Leading by Reading

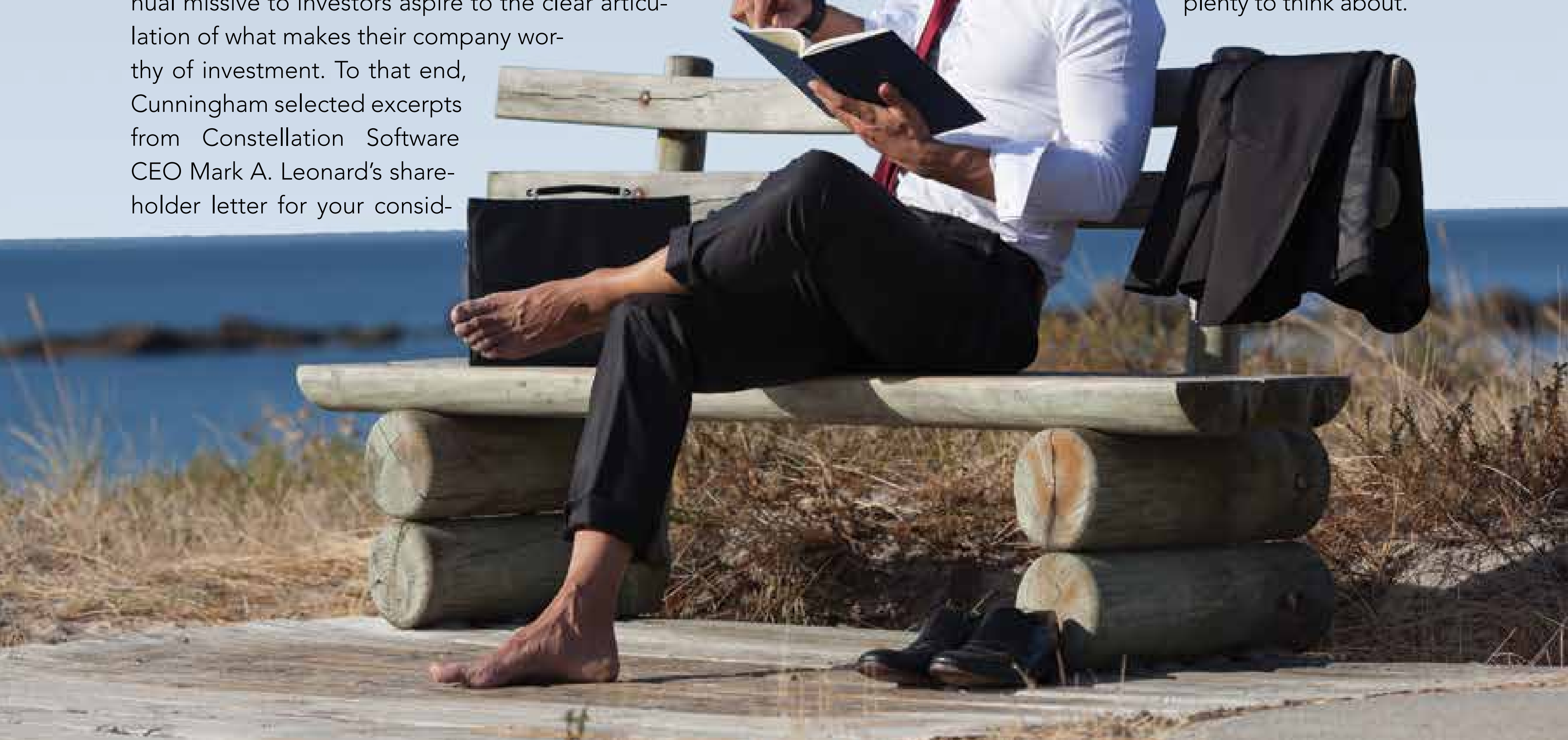
Although many media outlets release lists of must-reads this time each year, we feel confident that we bring an unparalleled approach given the dynamic nature of our membership and our own passion for stories and storytelling. In the following pages, we take a look at writings both corporate and literary that we hope will inspire, entertain, or provoke new ideas as you settle into the summer.

