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SURPRISING WAYS TO WIN OVER INVESTORS

By Matt Brusch

Lev responds by noting that he himself is “continuously surprised about what I see in research,” and there are plenty of new research findings in the book, which has led him to make many recommendations including some that may seem controversial.

Moreover, Lev had plenty of real-world business experience before he became the Philip Bardees professor of accounting and finance at the New York University Stern School of Business and director of the Vincent C. Ross Institute for Accounting Research. He was an accountant, an investment banker, a partner in a consulting firm, and has served on public company boards.

I recently interviewed Lev about his book and his views on the IR profession.

Matt Brusch: What led you to write this book?

Baruch Lev: Over the years, listening to corporate executives and observing what they do, I have concluded that many are captive to a web of misperceptions about the workings of capital markets. They think that investors are short-term oriented and obsessed with quarterly earnings; shareholder lawsuits are on the rise and are very costly to the company; the higher the stock price the better; activist investors are a nuisance; share buybacks are a great way to close valuation gaps, and many, many more. In fact, all are misconceptions. Solid research convincingly proves these are myths.

The problem is that these misperceptions shape management’s actions and communications and render them to a large extent ineffective. Based on extensive experience and research, I set out in the book to do two things – clear up the myths and misconceptions, and outline a capital markets strategy to regain the trust of investors, which I think is incredibly important today. We have just concluded one of, if not, the worst decade in stock market history which, in addition to investors losing lots of money, saw a parade of corporate accounting scandals, compensation abuses, and stock option manipulations. Investors worldwide are resentful and disillusioned, and it’s time for companies to regain investors’ trust, which can only be done by understanding their motives and the workings of capital markets.

Brusch: Each chapter of your book is thought provoking. For example, regarding your suggestion to correct overvaluation – we all know that when the stock price is high, everyone’s happy. How does an IRO realistically make a case to management that it should take action to lower the stock price? I also imagine the Street simply writing these efforts off as company
management trying to lower the bar. How do you suggest IROs go about addressing these issues?

LEV: I agree that when shares are overpriced people are happy. When you take drugs, you are also happy, for a while. I admit that it is not easy to make the overvaluation case; it’s also not easy to convince an addict to change. How do you start? This is a major theme throughout my book – you start by collecting evidence. You have to make a convincing case that share price overvaluation is large and protracted.

To see if you have a problem, look at your price/earnings ratio relative to peers. Examine the price earnings/growth ratio, analyst forecasts compared to internal forecasts, and other evidence of mispricing. Prepare a solid case. If the overvaluation is small or temporary, don’t bother about it. If it is large and protracted, it is your duty to discuss it with executives and if they wish, the board. Even if they don’t listen, you will be on record as warning them.

Begin presenting your case by hammering the message that an overpriced share is bound to fall to earth, usually on the first earnings disappointment. Otherwise, the share isn’t overpriced. When it falls dramatically, all hell breaks loose and then you, the IRO, will have to face the consequences with investors and even the board. It is a calamity in the making.

Many executives know when their shares are seriously overpriced. And what is further damaging is what managers usually try to do. Some exploit the overpricing by acquisitions, paying with cheap currency (overpriced shares). My recent research shows that these acquisitions were often disastrous for companies and investors. The second thing some executives try to do when shares are overpriced is justify the price by earnings manipulation, and this is equally damaging.

In general, I would like to see the IR function be more evidence-based. Once a year prepare an “earnings call checkup,” like the one you get from your doctor.

BRUSCH: You take a relatively controversial position in support of non-GAAP information. Companies are often criticized for providing this. Could you shed light here, and is non-GAAP data right for all companies?

LEV: Not every company has to provide non-GAAP information. It depends on the nature of the business and its life cycle. For example, in mature, non-growth companies with easy-to-understand business models, such as real estate, retail, and transportation, GAAP does a reasonable job.

But for early-stage or growth companies with complex business models, such as pharmaceuticals, telecommunications, high-tech, health care, and finance companies, GAAP has been shown to do a poor job providing investors’ information needs.

