Rapport

How to Win the Capital Markets Ball Game

Edmond G. Eberts
Chairman
Rapport Capital Formation Strategists Inc.

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RAPPORT CAPITAL FORMATION STRATEGISTS INC.
703, 141 Adelaide Street West
Toronto, Ontario M5H 3L5

Telephone: 416-366-9264
Toll free: 800-363-8134
Fax: 416-366-1855

rapport@rapport.ca
www.rapport.ca

How to Win the Capital Markets Ball Game

Investors often wonder why so few CEOs are able to run up a winning score during their time in the corner office. In the rush to try to keep up with the star performers, a number of wannabes revert to overstating their case. The laggards' most common complaint is that their respective company's stock is undervalued, when those in the know can prove that such is so only about 5 percent of the time. Whether they like it or not, the fact is that investors at large have an uncanny way of calling a spade a spade. Given as their very own money is on the line, they will not allow anyone to pull the wool over their eyes for long. Unfortunately, all too few CEOs are willing to admit to the error of their ways, at great expense to the shareholders and themselves.

The thrust of this paper is to cite and explain the characteristics of success, in the hope that many more business leaders and aspirants will be better positioned and prepared to play the capital markets ball game to advantage. Very few will ever get a second chance to prove themselves.

AN INVESTOR'S PERSPECTIVE

From an investor's perspective, like a World Series winner, the team's on-base percentage is the key to success. That is so because no one can score a run until they at least get to first base, and a home run counts for a whole lot more if all the bases are loaded. If one goes looking to buy a stock with the capacity to hit a single, a double or a triple, you are more likely to uncover a four-bagger before it comes to bat, or even steps into the on-deck circle, and well before a line up of other players recognize its potential.

However, if all investors do is sit on the sidelines, rather than get into the game, they are far more likely to foul or strike out whenever they finally come to bat. You should also know that retail investors usually take longer than portfolio managers to make up their minds. Rather than trade in and out at a furious pace, they strive to keep transaction costs to an absolute minimum. Their portfolios may have as few as five, and as many as twenty, positions at any one time. Institutional investors, on the other hand, tend to be indexed, the larger accounts owning more than one hundred and up to two hundred stocks in some cases. Obviously, the occasional four-bagger will have little impact in such cases. These sorts also have a long history of selling their winners too early and hanging on to their losers too long. How else can one explain the relative underperformance of most professionally managed funds?

Then again, why should they care? After all, they play the game for fees, not dividends, distributions or capital gains, and seldom have their own capital on the line. The good

news is that you and I are far more likely to handle our own money these days and in the future. Which means that we will soon rule the roost, just as we once did many long years ago. As such, it is vital that CEOs learn how to play the capital markets ball game to advantage. Here are the essential steps to take in order to come out a winner.

WHO'S ON FIRST?

Before anyone can expect to score a run they must safely get to first base. In the investor world, first base belongs to the investment dealer and independent research analysts. If you cannot gain their support, you will never make it to second base.

Like baseball players, each research analyst has a personal batting average. Only a very few are known to be home-run hitters. Some are fancied by the corporate box holders (institutional investors), others by those ordinary folks (retail investors) who prefer to sit in the bleachers. As such, each has a somewhat limited appeal.

A baseball team's success is dependent on how well everyone plays their respective position and on how many runs they score. Though the New York Yankees may be the best known team, they do not always win the World Series! Just as no single company or trust rules the stock market, no Canadian investment dealer, no matter how successful it may claim to be, has better than a 15 percent market share. The boutiques are stuck at less than 5 percent. Heroes in their own camp perhaps, but certainly not dominant players. As such those CEOs who want to be duly recognized must make a concerted effort to gain the concurrence of a goodly number of research analysts whose firms collectively account for substantially more than 50 percent of the total market for securities. Until they do, they will not have enough bench strength to win the capital markets ball game.

Please also realize that institutional investors seldom buy or sell based on a sole research analyst's recommendation. Rather, they much prefer to act on the consensus view of two, three, or more of their favourites. Who they are exactly, we will never know. On the other hand, most retail investors deal through a single firm and are somewhat beholden to its in-house recommendations. That is unless the particular stockbroker is seasoned enough to have figured out who the better research analysts are in the competing firms, and has the wherewithal to swap information with counterparts in other Bay Street firms.

Fortunately, such is my case. As a result my portfolios have steadfastly outperformed both the typical institutional investor and the standard stock market benchmarks over an extended period of time. Needless to say, my years of reading, and broad experience in sorting through the clatter, has also played an important role in helping me decide which stocks to buy and sell, and when to do so. I have also learned a lot from my past mistakes!

WHO'S ON SECOND?

Once the runner has rounded first base and is on the way to second, credibility becomes an important factor. Will the player have to slide in under the second basemen's tag, or can he make it safely standing up?

As discussed in an earlier essay, credibility does not come in a can. It must be earned. Then it must be protected and nourished. If it is ever questioned or lost, it is very difficult to re-establish. Therefore, the best advice anyone can be given is to always mind their p's and q's. The message, be it of hope or despair, must be to the point and presented in a

precise manner, allowing for questioning as need be by both research analysts and investors alike. If the process is repeated on a regular basis, the CEO in the crosshairs stands a good chance of earning their keep. If they fail to do so, their shares and options are never likely to be worth very much. Nor are they ever likely to be offered another plum job.