The first portion of this feature focuses on the art of shareholder communications—and Warren E. Buffett is a master of the form. Lawrence A. Cunningham, a professor at George Washington University and a director of the university's Center for Law, Economics, and Finance, has been a longtime student of Buffett's writings and contributor to this magazine. Here, Cunningham draws from his latest book, *The Warren Buffett Shareholder* (Harriman House and Cunningham Cuba LLC, 2018), co-authored with Stephanie Cuba. Cunningham paints a portrait of Berkshire Hathaway's shareholder base and examines how Buffett's approach to investor communications not only informs and enlightens shareholders, but creates a genuine sense of community as well.

Although Buffett has over decades set the gold standard for communications, there are other CEOs whose annual missive to investors aspire to the clear articulation of what makes their company worthy of investment. To that end, Cunningham selected excerpts from Constellation Software CEO Mark A. Leonard's shareholder letter for your consideration. Leonard's letter focuses on the role boards play in the success of a company and the importance of a culture where employees are encouraged to realize their full potential. His sentiments, given the exceptionally high rash of corporate culture crises of the recent past, are welcome reading and underscore the value that corporations play in our society at large.

We round out our package with a reading list that comes straight from the heart of NACD. We polled leaders within the NACD chapter system and our colleagues about their personal summer reading lists. (A few ideas from the editors of this magazine are thrown in for good measure as well.) From business to history to fiction, you'll be hard-pressed to find something you won't want to toss into a travel or beach bag this summer.

Although the writings of Fran Lebowitz didn't make our list, it's worth repeating the following from *The Fran Lebowitz Reader*: "Think before you speak. Read before you think." If we've done our due diligence (and we believe we have), these recommendations will leave you with plenty to think about.



Warren E. Buffett, right, and Charlie T. Munger, are projected on large screens as they preside over a session during Berkshire Hathaway's 2018 shareholders meeting.

ASSOCIATED PRESS

Buffett's Letters Plus the Berkshire Meeting Reinforce BRK's Corporate Culture

By Lawrence A. Cunningham

Warren E. Buffett's letters to the shareholders of Berkshire Hathaway have achieved iconic status for their candor, clarity, and wisdom. But their most important role, year after year, has been to deepen Berkshire's culture.

Buffett adds enduring value to his annual letters by making them the centerpiece of the ensuing shareholders' meeting, an equally iconic spectacle that draws tens of thousands. There, Buffett is joined by Vice Chair Charlie T. Munger for a daylong Q&A session, where participants are expected to have read the report.

Recurring themes appear in the reports and meetings, increasing the value of both. Together, these devices amount to a long-term program of defining Berkshire's distinctive ways and educating shareholders about their value.

Corporate leaders prepared to invest the time and effort to write an effective shareholder letter should consider taking a page from Buffett by linking it to their annual meeting. Buffett himself has made the connection explicit, writing in his 2010 report about Berkshire's culture and how it is shaped:

"Our final advantage is the hard-to-duplicate culture that permeates Berkshire. And in businesses, culture counts. To start with, the directors who represent you think and act like owners. This same owner-orientation prevails among our managers.…Our compensation programs, our annual meeting, and even our annual reports are all designed with an eye to reinforcing the Berkshire culture.… This culture grows stronger every year…"

Berkshire shareholders have gotten the message. In a recent collection of essays, *The Warren Buffett Shareholder: Stories From Inside the Berkshire Hathaway Annual Meeting*, co-editor Stephanie Cuba and I asked dozens of them to explain the importance of the meeting. Many immediately connected the meeting to Buffett's letters, and a few wrote inspiring essays about their compound value, all worth a read.