Think about pharmaceutical and biotech companies – their most important development is what happens to the product pipeline – the state of clinical tests, FDA approvals, and so on. This is what creates or destroys value for these companies, but pipeline information is not required by GAAP.

Or take telecom and Internet companies. It is the number of new customers, customer acquisition costs, churn rate, and so forth, which create value, but all of these are not GAAP-required disclosures.

In such cases, companies clearly ought to provide additional information. It is good for shareholders and management alike. Sharing information is not a zero-sum game. When you share relevant information, studies have shown, the volatility of share prices decreases significantly. Regularly sharing information means there are fewer surprises. The cost of capital goes down, too. It is good for everyone.

Pro forma earnings get a bad rap in the media, but studies have shown that investors pay close attention to them. “Street” earnings (where analysts adjust for different factors) have been found to be more correlated with share price changes than GAAP.
earnings. So my message to IR people is that if you think your earnings number doesn’t reflect reality due to unusual expenses or gains, then by all means provide pro forma earnings. Despite what pundits say, they are not ignored by investors.

BRUSCH: Your findings regarding earnings calls will certainly be comforting for NIRI members who sometimes struggle within their companies to effect the types of rec-

ommendations outlined in your book. What guidance would you give to an IRO who is challenged by corporate counsel or C-suite as he or she attempts to implement changes designed to improve earnings calls?

LEV: Once more, start with evidence. In general, I would like to see the IR function be more evidence-based. Once a year prepare an “earnings call checkup,” like the one you get from your doctor. For example, look at how many investors and analysts attend your calls compared to competitors. There is a message in a low number. They won’t come if they don’t get new information.

Second, how much “buzz” is created by the calls? Look at the volume of trade during the call and the rest of the day. If the volume around the call isn’t above average, then the conference call was a waste of time. It didn’t provide new information. Third, look at analyst response to the calls – how many analysts revised their earnings after the call compared to peers? This way, I would create an annual scorecard for the conference call. If everything is OK compared with your peers, then don’t fix it. But if not, then most likely your conference calls are uninformative.

It is clear that analysts and shareholders want guidance. A recent study looked at stock price reaction upon the announcement of the cessation of quarterly guidance. The study showed significant stock price declines upon the announcement.

When I listen to CEOs on many of these calls, I often get the impression that their major objective is to finish the call unharmed – get out in one piece. A CEO after one recent earnings call was overheard saying, “Thank God it’s over.” That is the wrong attitude. In sports, defense is always important but it doesn’t win games. Conference calls are a great opportunity to change investors’ perceptions, and companies should not miss these opportunities.

Research suggests that managers shouldn’t waste much time in earnings calls on so-called “big issues” that management loves to speak about – strategy, economic trends, environmental issues, and so forth. Most analysts are not interested in these issues.

Don’t sugarcoat poor results. Investors want the truth. Studies have shown that after poor earnings, conference calls that have more negative terms are actually more effective at changing investor’s perceptions. It shows that managers face reality. Don’t be cryptic, evasive, or impatient.

Speak mainly about the business model. Explain what didn’t work and why, and what corrective actions you will take. Put targets on the table – that way you will be credible. When you feel comfortable with it, give forward-looking guidance. These are the character-

istics of conference calls that work. I know that for executives there is some risk in forward-looking information, but if you want to make the call informative and interesting, you have to take some risks.

BRUSCH: Throughout the book, you make a number of comments about the effectiveness of public company investor relations programs. Based on your extensive research, what are your opinions on the profession, and what is your advice to our readers as they seek to be as effective as possible?

LEV: I have always believed IR is an extremely important function. It is really indispensable. Regarding my advice to readers, it would be presumptuous of me to counsel IR professionals how to conduct their affairs. But if I were an IR practitioner, I would perform, in addition to the routine tasks, a comprehensive “IR checkup” about once a year. I would closely examine the major areas in the “IR space”: the share valuation gap (under- or overpriced); the effectiveness of the company’s disclosures...
and communications (beyond-GAAP information, earnings calls); the quality and accuracy of company-related information disseminated externally by analysts, bloggers, and short sellers; and the consequences of actions aimed at changing investors’ perceptions, such as share buybacks, stock purchases by managers and directors, or stock splits and special dividends.

