Rapport

Do or Die

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Do or Die

It has been five full years since the world's stock markets topped out in 2000. Most of us survived the correction in share and trust unit prices, and many have profited from the subsequent recovery. Though the S&P/TSX, NYSE and Nasdaq have yet to match their respective all-time highs, the market leadership has changed. No longer are the concept stocks the flavour of the day. Rather, investors are focusing on fundamentals, underlying values, and payouts. Unfortunately, the quality and quantity of traditional research coverage continues to slip away which should come as no surprise given as U.S. investment banking firms are no longer allowed to issue fawning research reports on stocks they have underwritten. When coupled with the pressure coming from pension and mutual funds, seeking still lower commission rates in lieu of better research, it is little wonder the budgets of the largest Wall Street firms with the greatest placing power have been reduced by more than 40 percent. Now comes word from Thomson Financial, the keeper of all the "consensus" estimates, that fully 60 percent of American research is coming from independent firms. Though Wall Street may still have solid economic models to offer, and good fundamental industry information to work with, many say it is no longer the place to go for the best of investment advice. Whereas the ripple effect of U.S. regulatory changes has been slow to impact the investment industry in Canada, it will prevail in time. Therefore, we should not count on Bay Street's research getting any better. Such is just not going to happen without skilful prodding by issuers and investors bent on maximizing share and trust unit prices.

Furthermore, rather than allow a company or trust's wherewithal and promising prospects to be boiled down to just three simple estimates of cash flow, earnings, and the dividend or distribution per share or unit, the CEO must find a way to convince the market as a whole that there is more to the story. Investors need and want to know about current operations, plans for the future, and the prospects for continuing success. In the case of a turnaround, the research analysts must be brought on side early on in order to encourage the long-suffering share and unitholders to stay put and not to give up the ghost, which is easier to do when they know things are about to change for the better. If a downturn in fortunes is anticipated, the owners deserve to be told in advance why this is likely to happen, what is being done to mitigate the situation, whether or not the payout is in jeopardy, and when operations can reasonably be expected to return to a more normal pattern of growth and profitability.

If those responsible fail to keep the investors well-informed, they should be called on the carpet by the independent directors and fired with cause. Given the many scandals that have come to light in recent years, investors, with their very own money on the line, will never again settle for lame duck excuses. In a similar vein, directors who resign in mid-term should be castigated and required to refund the fees and expenses paid. In this way, they will spend more time and effort deciding which boards to join in the first place, and those to stay clear of. A double-checking, if you will, before they sign on.

THE BENEFITS OF RESEARCH ANALYST SPONSORSHIP

As you know, every author has a story to tell, and every book is begging to be bought, particularly those in the bargain-price basket. Such is the case with every common share or trust unit, all having an offering and a bid price. Those with a carefully documented story nearly always sell for a premium price to the others that are not as well covered by the research analysts, or whose attributes are less well-known or regarded by investors. All of which suggests that CEOs should spend whatever time and money it takes to have their enterprise's tale become one of the more respected "stories" about town. Until they do, the chances are that the stock or trust unit price will do little more than just tread water or, quite possibly, be relegated to the new fifty-two-week low list, from which it is very difficult to escape!

With the dustbin filled with discarded corporate executives, auditors, lawyers, investment bankers, and, yes, the odd research analyst who was on the take, it should come as no surprise that investors view most of the so-called "professionals" with a somewhat jaundiced eye. As such, every CEO would be well advised to try and keep the critics and the investors fully in the know. To take them for granted would be a costly mistake, one that all too often takes years to recover from!

THE FIRST LINE OF OFFENCE

All CEOs are aware that security prices go up and down. Experience tells them that they have an annoying tendency to stay down longer than they should. This is so because there are so few truly successful publicly traded entities. The vast majority are but a bunch of also-rans, and many will come a cropper in time. No matter what, executives with an inquiring mind will always want to know what the competition is up to, particularly about the plans and prospects for growth. So too will every research analyst and investor.