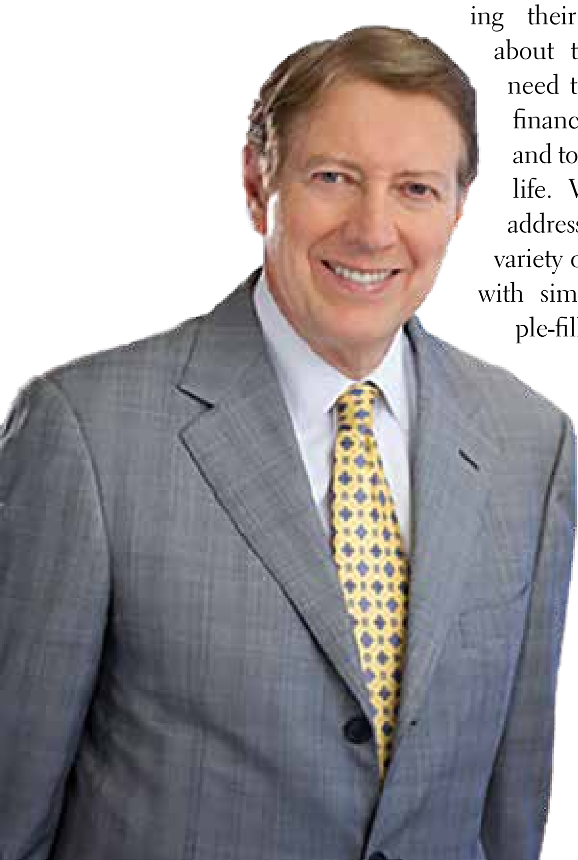
Robert E. Denham, a longtime Berkshire denizen and Buffett confidant, is well-positioned to understand how Buffett's letter and Berkshire's meeting together reinforce Berkshire culture. Denham served at Buffett's request as CEO of Salomon from 1992 to

1997, turning it around after a life-threatening bond trading scandal. Now a corporate lawyer at Munger Tolles & Olson (the firm Munger founded), as well as a director of several public companies, including The New York Times Co. and Oaktree Capital, Denham explains:

"Berkshire's annual report provides a great field guide for those attending the meeting. It is written carefully and clearly to explain Berkshire's businesses and the economic environment in which they operate to co-owners not involved in the business but motivated to understand it. Those having read the annual report are well-prepared to ask questions, understand the answers, and put both questions and answers in a broader business context. In other words, they are prepared to be a participant in the meeting and in the weekend's multiple conversations surrounding it."

Denham expounds on the tenor of the action at the meeting, its surprisingly broad scope, and Buffett's tactful style of address, which reflects on how to think rather than what to think.

"As they answer questions, Warren and Charlie combine the postures of managing partners reporting to their fellow owners and teachers educating their audience about things they need to know for financial success and to live a good life. While they address a great variety of questions with simple, example-filled explanations, they follow a basic rule of not conveying information that would destroy or diminish proprietary advantages Berkshire may possess. And when they decline to answer, they do so explicitly, rather than giving the non-answer answers one often hears from corporate leaders."



Robert E. Denham

Buffett never fills in the parameters for his listeners or gives his answer. This reticence reflects a belief that every investor has to take responsibility for forming his or her own view of such fundamental items. Although the central focus of discussion is Berkshire's business and more or less related questions about markets and economics, there is also discussion of how to live a morally valuable life. These discussions reflect the deep commitment of Warren and Charlie to teaching others not only how to live not just an economically successful life, but also a virtuous and meritorious life.

Simon M. Lorne, a former partner of the Munger firm who also served at Salomon during its post-scandal rehabilitation, offers further insight into how this formula works particularly well for Buffett and Berkshire: "In a way, the meeting is the natural outgrowth of Warren's famous shareholder letters.…Just as the letters evolved over the years, so has the meeting.… But in fact, just as the meeting is the natural evolution from the letters, the letters are the natural outgrowth of Warren's nature…Warren treats Berkshire's shareholders as the true owners of the enterprise. The letters come from that vantage point, and to many the meeting may be its most visible expression…

"Why? Well, if you write a 30-page letter to your investors, and try to write it as though you're writing to your quite intelligent, but financially less sophisticated sisters, why wouldn't you conduct your annual meeting as though you were sitting with them in their living room? Of course, when you've got 30,000 or so people in that living room, you have to change a few things, but that's the model.