Based on this evidence-based examination, I would develop an “IR scorecard,” determining the state of affairs (e.g., a significant share undervaluation, ineffective earnings calls, etc.) and propose a detailed action plan to address the problems. I would then closely follow the execution of the remedial plan, and provide before-and-after measures to gauge its progress (such as the change in the number of analysts attending the calls). Such a periodic “IR checkup” will not only elevate the IR function to the top managerial and board level, it will also be exciting and fun to do.

BRUSCH: You come down on the side of providing guidance (with certain caveats). Could you explain your rationale, and what would you say to those who are stridently against guidance?

LEV: Frankly, I’ve never understood those who are against guidance. Guidance is now given by close to 30 percent of public companies. Some 600 companies out of the 5,500 registered public companies in the United States give regularly quarterly guidance. The rest give annual guidance. If executives are comfortable with this, why should outsiders complain?

My position on guidance is, again, based on research. It is clear that analysts and shareholders want guidance. A recent study looked at stock price reaction upon the announcement of the cessation of quarterly guidance. The study showed significant stock price declines upon the announcement. How can one argue that guidance is not useful when investors clearly tell you that they want it?

My study shows that when guidance is given, within a day or two most analysts revise their earnings forecasts. Clearly guidance is important to those “shapers” of investors’ opinions. I looked at companies that stopped guidance and compared them with those that continue quarterly guidance. When they stop guidance, bad things happen. Analysts desert them, the volatility of share price increases, and there is enhanced uncertainty of investors regarding future earnings. The variance or dispersion of analyst forecasts around the consensus increased significantly.

To me it is a no-brainer. If you can predict earnings better than analysts, why not provide guidance? You have all the safe harbor protections from the Securities and Exchange Commission. You are not going to be sued unless you lie to investors. Why not share your views about the future? Of course, if you are not comfortable, don’t do it. But I cannot understand the venom of people against quarterly guidance. It is nonsense that guidance increases “short-termism.” Analysts will continue forecasting your quarterly earnings whether you provide guidance or not. Doesn’t Google, a no guider, try to beat the consensus?

BRUSCH: You have studied capital markets and the interaction of public companies and their shareholders for many years. Is there anything in this book – research findings, recommendations, and so forth – that surprises even you? Similarly, anything that will surprise tenured IR professionals?

LEV: I have a good life because I am continuously surprised by what I see in research. For example, just a few days ago, I got the preliminary results from one of my current research studies that show that the tone of executives and the tone of the questions on conference calls changes during the day. In the morning it is more positive, optimistic, and cheery; and later in the day it becomes more negative, testy, and combative. We have a sample of 32,000 quarterly conference calls and use sophisticated language tracking programs that identify the tone of the discussion and the Q&A, and we found that as the day wears on the negativity, aggressiveness, and impatience increases (fatigue, hunger). And this is detrimental to the share price. You asked me about surprises – I was astounded!

In the book, IR professionals will find lots of surprises. For example, how many of them know that for the companies in the S&P 500, the overall correlation between return-on-assets (company performance) and CEO compensation is zero? Many people will be surprised by that.

How many know that targeted corporate social responsibility programs boost sales more than advertising? Most executives pooch-pooh corporate social responsibility but some activities are very effective not only in doing good, but in boosting sales.

There is also a perception that shareholder litigation actually decreases. I bet that many IR people will be surprised that shareholder litigation actually decreased from 2001-2006, and only increased slightly thereafter because of the impact of the financial crisis on financial institutions.

And how many know that intruding, active hedge funds in most cases improve the operations of companies?

There are many more surprises in the book, even for veteran IR people who have seen it all. Some will be controversial, but I welcome the discussion.

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