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# Forked Tongues


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We all bear the brunt when the regulators pussyfoot about a question of principle, and CEOs are unwilling to discuss the prospects for the future. This essay is about the lack of guidance, the importance of research analysts in the age of electronic trading, the constructive role hedge funds can play in maximizing shareholder values, what advisory firms should be doing for small investors, and the outlook for the stock market.

## GUIDANCE AND SHORT-TERMISM

Companies which fail to meet profit estimates are taking more punishment than usual these days. The number of S&P/TSX composite stocks to fall 10 percent after reporting disappointing second-quarter results was the highest since the market turned bullish in October 2002. On average, those that trailed the consensus forecast dropped 3.3 percent, the most since the first quarter of 2005. Companies beating the mark rose by an average of but 0.3 percent, the smallest advance in nearly four years. Overall, research analysts foresee S&P/TSX composite index per share profit growth of 18.5 percent for 2006, 15.4 percent in the case of the S&P 500. The 2007 forecasts are somewhat tempered for the moment.

While Britons are questioning the cost and quality of their securities regulation system and SOX is unlikely to stop future frauds in the United States, one has to wonder what CEOs and the research analysts must have been thinking or drinking to come to the conclusion that quarterly guidance should be dispensed with, the pressure to achieve short-term earnings forecasts not worth the time, effort, and expense. Yes, that part of the equation is true. But when are these poor souls ever going to understand that without in-depth research and an open and ongoing discussion about an enterprise's goals, strategies, and prospects for the future, quarterly guidance is all most investors have to go by. Lest the bigwigs forget, it is the shareholders or unitholders who ultimately pay for all the fees, commissions, salaries, bonuses and option gains from one year to the next, and they deserve to be treated with respect. The CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics Symposium Series on Short-Termism's shoot-yourself-in-the-foot strategy is not what is called for. It is time these folks came to their senses as, in the absence of a well-defined and believable growth strategy, imposing short-term discipline on corporate management has resulted in a substantial increase in long-term investment gains. Guidance has not resulted in destroying value, decreasing market efficiency, reducing investment returns, or impeding efforts to strengthen

corporate governance as the study claims. Nor should we be swayed by the misguided journalists and politicians calling for Canadian content commitments, including clear targets for capital spending and purchases of supplies and services whenever a company falls into foreign hands. Or even compel the use of our financial institutions for future underwritings thus easing Bay Street's angst that any additional financings will be struck in New York, or elsewhere. I say let the investors' money be put to use where it is bound to produce the greatest return. Break fees should be outlawed. In the case of the proposed Inco. Ltd. takeover of Falconbridge Ltd., they amounted to more money than the target company had planned to spend on capital investment for a whole year. Fortunately its shareholders turned down the bid and the $450-million charge was never paid.

The paradox of short-termism concerns is that, whereas there is to be considerably greater detail and transparency with regard to executive compensation, whether or not and how a company or income trust will make money, and how much over the next three to twelve months, is to be kept a deep, dark secret. It is also interesting to note that, dating back to 1940, an almost steady increase in short-term trading has resulted in a nearly parallel increase in long-term gains for investors. So whether CEOs like it or not, they will remain in the hot seat. Nor are investors going to change their way until such time as they are convinced the securities commissions, senior executives, auditors, underwriters, dealmakers, and research analysts are giving them a fair shake for their money. At the moment, that is not happening, and there is little light at the end of the tunnel.

### THE IMPACT OF ONLINE TRADING

When an outfit is gobbled up by another many fear fees will rise and the scope of services narrow. In the case of the former TD Waterhouse – now TD Ameritrade – stock commissions dropped from as much as U.S.$17.95 to U.S.$9.99 per trade, and investors are now offered an even wider range of services. Customers of Brown & Co. and HarrisDirect, both acquired by E*Trade, benefit from access to bank accounts, home mortgage insurance, estate planning, and financial advice. For depth of online research, Fidelity Investments heads the list with a plethora of analysis and investment tools. Though Charles Schwab's research is not as diverse, it does have a proprietary stock-rating system that has trounced the S&P 500 index's performance since its May 2002 introduction. The firm also gets top marks for execution.

Electronic trading represents one third of total professional traffic in the United States. A new survey by Greenwich Associates of 155 Canadian money managers found that some form of such trading accounted for 24 percent of the activity to date in 2006, and is expected to rise and match the U.S. tally within three years. Bay Street will soon be ruled by computer programmers, not stock jockeys. The shift has enormous implications for the way investment dealers are run, and how they make their money. Instead of the traditional 4 to 5 cents a share, large institutions will pay but 1.7 cents per share for online trades. They are also demanding anonymity, increased liquidity in large- and small-cap stocks, reduced information leakage, and market impact. In other words, they do not want buy orders to be shopped about and, as a result, drive the stock or income trust unit price in question higher before they get their fill, or lower in the case of a sell order. Given the substantial boost in computer power, portfolio managers and the investment dealers will become more scientific about tracking the value of research analyst insights, and sales and trading coverage.