"Summarize for the shareholders as best you can what's going on with their company, answer their questions to the extent you can without unduly hampering the business itself, and handle the formal necessities (electing directors, approving auditors) after they've gone. And if you can liven the conversation up with a few jokes, quips, mildly needling comments

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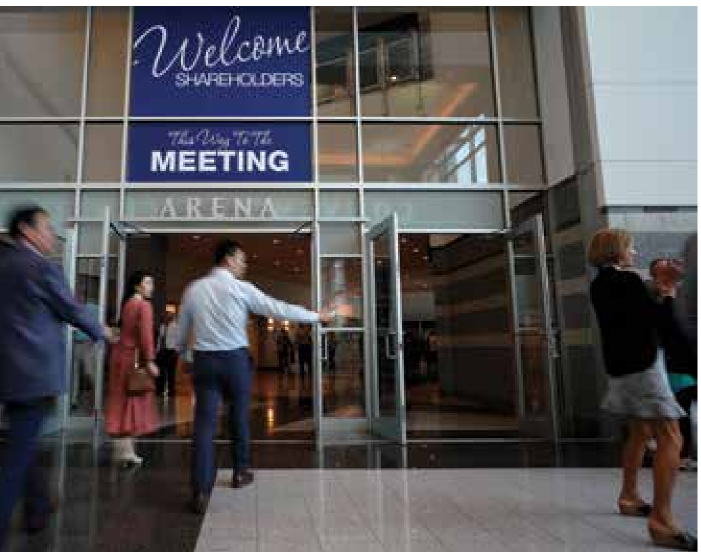

Berkshire Hathaway shareholders arrive at the company's annual meeting in Omaha.

to your partner and the like, by all means do."

After stressing every company's uniqueness and the need to adjust each company's letter and meeting to given cultures, Lorne identifies a single strategic benefit of potential value to all: if it's worth the effort for Berkshire, why don't more companies do it?

"Well, right. It is, and they—at least some of them—should," he says.

"The essential elements of the meeting—a serious discussion, the availability of senior executives to respond to intelligent questions for a sustained period—could well be emulated elsewhere, and in many cases undoubtedly should be.…The rapport that Warren and Charlie have with their shareholders through devices like the letters and the meeting, and the trust that is engendered by that process, give them leeway for occasional missteps that other corporations could use."

To follow the Berkshire example, moreover, does not require the elaborate lengths of either the letter or the meeting. It only calls for awareness of how an investment in one warrants investment in the other. After all, some shareholders may think they learn all they need to from a letter. But many don't.

In *The Warren Buffett Shareholder*, Prof. Prem Jain of Georgetown University recounts his own experience along these lines: "I got all of Mr. Buffett's annual letters since 1979.…The annual letters were useful but they never explained to my satisfaction the methodology of Mr. Buffett's success that could be taught and copied.

"It was 1992 when…I decided to attend a Berkshire annual meeting.…I listened to Messrs. Buffett and Munger for the whole day, paying close attention, and looking for concepts they emphasized... Since then, I have noticed that Mr. Buffett speaks about passion frequently and I too began to understand its importance…

"At the annual meetings, Messrs. Buffett and Munger continued to speak at length about Berkshire's managers and employees. Being an accounting and finance professor, I did not understand why they talked about people so much. The emphasis in my view should have been on past and future financial metrics and analyses. I remained frustrated in my quest to understand fully why Mr. Buffett was so successful.…Year after year, Messrs. Buffett and Munger continued talking about various managers they admired at Berkshire Hathaway. They spoke about their managers frequently and passionately and never disagreed in their judgments—where they tended to disagree a lot on many other matters from acquisition prospects to national economic affairs. Rarely, if at all, did they outline expected future cash flows, which professors consider to be the cornerstone of valuation.