Therefore, the first line of offence must be to build, encourage, and maintain a broad base of well-informed research analysts within the underwriting syndicate firms and far beyond if the CEOs have their wits about them. This is necessary because the aftermarket for new issues is what determines the price of the next treasury offering, and many investors lucky enough to participate in the most recent financing are more likely to be sellers than buyers, for the foreseeable future. That is particularly the case for institutional investors that only got a partial fill. Another of the inherent problems is the reluctance of independent research analysts to cover the company or trust in question on a more consistent basis, particularly when their respective firm is not likely ever to be a part of the underwriting syndicate gravy train. That said, RAPPORT has been able to get many to do so for hundreds of issuers for over the past three decades. So it can be done if you know who is who, and what to do to make it very easy for all the full-, part- time and independent research analysts to be kept up to speed!

Put another way, the underwriters no longer have as much influence as they once did in establishing the day-to-day price of an outfit's common shares or trust units. They will, however, still insist on a strike price that is a discount to the previous day's closing, attempting to make certain never to get caught holding the bag. It is also a way of flattering their biggest trading volume accounts, in the hope of doing more commission business in the future. Quite frankly, most of these well-dressed folks could care less about the smaller, longer-term investors. This is in spite of the fact that they are the ones who tend to add to portfolio positions as time goes on: the type that ultimately determines the closing price of every stock and trust unit every trading day of the year, the mark off which the next equity issue, or merger, or acquisition, or takeover will be priced, and the only investors to be found when times are tough and the stock market takes a turn for the worse.

Having said that, institutional and retail investors know from experience that few underwriters, under normal circumstances, are likely to publish a sell recommendation for fear of being cut out of the next lucrative deal or financing, or possibly even an unrelated new issue opportunity. As such, the credibility of their research analysts' recommendations has always been somewhat suspect. So if CEOs ever hope to gain an above-average price for their outstanding shares or trust units, even for those to be issued at sometime in the future, they would be wise to seek out constructively critical comment from the most respected independent investment advisors. An off-the-cuff recommendation will simply not have the wherewithal to make a real difference. They should also realize that there is a limit to the placing power of each investment dealer, 15 percent market share being the maximum from month to month, year to year. So it is vital that the CEO finds a way to gain positive and informative coverage by firms whose investor clients account for better than 50 percent of total day-to-day trading on the TSX or TSX Venture Exchange.

ATTRACTING THE BETTER INVESTOR

Given as most institutional investors are bombarded with research analyst recommendations, invitations to conferences, and requests for one-on-one appointments with CEOs, you might think they would have the upper hand over the lowly retail types dealing with just one, or possibly two, stock brokerage firms. They do, but they don't! Simply put, despite all these advantages, most professional money managers have had, and continue to have, a devilishly difficult time matching or beating the performance of the S&P/TSX composite index. The number of mutual funds capable of doing so is surprisingly limited. On a dollar-weighted basis, the record is even worse.

Statistically speaking, since 1999, only 35 percent of Canadian equity funds have bettered the master index. When compared with the less risky capped composite, which limits the weightings in any one investment to 10 percent, as a balanced portfolio should, only 18 percent of actively managed funds did so. This scorecard does not include the impact of up-front or trailing sales costs, and applies only to funds that were in existence at the beginning and end of each measurement period. These disappointing results are, needless to say, reason enough for retail investors to go it alone, as they did in purchasing royalty and income trusts units, or buy more in the way of exchange traded funds that simply, and more effectively, track the S&P/TSX composite. That is why a number of mutual fund companies are going to indexing, announcing cuts in the expense ratios, attempting to reduce costs, improve overall performance and stem the tide of redemptions.

Believe it or not, these very same people are now on a tear marketing hedge funds that rely on arbitrage and derivatives trading, short selling and other complicated investment techniques that are opaque rather than transparent by nature, and quite a bit more risky. As a large number of unsuspecting investors will soon discover, many are an accident waiting to happen. In addition, a host of structured products are now being offered – a long list of creative notes, closed-end funds and fund-of-hedge funds – all readily available through the major financial institutions to small investors. They are designed to skirt the rules requiring accredited investors to have more than $1 million in assets. By filing a prospectus, the complex and subtle nature of these securities and the potential minefield that they are, is seldom adequately explained to unsophisticated investors for fear of cutting off the substantial flow of commissions and fees they generate. CEOs and investors may have another axe to grind in that hedge funds pride themselves in taking short positions, in effect betting that a stock's price will soon top out and decline.

Strangely enough, these are many of the same folks who could not get it right by going long so, pray tell me, how are they ever going to do better by also going short! Whereas many had a tendency to put undue selling pressure on top-performing stocks in the past, the good news is that nowadays they may have to pay up to cover for the error of their ways. As these sort of funds must shoot for above-average returns to justify the substantial 2 percent management fee and the exorbitant 20 percent cut of investment gains they typically charge, the securities commissions across North America are beginning to keep a closer watch on what they are up to!