Assuming one successfully reaches second base, getting to third presents a number of other challenges.

WHO'S ON THIRD?

Third base is where the investors stand, protecting their money from those who would like to get their hands on it. While many a base runner may appear to be very close to reaching third base, the third baseman and the shortstop will do their utmost to test the CEO's fortitude. These two players can be very tight fisted. Very few ground balls ever get by them!

That said, if one has taken the steps necessary to gain research analyst sponsorship and earn a good measure of credibility, both retail and institutional investors will be much better prepared and far more willing to give a CEO the time of day. They will not do so otherwise. Those who try to short circuit the process will come up short of their ultimate objective and be called out at either first, second or third base, never to score a run.

CROSSING HOME PLATE IS THE ULTIMATE GOAL

Home-run hitters, just like every other player, must touch first, second and third as they round the bases. If they fail to do so, they will be called out. To their credit, they very seldom miss a beat. That is why they are so well paid, compared to those who are but able to hit singles, doubles and triples.

The same is true in the stock market. Those issuers who try to track down the research analysts, with or without success, but are unable to gain credibility are never likely to have a very supportive audience of investors if and when they make it to third base. Until they do, they will never cross home plate and earn a premium stock or trust unit price, or be the envy of their peers.

So what truly is the sort of enterprise that wise investors are looking to invest in? Do the index beaters have common characteristics? What might they be? How does a CEO win the capital markets ball game?

THE CHARACTERISTICS OF A TOP-NOTCH COMPANY OR TRUST

Given the concerns about the massive and still growing twin deficits in the U.S., and helter-skelter spending by Canadian governments, it is no surprise that North American investors of all stripes are drawn to companies and trusts with robust balance sheets. This financial might provides both the chance to act on opportunities and shelter should times take a turn for the worse.

Investors are also willing to pay up for outfits that have a propensity to keep costs in check, while increasing margins and the return on the equity employed. However, doing so by way of leverage no longer fits the bill. In fact, it scares away most share and unit holders, and will for the foreseeable future.

As the trusts have proven time and time again, high payout ratios and ever-increasing

distributions have resulted in unit prices that are far superior to comparable common share values. This pattern of investor behaviour is being somewhat matched by companies whose fortunes are improving measurably and are announcing dividend increases. Unfortunately, many of the most well-off corporate entities seem to be more inclined to announce the occasional stock buyback, rather than commit to a substantial dividend increase, the rationale being that the till should remain full in the event of a new opportunity and cash is required to close the deal. Hopefully more CEOs will come to realize that the shareholders would be better served by increasing the payout ratio, driving the share price through the roof, off which additional equity could easily be raised at a much reduced cost should the right sort of acquisition come along. In other words, investors are prepared to pay up when the managers payout most of the surplus cash. Buybacks and modest dividend increases, though better than nothing, are not enough to win a capital markets ball game these days!

So if they ever hope to appear on the TSX's new fifty-two-week-high list on a more or less consistent basis, many CEOs will have to change their tune. If they do and can convince a wide array of investment dealer and independent research analysts to come along for the ride, their credibility will soar and chances are they will come to be known as an all-star player. Were that to happen, they could earn as much as a home-run hitting baseball player, perhaps even more, cheered on by those in the bleachers, the investors who ultimately determine the closing price of every common share and every trust unit, every trading day of every year. What more could a CEO possibly hope for?

GETTING AND STAYING ON THE SAME WAVELENGTH

Instead of CEOs and investors being at opposite ends of the schtick, as was the case when the stock market topped out in 2000, they must find common ground. Given as the shareholders, in fact, own the outfit, they deserve to have the upper hand. Nonetheless, everyone involved in playing the capital markets ball game must appreciate each other's role in the creation and protection of shareholder wealth. No one player can win the World Series single-handedly!

Although the road ahead is bound to be somewhat bumpy for the next number of years, as the many excesses of the past are identified, defined, and dealt with, the sooner CEOs do what must be done to get investors back on side, the better it will be for all concerned.

THE ROLE OF THE OUTSIDE ADVISOR

Though CEOs are ultimately responsible for the success or failure of the enterprise, all need to surround themselves with capable outside advisors. In baseball jargon they are called pinch-runners and pinch-hitters. The first are fleet of foot, inserted into the lineup in the hope of distracting the pitcher, stealing a base or two, or outrunning the tag at home plate. However, they have no role to play until such time as some other player actually makes it safely to first, second, or third base.

Pinch-hitters are a different lot. Their role is to get on base, positioned to score a run. Or simply to hit a fly ball deep into the outfield that will allow a runner on second or third base, or both, to score. They are trigger players capable of knocking in the winning run.

Expressed another way, pinch-runners are like short-fused stock promoters – all flash and dash but with very little in the way of staying power. RAPPORT, on the other hand, is a pinch-hitter. We can and do make a real difference longer term. In fact, over the past thirty years, every one of the companies and trusts that has retained us on a year-over-year basis has made significant and measurable progress in terms of outscoring its closest competitors. We are very proud of our track record, and with good reason. If you ever hope to win the capital markets ball game, give us a call. You will be very glad you did!