"After many years, it dawned on me that the deeper answer I was seeking was right before my eyes. The answer was there when Messrs. Buffett and Munger talked about Ajit Jain, Lou Simpson, and dozens of other able, trustworthy, and passionate managers at Berkshire. There it was, the answer to Mr. Buffett's success: his ability to identify outstanding people.

"I concluded that when Mr. Buffett invests, he invests in exemplary managers, not thinking of companies separately from management. He allocates capital to people, not just to companies. Products, operations, and financial metrics are important, but secondary….I am happy that Mr. Buffett taught me the lesson to find outstanding people and I found one in Mr. Buffett both as a wealth creator and as a professor. Going to the Annual Meetings was the key."

As the editor and publisher for two decades of *The Essays of Warren Buffett: Lessons for Corporate America*, I consider Buffett's letters masterpieces in the art of corporate communications. They are well worth the effort he invests in them and I commend the output as a model for other corporate officials.

Now, as co-editor of *The Warren Buffett Shareholder: Stories From Inside the Berkshire Hathaway Annual Meeting*, I can attest to the added value of an annual meeting that builds on the letter's content. Both require hard work, but linking the two greatly increases the payoffs from each.

REUTERS/RICK WILKING

'A board's real mission is to build intrinsic value.'

Annual Letter From Constellation Founder is a 'Model of Engagement'

During our very first discussion about board service, Mark A. Leonard, founder, chair, and president of Constellation Software, told me it usually takes several years for a new board member to learn enough about a company to add real value as a director. At Constellation, Leonard and the board gave me a unique head start by engaging me to perform a study of its corporate culture before joining.

Another advantage I had, available to anyone being considered for the Constellation board: Leonard's letters to shareholders. In these dispatches, dating back more than a decade, Leonard provides transparent views into the company, revealing its distinctive business model and corporate culture, and how they interact and evolve. In his most recent letter, excerpted below, Leonard offers directors a model for engagement to add value over long periods.

Constellation's business, with annual revenue exceeding $2 billion, is acquiring, improving, and permanently owning vertical market software firms—those developing mission-critical products for particular sectors such as transit agencies, utilities, hospitals, or hotels rather than for general (horizontal) application. Currently comprised of 243 separate business units, the culture embraces autonomy and decentralization around a system of best practices: managers of acquired firms enjoy wide operating deference and administrative authority over their units and capital, while sharing knowledge across units to produce high-quality businesses.

Leonard's letters reveal a culture of ownership, with senior managers and directors holding substantial equity in the company. Incentive bonuses, rewarding profitability and growth, as well as director fees, must be invested substantially in Constellation stock and held in escrow for an average of four years. With a corporate commitment to perpetual ownership of acquired businesses, the result is a lengthy time horizon, where short-term pressures do not faze and long-term dynamics are the focus.

Leonard's letters are a model of what the best shareholder reports do: highlight what's special about a company and its culture. They educate incumbent shareholders and other constituents, such as employees, directors, and prospective business sellers; they serve to attract those who embrace the strategy and repel those who don't. Leonard's letters often boast hardy tributes to employees and offer coaching tips for managers.

Leonard provides transparent views into the company, revealing its distinctive business model and corporate culture, and how they interact and evolve.

In the ensuing selections from Leonard's 2018 letter, he reflects on the difficulty of recruiting outstanding directors, those able to go beyond conventional governance to add value by mentoring a deep bench of managerial talent. For non-management directors, developing that valuable ability requires years of service, warranting long director tenures. Leonard then explains the managerial structures and goals at Constellation, drawing clear parallels between the best directors and the best managers.

—*Lawrence A. Cunningham*

Lawrence A. Cunningham, a professor at George Washington University and longtime editor and publisher of *The Essays of Warren Buffett: Lessons for Corporate America*, joined the Constellation Software board in 2017.

