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Expert panel: What are some CEO red flags for institutional investors to consider?

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According to an old adage, the fish rots from the head down.

With the chief executive officer being the head of a corporation, are there any red flags to make institutional investors anticipate the rot when considering investee companies?

Notable American businessman Charlie Munger was once asked what advice he would give to young investment managers. He said they must have two things — discipline and integrity — and if they compromise either, they'll fail. Discipline is extremely important. Humans have difficulty making decisions that entail sacrificing short-term pleasure for long-term gain or putting up with short-term pain for long-term gain, something that value investor Tom Russo calls the "capacity to suffer."

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The CEO needs to have a long-term perspective to overcome short-term challenges and temptations. Focus on the short-term and quarterly earnings promote short slightness and the pressure associated with it sometimes sows the seeds for fraud.

Integrity is also extremely important. The CEO needs to mean what they say and say what they mean. Investors need to trust the leading executive. A CEO who is saying one thing and doing something different is not to be trusted. Trustworthy executives tend to attract long-term investors, who U.S. investor Warren Buffett calls "quality [long-term] investors" and who don't care or pressure the management of a company for quarterly updates and discussions.

Moreover, it's much easier to model a company's value if you trust that the CEO will do what he is saying he will. Integrity goes together with ethics and ethical behaviour. Corporate fraud is more common when there is no integrity. Enron Corp.'s managers, for example, had discipline but no integrity. As a result, two key CEO red flags to start with are a CEO that shows no discipline and, more importantly, no integrity.

Some other red flags to consider include:

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The CEO creates a complex corporate structure: Complex companies are difficult to manage and more difficult to value. Jack Welch, the former CEO of General Electric Co., made the company very complex. Subsequent managers had difficulty managing the company with GE becoming one of the most value destroying companies in the U.S. market. A classic example of this is when another former CEO at GE, Jeff Immelt, gave an interview three weeks before the company announced earnings and made a forecast that was way off the actual numbers — a result of GE being too complex and difficult to manage. The firm under its current chairman and executive leader Larry Culp has become simpler and more focused company that's targeting the creation of value for shareholders.

They're extremely active with mergers, particularly unrelated mergers: Six out of seven mergers destroy value. This is particularly true for unrelated mergers as they create conglomerates that increase complexity and create serious integration problems. Increased merger activity sometimes is driven by executive compensation incentives and have nothing to do with value creation. If a CEO's paycheck is determined by the size of a company's assets, it will give them an incentive to create a larger company, not necessarily a more valuable company.

They have a large incentive with options: If a large part of a CEO's salary is based on options, they will do anything to make sure the options are in the money. This may involve repricing options, an action that can be harmful to shareholders from its impact on dilution; backdating options, which is now subject to legal and regulatory enforcement since the Sarbanes-Oxley Act of 2002; or sometimes refusing a good offer by a buyer company simply because the offer is below their options strike price.

The CEO displays an extravagant lifestyle: Enron's parking lot, for example, was full of Ferraris, Maseratis and Bentleys and one has to ask, who normally pays for such an extravagant lifestyle? Mostly the shareholders.

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The CEO has prior history of violations: This one needs no explanation.

The company under the CEO's leadership repeatedly re-states financials and incurs non-recurring charges: It's difficult to value companies that keep restating their financials and this goes back to the integrity of leadership too.

The CEO has no relevant background or experience in relation to the industry: A case in point is when Carly Fiorina, a marketing executive, was hired in 1999 to run Hewlett-Packard Co., a very sophisticated, technology business. Or when Dave Calhoun served as CEO at Boeing Co., an accountant by education, not an engineer or an aviation design expert. A related red flag is when a chief financial officer becomes the CEO with the mandate to prioritize cutting costs. Again, Boeing is a classic example of a CFO-turned-CEO effort to cut costs for which Boeing paid a huge price.

The CEO receives ample media coverage: Executives are human and ample media coverage enhances their self-confidence, making them believe they can do anything, fool anyone and get away with murder. Former Enron CEO Jeff Skilling is a classic example of this. Sam Bankman-Fried, the face of the FTX Trading Ltd. cryptocurrency exchange scandal, is another one, as is Elizabeth Holmes, the founder and CEO of now defunct Theranos Inc. In fact, the latter two CEOs' headshots appeared on the cover of Forbes magazine shortly before both would end up going to prison for fraud.

These red flags can also be used as a checklist to anticipate possible rot before it's too late. While nothing is guaranteed, having a disciplined way to examine CEO quality will go a long way in helping institutional investors achieve their long-term goals.

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