The CEOs true test will be in keeping a wide audience of research analysts and

stockbrokers in the know and on the telephone and electronic networks spreading the good news, or limiting the impact of disappointing results. This will never come to pass until such time as they are willing, prepared, and confident enough to talk openly about the near- and longer-term prospects for their enterprise, and those of their competitors'. The days of just producing a quarterly guidance number, one certain to be matched or exceeded, will not be enough to carry a stock or income trust unit price to a new fifty-two-week or an all-time high, making a CEO's job more tenuous than ever before.

### HEDGE FUNDS CAN HAVE A CONSTRUCTIVE INFLUENCE

Stock market volatility is the bane of every investor and CEO. Unfortunately, the Federal Reserve Board and the growing number of hedge funds are much to blame. Investor reaction to Ben Bernanke's apparent focus on price indexes – buying stocks when he hints that interest rates may decline, and selling when they suspect they will rise – is understandable. These reactions do not imply wily investors prefer inflation, but rather they suspect the Fed will over or undershoot the exact mark. People are entitled to their own opinion, but not to their own facts. Perhaps it is time to get rid of macroeconomic myths and jargon, to discard undue focus on mismeasured, incomprehensible, statistical aggregates and, instead, let market prices guide the central bank's policy, whereby supply will expand to meet demand, and inflation pressures will abate.

The hedge fund cops may be down, but they are not out. The SEC is hot on the trail of enough shady practices to keep investigators busy for years to come. Valuation is a ticking time bomb. Some funds are under scrutiny for improperly valuing investments – to hide losses or trump up returns – in order to protect performance fees. This practice has reached the point where some of the more responsible portfolio managers have decided to switch back to running traditional pension and mutual funds. While the dizzying 100-point-plus swings in the Dow Jones Industrial Average and the S&P/TSX composite index over the past few months were enough to drive some investors to tranquilizers, others suggest volatility be considered as an asset class in and of itself, like stocks, bonds, and commodities. Volatility funds, a subset of hedge funds, are famous for jumping in and out of markets quickly and aggressively. Most make specialized bets on everything from merger and acquisition activity to convertible bonds, without regard to the stock market's overall direction. They gamble solely on swings in volatility, dealing mostly in options and stock indexes, and the Chicago Board Options Exchange's Volatility Index, known as the VIX, or the fear index. Then again, investors who have watched their mutual funds gyrate wildly in recent months might think that doing nothing is the riskiest strategy of all!

Back in the good old days, corporate advisors routinely viewed transactions as a *fait accompli* upon the announcement of a deal, arranging for elaborate celebratory dinners in tony restaurants the next item on the agenda. Though regulatory concerns could occasionally scuttle plans, shareholder support was almost a foregone conclusion. Not so now. Thanks to hedge fund activists, dealmakers can no longer rely on shareholder passivity. Due to a significant percentage of past takeovers having destroyed longer-term shareholder wealth, investors of all stripes are prepared to go out of their way to ensure potentially destructive transactions are never ratified. Fairness options by experts-for-hire are seen for what they truly are: nothing more than cover for the board of directors. Executive compensation consultant recommendations have always been regarded in much the same way. Yes, hedge funds can have a constructive influence.

### TREATING CLIENTS FAIRLY

While not all companies in the financial industry keep their clients guessing as to how their retirement savings and other investments are performing, the vast majority do not disclose how much such portfolios are making or losing each year. It is yet another example of how the investment world has a habit of treating its clients as though they were nincompoops, instead of providing annualized rates of return on account statements or websites. This is common sense stuff. It is surprising the Ontario Securities Commission has not insisted that this sort of information be furnished, even comparing the data with relevant stock and bond market benchmarks, and that used in preparing the client's original financial plan. While they are at it, could they possibly explain why Canadian mutual fund management fees are twice the average charged in the U.S.? Except for the gain in the value of the loonie, the relative performance has not been impressive.