To Our Shareholders

Mark A. Leonard describes the board's role at Constellation Software: Build intrinsic value, coach, nurture, and mentor.

Qualified and competent directors are very rare, and not surprisingly, the track record of most boards is awful. According to the 2017 Hendrik Bessembinder study of approximately 26,000 stocks in the Center for Research Security Prices (CRSP) database, only 4% of the stocks generated all of the stock market's return in excess of one-month T-Bills during the last 90 years. The other 96% of the stocks generated, in aggregate, the T-bill rate over that period. This means that 4% of boards oversaw all the long-term wealth creation by markets during that period. Even more disturbing, the boards for over 50% of public companies saw their businesses generate negative returns during their entire existence as public companies.

This governance problem is well understood, and the tools *du jour* for fixing boards are Director independence, diversity, and term limits. These tools are a great starting point when you are dealing with most public companies. However, when you are dealing with a high-performance company, I don't think governance should be the key role of the board. Governance is still necessary, but it is not sufficient. Helping extend the extraordinary track record of building intrinsic value should be the board's primary function. You are unlikely to achieve that by replacing their proven and obviously very rare Directors and Officers with new ones who are statistically unlikely to have ever experienced anything like consistent high performance.…

There was a 1994 peer-reviewed journal article about the role of deliberate practice in becoming an expert [written by K. Anders Ericsson and Neil Charness]. The concept was popularized and extended by Malcolm Gladwell in his book *Outliers* as the 10,000-hour rule. I understand that you don't need 10,000 hours of deliberate practice to be able to fire a CEO who has his hand in the till or is abusing employees. I'll refer to this as the "governance" role of Directors. However, I also think there's something to be said for Directors intently studying an industry and a company over a period of many years to acquire relevant expertise so that they can contribute more than just governing. I'll refer to this as the "coaching" role of a Director.…

Our outside Directors spend about 30 hours in board meetings each year, and let's assume preparation time doubles that. For an especially engaged Director, committees, special projects, and extracurricular Constellation-related activities might drive their time with us up to 200 hours per year. At 200 hours per year, and if you believe the 10,000-hour rule, then this especially engaged Director needs to put in 50 years on the job to offer deeply contextual expert level coaching.

Some prospective Directors don't have the appetite or incentive to invest 10,000 hours to make the transition from a monitoring/governing role to a coaching/nurturing role. Most prospective Directors are simply too old to make that journey. Unfortunately, that means that the default role for most Directors is as a governor, not a mentor. Some investors find that acceptable. I'd argue that governing is table stakes. Coaching and talent nurturing are the places where Directors can make a significant contribution and help a company become part of Bessembinder's 4%.

Simple math suggests that if a Director is not from the industry or the company, then they have no hope of coaching and nurturing unless they start in the Director job when they are young. Ideally, we'd like to get them in their 40s or 50s and keep them for 30 or 40 years or until their health deteriorates. We certainly don't want to kick them out after they've served for 10 years.…

The current movement to limit Director tenure makes great sense if you think your investee company is poorly governed. However, if you think the governance is good, then limiting Director tenure hurts the company. It is analogous to firing a high-performance employee on their tenth anniversary.…

Our objective is to be a great perpetual owner of vertical market software or VMS businesses. We like VMS businesses because they are asset light, have robust moats, and attract the sort of managers and employees with whom we enjoy working. Lots of investors seek businesses with those characteristics, but great owners are rare.…

As perpetual owners, we care about the long-term health of our many small businesses. We try to provide an environment in which they can flourish. The primary way we can do that is by making sure that they have high-quality managers who are compensated according to rational long-term oriented incentive programs. We make sure that the business unit (BU) managers have access to capital when they have opportunities. We try to foster a collegial environment so that best practices are shared. Late last year, when we reviewed our BU demographics, we had 243 separately managed BUs, up from 193 the prior year. We currently see no fundamental limit to the number of BUs that we can manage, but we are very worried about limits to the number of good VMS businesses that we will be able to buy at reasonable prices.…