All of which suggests that, if a CEO wants to go looking for a more astute, less likely to panic ownership base, they should make a point of including the stockbrokers advising high net worth, longer-term retail investors as an integral aspect of a comprehensive investor relations programme. Short-fused institutional types, who trade portfolio positions in and out at a furious pace, are really not the sort of people one should be aiming to cultivate. Rather, the CEOs would stand a better chance of getting and staying ahead of the curve were they to pay more attention to those investors whose portfolios do better than the stock market averages. It is the only way to gain and keep premium multiples of cash flow and earnings. Such does not happen by chance!

A PLAN OF ACTION

As you would expect, research analysts have a difficult task to perform. Like any other busy person, they too have only so many hours in a day. Their firms are in the fee and commission game. Underwritings and syndicate participations are very profitable, their life blood so to speak. Though the day-to-day block trading list may provide a few with bragging rights, there is precious little in the way of big money to be made. Many are reluctant to even "take a look see" at an outfit which is unlikely to generate any underwriting or merger and acquisition business, or that is so small the gains would be miniscule as far as most Bay Street firms are concerned. CEOs must also realize that the up-and-coming research analysts and stockbrokers, though long on enthusiasm, are usually short on placing power. They would be much better off to go looking for an audience of experienced men and women with a few gray hairs, and an armful of wealthy clients to advise!

In any case, what good is another buy recommendation without some sort of commentary to back up the numbers. Just having a research analyst say they like or dislike

a particular stock or trust unit, without clearly stating the reasons why, has little or no impact where you want it most, that being in the hands and minds of successful retail investors, and the very few institutional types who buy to own, rather than buy to sell at the first such opportunity, whether or not the price goes up, or down, or sideways. Bye the by, if the aforementioned underperforming mutual funds are ever to do better the portfolio managers must learn to hang on to their winners, and sell their losers at the first sign of trouble. As it now stands, they tend to sell their winners too soon, and hang on to their losers too long. There is no other way to explain the relatively dismal returns.

IN CONCLUSION

If all the investment community and the investors ever know about an enterprise is the "consensus" estimates of cash flow and earnings, and the results subsequently come up short by even as little as a penny per share or trust unit in any one quarter, the chances are the trading price will get hammered down. On the other hand, if they have come to know the CEO, understand what the company or trust is all about and where it is headed, such is not as likely to happen and certainly not to the same extent. This is because there will be a host of astute buyers, from far and wide, standing at the ready to respond in a positive way at any sign of short-term weakness. Trying to shore up support after the fact, as many lugs have attempted and failed to do in the past, is not nearly as effective a strategy. One must also never forget that once public opinion goes against an outfit, it is extremely difficult to get it turned around in your favour.

The good news is that an on-going and proactive investor relations programme will not only help to mitigate the impact of a poor quarter's disappointing results, it will also tend to increase the number and narrow the range of the forecasts, thereby improving the quality of the consensus estimates, and thus boost an outfit's multiples in the intermediate to longer term. On the other hand, if the CEO goes into hiding every time something goes wrong, as all too many have a tendency to do, they are only asking for more trouble and, believe me, they will get it! However, if the CEO keeps a firm grip on those who are the real movers and shakers in the investment community, the company's or trust's cost of capital will be more competitive than it might otherwise be, their very own investment positions and options worth more than they may have expected. From a successful investor's point of view, we question why it takes so many senior executives such a long time to figure these things out, as it is so obvious to the rest of us what needs to be done!

When it comes to seeking outside advice, go looking for a firm of capital formation strategists and investor relations advisors whose credibility has been built by adhering to the principle that the share and trust unit investors are the primary stake holders, and that it is their best interests that have to be addressed. New-issue road show types that run about with underwriters offering premium commissions to stockbrokers and price discounts to security buyers simply do not have the *savoir faire* it takes to build on-going research analyst sponsorship. Please also remember that the rules of fair play must never be bent to satisfy the selfish whims of the CEO, senior management and directors, the Sarbanes-Oxley Act, and pending legislation in Canada, proof that such behaviour will no longer be tolerated. If you really want to do rather than die, call RAPPORT!