### THE OUTLOOK FOR THE STOCK MARKET

Prompted by investment bankers and private-equity firms, never have so many quarreled over corporate prey like wolves at a kill. According to the *Financial Times,* a total of U.S.$1,930 billion of deals were consummated worldwide in the first half of 2006. Some claim this record is a sure sign the world economic and market cycles are peaking. However, if you adjust for the 15 percent decline in the value of the U.S. dollar since September 2004, that may not be so. The Canadian statistics are 893 mergers and acquisitions worth $100.6 billion. If the trend holds true, 2006 could end up with more than 1,700, making it the second most active ever. The record year was 2000, with 2,118 takeovers worth just over $201 billion. Comparison of this sort of activity in the oilpatch over the past seventeen years suggest that as the dollar amount of transactions increase or decrease, the price of energy stocks follow suit. In keeping with the S&P/TSX sub-index's appreciation of 167 percent over the past three years, its share of the composite's earnings has increased from 28 percent in 2005, to 38 percent currently. Though it now has the second largest weighting at 31 percent, takeover activity appears to be on the wane. This is in part because the royalty trusts are not as active as they once were, preferring to merge instead. Operating costs have increased, as has the value of the loonie vis-à-vis the greenback. Investment community support has been hit or miss, and the potential gains are not as obvious as they once were. However, given strong balance sheets, record levels of cash flow, the considerable lead time before substantial new tarsands production kicks in, all hell may break loose before too long!

The months after the Federal Reserve Board decides not to raise interest rates any further can be a great time for equities, as long as there is no recession. The logic behind this perverse relationship lies in the Fed model, which says that the fair value of equities is determined by government bonds. If ten-year U.S. treasuries are yielding 5 percent, the stock market should be trading at about 20 times earnings (ie., 100 divided by 5). Bond yields of 4 percent justify paying 25 times earnings, and so on. That is why U.S. stocks often jump when the economy weakens. Apply the model to the S&P/TSX composite index, and you can make the case that now is a good time to be buying Canadian stocks. Yet our stock market seems to be, at least temporarily, stuck at 17 times recurring earnings, about the average by historical standards, suggesting inflation may once again rear its ugly head. If so, the Bank of Canada will have no choice but to raise short-term interest rates another notch or two. There is also the chance that the U.S. economy is cooling off at a more rapid rate

than first thought, and as it is the number one or two consumer of crude oil, natural gas, coal, copper, rubber, lead, zinc, and tin, the outlook for our stock market may be less robust next year.

If you are an investor, you must always remember that the day will eventually come when the appeal of cash overshadows the lure of stocks. Be that 2007 or 2008 is anybody's guess. As it now stands, the materials sector recorded a stunning profit increase of 87 percent in the first half of this year, compared to 10 percent for the energy, and 7 percent for the financial sub-indexes. Natural gas and gold could be the wild cards. Should the price of the first-mentioned recover, it would drive Canadian energy stocks and the S&P/TSX composite higher. If the price of the latter tails off, reflecting a decline in the U.S. budget deficit, the S&P 500 index should do well. As has been discussed in the national press, Stephen Harper's plan is to have Canada emerge as a global energy powerhouse by 2015. Unfortunately, there is bound to be a stock market correction or two between now and then.

At this point in time, gloom is busting out all over. War, terrorist plots, high gasoline prices, and talk of a housing-led recession in the U.S. all feed into a dismal mood in North American public opinion forums, including the political polls and financial markets. While short sellers are rooting for a collapse in stock prices, many with accumulated cash reserves are standing by, waiting to buy bargains. As noted earlier, one simple gauge of stock market sentiment is the price-to-earnings ratio, which displays in a single number how much investors are willing to pay per dollar of current earnings power. The multiples of the S&P/TSX composite and the S&P 500 index have been cut in half over the past four years. A basic contrarian point of view suggests there is an enduring case to be made for buying stocks whenever and wherever pessimism prevails, which helps to explain why there has been a dramatic increase in share buybacks. On top of which, ever since the Federal Reserve Board stopped raising the central bank rate, the interest rate on ten-year U.S. treasuries has declined from 5.22 to 4.60 percent, or thereabouts. In a world of robust profits, competition can be expected to increase and wages rise, with bearish implications. There have been nine periods of margin compression since 1950. Yet the S&P 500 index has risen an average of 10 percent in the year after earnings peaked, with subsequent gains of 19 and 30 percent in the following two and three years, respectively. These advances are in keeping with those realized throughout the entire post-1950 period. Simply put, lower inflation and interest rates tend to boost stock-price multiples, providing a potent offset to lower margins. The three exceptions occurred in 1966, 1973, and 1977, when stock markets faced the additional challenge of having to cope with much higher interest rates.

The impressive growth in corporate earnings of the past number of years reflects the powerful supply-side benefits of surging productivity growth, which has helped to contain the impact of labour cost increases. The protracted upturn since the early 1990s mirrors that of the 1950s and 1960s, other periods of impressive technological advances. So even though spreads are likely to narrow somewhat, the stock market should deliver decent returns in the years ahead. A stronger loonie bodes well for the S&P/TSX composite index, encouraging foreign investors to buy Canadian stocks, trusts and bonds. Which I believe will be the case. We all stand to benefit if people stopped talking with forked tongues.