. In the 4th quarter of 2008, it reached a low of $47.41 and then a low of $59.13 in Q1 2009. A year later (Q1 2010), the stock traded at a high of $178.56.

If we can discern a pattern here, shareholders could expect a significant option grant the next time the company's stock takes a deep dive.

Over the past ten years, the company granted employees 156.9 million restricted stock units. At the end of 2006, the company had 412.7 million shares outstanding. The forfeiture rate is about 7.5%. If 92.5% of the units vested over the ensuing ten years (same may still be

subject to vesting conditions, but others granted before 2006, invariably vested), without stock buybacks there would have been approximately 555 million shares outstanding today for a 35% dilution rate. No shareholder on earth would tell us that they have any interest in, approval of, or desire for this kind of dilution. The stock buybacks helped to mitigate this pain, but there is no gainsaying that using stock for compensation purposes is a massive smoke-and-mirror show.

If Goldman is concerned about maintaining an above-market P/E multiple, we would suggest a sure-fire way of obtaining such a multiple. Announce that from now on, Goldman Sachs will pay employees in hard cash only. All stock buybacks will go towards shrinking the share count. Shareholder dilution is a thing of the past. Warren Buffett (Berkshire owns Goldman Sachs stock) will in all probability make a public statement to praise management, and we have no doubt Goldman's stock will become a prized possession in stock portfolios.

About 15 years ago, we presented a friend who worked in the Treasury Department at Microsoft with an analysis of the company stock option program, similar to the review we did on Goldman and Dell cites above. In essence, we demonstrated that the company's earnings per share would have been considerably higher than the reported numbers if it had paid employees a cash bonus equal to 15% of revenue in lieu of stock options, and used the remaining cash flow to repurchase the same number of shares it bought back to mop up dilution.

We used the market multiple of Fastenal to enforce a point. Fastenal is not a high-tech company, instead, a real nuts and bolt company. If we recall, Fastenal had approximately 87 million shares issued and outstanding when it became a public company back in the mid-eighties. At the time we did the Microsoft analysis, Fastenal still only had 87 million shares outstanding, because it shunned any form of stock-based compensation, and yet it maintained a P/E multiple that was noticeably higher than Microsoft for most of the years that covered the period of the analysis. A year or so after we submitted our report, Bill Gates told the media that his one regret in business was the use of company stock to reward employees. The headline on the front page of the *Wall Street Journal* on July 9, 2003, read: "Microsoft Ushers Out Era of Options."

Just for the record: today Microsoft's trailing 12-month and forward P/Es are 52.7 and 22.88, respectively. Fastenal's P/Es are 24.63 and 20.84, respectively. Goldman compares with 18.9 and 9.37, respectively.

The letter closes with a word of thanks:

"for sharing your views with us – shareholder perspectives are of great interest to both our management and the board, and we welcome continued dialogue."

Conclusion

One argument not raised by the CFO is that shareholders routinely vote on new option grants. Shareholder democracy is another fallacy that prevails. Shareholders vote with their money. We made our investment in Goldman Sachs during a time when the stock traded below book value. Still, our holding has not outperformed the S&P 500. We reached out to the board in 2013, hoping to bring some critical thinking to equity-based compensation at the company. We are at the point of voting, but not by proxy. Do shareholders fully grasp the nuances of a proposed equity-based program? Index fund managers, the ones who could change corporate culture, for the most part, vote with management. They cannot vote with their money. If a company is in the index, they have to own the stock.

The whole process by which insiders have been able to divert enormous amounts of wealth from shareholders to their wallets has been carefully designed to obfuscate, confuse and befuddle investors. Most people's eyes glaze over when they hear about Monte Carlo simulation, Black Scholes formula, the Whaley Quadratic and binomial option pricing models. The Accounting profession and regulators aided and abetted in the process. For example, in this context, the correct terminology should have been stock warrants, a term that one readily associates with shareholder dilution. A standard way for companies in distress to borrow money is to add stock warrants as an incentive to the debt offering. Stock options do not readily imply shareholder dilution. Call and put options are traded on exchanges all day long.

For the past 25 years, we have taken a very keen interest in equity-based compensation, both in the way the accounting rule makers have botched the rules relating to the reporting practices, as well as figuring out the real economic consequences of equity-based compensation. It was a bad idea 25 years ago, and nothing to date has convinced us otherwise, despite reviewing extensive material on the topic and analyzing in great detail the equity-based compensation plans of more than 1,000 companies.

In closing, let's bring some humor to the table. Scott Adams, the creator of the comic strip Dilbert, has one under the title: **"Stock Options according to Dilbert."**

Dilbert and two board members, including Catbert, the Evil Feline Director of Human Resources are in conference. Catbert announces that "Stock options will be replaced with a bonus system." Dilbert objects: "So... now my happiness depends on the kindness of management instead of the gullibility of our investors?" Catbert: "Allow me to respond by hacking a hairball in your direction."