My motivation is to help create a company where worthy people succeed. Whether they join us with an acquisition or are hired from the outside, I want to support and encourage employees who work hard, treat others well, continuously learn, and share best practices. I try to make sure that sycophants, spin-doctors, and mercenaries don't survive in Constellation's senior ranks. Harder, but not impossible, is helping identify and remove hidebound managers who rely upon habit and folklore to run their businesses rather than rational enquiry and experimentation. Constellation is as close to a meritocracy as I have experienced. I hope it will continue to provide an environment where entrepreneurs and corporate refugees can invest their lives and their capital and thrive.

A career path for an ambitious employee joining Constellation might be something like this: Immerse yourself in learning about the peculiarities of VMS economics. At some point, transition from analyst or knowledge worker into a leader of people. I find there is no magic to managing and leading. If you are smart, work harder than everyone else around you, treat people fairly, do not ask them to do anything you would not [do] or have not done, share the credit, keep learning and keep teaching, then pretty soon you have followers. If you make sure that the team members are intelligent, energetic, and ethical people with whom you would want to work for the rest of your career, it won't be long until you are running one of our BUs….

For those whose ambition exceeds their good sense, we have a role that we call a Player/Coach. A Player/Coach continues to run their BU, but ambition drives them to acquire a sizable business, usually in another geography or another vertical. We set up most of these acquisitions as stand-alone BU's because verticals differ, and it is difficult to create a high-performance team if they are geographically dispersed. The BU manager for the newly acquired business is nearly always from the acquisition itself, and hence has deep expertise in the vertical. Should the Player/Coach find a second or third stand-alone business to acquire, they eventually have to give up the day to day responsibilities for running their original BU and become a full-time Portfolio Manager (PM). If the PM is good at finding acquisitions and helping them learn relevant best practices, and continues to deploy at least the FCF produced by their portfolio, then we refer to them as a Compounder.

The journey from Craftsman to Compounder can be very financially rewarding, but there are some significant sacrifices. At best, a PM is an advisor: they fly in (usually clocking hundreds of thousands of airmiles per annum), gather information, share ideas, provide referrals to others within Constellation who have dealt with similar issues, and then they move on to the next portfolio company. The excitement and satisfaction of doing and deciding has to be traded for the lukewarm cocoa of mentoring and coaching. Fortunately, the Compounders are regularly learning about new verticals, and acting as ambassadors to VMS entrepreneurs who might one day want to sell their businesses to Constellation. The multi-year relationships with VMS founders can be very rewarding.

The difference between a Craftsman and a Compounder is often one of personality. Successful Craftsmen can be autocratic or consultative, [of] brilliant or average intelligence, introverted or extraverted, mercurial or imperturbable. Lots of different personalities and styles work.

Successful Compounders have no choice but to be (or become) more hands-off and trusting. They can be curious and driven, but they can't be directive. They can nurture, goad, and suggest, but they can't order. No PM can personally know the customers, products, employees, and competitors sufficiently well across multiple BUs in different geographies and verticals, to make the critical decisions required at the BU level. In the infrequent instances where the manager of a BU isn't making the grade…if they are failing to build the team, extend their moat, and generate an adequate return on their capital, then the PM needs to find a replacement for the BU manager.…

Hopefully the analogy between the Compounder's job and that of Constellation's board is obvious. Both have a governance role. In the rare instance where the manager who reports to them has to go, they need to pull the plug. If this governance role is consuming most of their time, it is a sad reflection on their competence.

Our expectation is that both the Compounder and the Constellation Board spend much of their time in coaching/nurturing roles, bringing along managers and their teams, and making sure that there is a strong bench of talent.

Excerpted from Constellation Software's 2018 Letter to Shareholders written by Founder, Chair, and President Mark A. Leonard.