# Are You Keeping Tabs on What Management Is Doing With Your Money?

## Description

The idea behind making an investment in the equity of a publicly traded company is that you're essentially handing over your hard-earned capital to the company's managers, who you are expecting to earn you a fair return on your investment.

But how sure are you that's what's happening with the investments you currently own?

**Understanding the shareholder-manager agency problem**

The shareholder-manager agency problem is a problem that is about as old as capitalism itself.

The problem arises because the shareholders — that would be you as an investor, or the owner of a company — are the one providing the capital, or money, to pay the bills, hire staff, and invest in capital expenses like plants and equipment.



Yet it's actually not you, but rather the employees, or management, of the company who are actually the ones responsible for making the hiring, firing and investment decisions on a day-to-day basis.

That means it's up to the owners — and not the senior managers — of the company to ensure that management is making responsible decisions with the profits of the firm.

Let's take a closer look at the options available to management as to what they are able to do with a firm's capital and how those decisions can impact shareholder wealth.

**Mergers and acquisitions**

This is potentially the avenue most fraught with disastrous outcomes. That's because sometimes managers of a company find themselves incentive to pursue merger and acquisition (M&A) opportunities to meet certain financial targets.

But the problem arises when those managers place undue emphasis on short-term financial incentives, like year-end bonuses, at the expense of more positive long-term shareholder outcomes.

That type of scenario can lead to disastrous investment outcomes. Look no further than the fate that befell **Valeant Pharmaceuticals Intl Inc.** (TSX:VRX)(NYSE:VRX) as but one recent example of an M&A strategy gone wrong.

**Retiring debt obligations**

Management can use a firm's profits to retire outstanding debt obligations; sometimes it makes sense, and in other cases, not so much.

If, on the one hand, your firm (for example, the aforementioned Valeant Pharmaceuticals) has racked up an unsustainable balance of debt, paying down those financial obligations can be the responsible thing to do.

On the other hand, it may raise questions as to how management got themselves in that position in the first place.

In most cases, firms will target what is referred to as an optimal capital structure — or the optimal mix of debt in relation to assets and equity. Allocating capital in this manner can be an indication that management is, in fact, creating shareholder wealth by adding to or subtracting from its liabilities.

**Returning profits to shareholders through dividends and buybacks**

Paying a healthy and growing dividend has to be the most tried and true — and probably most "fail-safe" — approach to dealing with shareholders' money in a responsible and sustainable manner.

Returning firm profits via either dividends or buybacks ensures that shareholders have a say on where the money will be directed — either through reinvestment in the firm or otherwise.

**Bottom line**

The best thing that investors can do for themselves to help mitigate the risk of the shareholder-manager agency problem is to only invest in companies with demonstrable track records of creating shareholder wealth.



Following that simple rule of thumb will help keep you from staying awake at night wondering what those strangers are doing with your money.

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**Date**
2025/09/10
**Date Created**
2018/06/29
**Author**
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