THE CORPORATE-FUND MANAGEMENT INTERFACE: OBJECTIVES, INFORMATION AND VALUATION

ESRC Centre for Business Research, University of Cambridge
Working Paper No. 293

By

Richard Barker, Paul Sanderson, John Hendry* and John Roberts
(Centre for Business Research, Judge Institute of Management,
University of Cambridge and Brunel University*)

Please address correspondence to:

Richard Barker
ESRC Centre for Business Research
Judge Institute of Management
University of Cambridge
Trumpington Street
Cambridge CB2 1AG
Email: r.barker@jims.cam.ac.uk
Telephone: +44 (0) 1223 339646
Fax: +44 (0) 1223 339701

September 2004

This Working Paper forms part of the CBR Research Programme on Corporate Governance.

Abstract
Fund managers are the primary investment decision-makers in the stock market, and corporate executives are their primary sources of information. Meetings between the two are therefore central to stock market investment decisions but are surprisingly under-researched. There is little in the academic literature concerning their aims, content and outcomes. We report findings from interview research conducted with chief financial officers (CFOs) and investor relations managers from FTSE 100 companies and with chief investment officers (CIOs) and fund managers (FMs) from large institutional investors. Of particular interest we note that FMs place great reliance on discounted cash flow valuation models (despite informational asymmetry in favour of CFOs). This leads the former to seek to control encounters with the latter and to place great store on the clarity and consistency of corporate messages, ultimately relying on them for purposes other than estimating fundamental value. We consider some of the consequences of this usage.

JEL Codes: G30, G34, O16

Keywords: valuation, institutional shareholders, investor relations

Acknowledgements
This paper is part of the output of an ESRC Centre for Business Research core funded project on ‘Institutional Investment and Corporate Accountability.’ The authors wish to thank the various fund managers and FTSE100 directors who agreed to allow their meetings to be observed and who gave their time by way of interviews in connection with that project.

Further information about the ESRC Centre for Business Research can be found at the following address: www.cbr.cam.ac.uk

Introduction

Fund managers (hereafter FMs) are the primary investment decision-makers in the stock market. Senior corporate executives in listed companies are the primary source of information on which FMs' decisions are based, and formal, private meetings between these executives and FMs are the primary point of contact. It is clear, therefore, that these meetings are central to stock market investment decisions, and so it is perhaps surprising that they are under-researched. While the academic literature contains many studies in related areas ('side-shows' in effect) - such as the share price effects of sell-side analysts' research or of corporate public announcements – there is very little in the literature concerning the aims, content and outcomes of formal corporate-fund manager meetings.

This paper reports findings from interview research conducted with Chief Financial Officers (CFOs) and investor relations managers from FTSE 100 companies and with Chief Investment officers (CIOs) and FMs from large institutional investors. The objective of the research and of this paper is to contribute to our understanding of investment decision-making.

Prior Research

The corporate-fund manager meeting can be a critical factor in conditioning the relationship between a company and its investees. It is part of the investor relations (IR) function within a company enabling it, according to the Investor Relations Society (2000), to present 'an accurate picture of corporate performance and prospects, thus allowing the investment community, through an informed market, to determine a realistic share price.' Holland (2001) observes that corporates can use four different routes to manage the flow of information to investors; (i) mandatory public disclosure, (ii) voluntary public disclosure, (iii) private disclosure and (iv) nondisclosure, and that the third of these is the most important, most corporates and institutional investors considering public disclosures 'insufficient' for their needs (Holland 1998a). A consistent survey finding is that fund managers' meetings with senior management are their most important source of information, and that institutions favour regular, private one-to-one meetings with corporates above all other means of corporate communication (Gaved 1997; Barker 1998; Marston 1999). These meetings are frequently held around the publication dates of the annual and interim accounts and tend to focus on long-term strategy rather than short-term earnings (Golding 2001). Bence *et al.* (1995) and Barker (1998) report that fund managers proactively seek novel information on the long-term prospects of a company, which contrasts with the sell side's reliance on routinely issued short-term data.

There have been few studies examining the overall effectiveness of IR programmes. Theoretically, as argued by Diamond and Verrecchia (1991), increased disclosure ought to increase the liquidity of, and demand for, a firm's securities, so reducing its cost of capital. Later research by Leuz and Verrecchia (2000) on German companies confirmed that those voluntarily adopting more open US GAAP accounting rules did indeed face lower costs of capital. Other papers claiming benefits for IR have tended to do so on the basis of analysts' perceptions (Kennedy and Wilson 1980), the presumption that increased information will inevitably engender long-term investor support (Pound 1993), or by developing one of a number of divers theoretical models. Merton (1987), for example, predicts that a firm's cost of capital will be inversely related to the size of its shareholder base. Several studies indicate that IR activity may account for temporary changes in trading patterns as a result of increased market attention following, for example, corporate presentations (Sundaram *et al.* 1993; Byrd *et al.* 1995) and conference calls to analysts (Frankel *et al.* 1997).

There is also a large disclosure literature but the majority of it relates to public disclosures (Marston and Shrives 1996). A number of researchers have assessed the relative importance to investors of such disclosures, finding the profit and loss account most highly valued, followed by the cash flow statement, balance sheet, chairman's statement and directors' reports (Lee and Tweedie 1981; Arnold and Mozier 1984; Day 1986; Clarke and Murray 2000; Barker 2001) Prior to the current US accounting scandals Lev (1999) surveyed various disclosures that exert a significant impact on perceptions and market values. These included (i) strategy announcements, such as investment decisions, (ii) acquisition programme announcements (on both see Schipper and Thompson 1983), (iii) new product announcements (Chaney *et al.* 1991), (iv) earnings forecasts (Firth 1976; Maingot 1984), (v) profits warnings (Skinner 1992; Kasznik and Lev 1995), (vi) dividend increases, (vii) CEO/CFO commentary in annual report (Lev and Thiagarajan 1992), (viii) analysts recommendations (Foster 1979), (ix) partial floatations, and (x) anti-competitive (deterrent) announcements (Smiley 1988). He noted that the impact of disclosure was not limited to share prices and volumes, affecting in addition, share volatility and bid-offer spreads (and thus stock liquidity), shareholder mix, proxy contests, and the confidence of suppliers, customers and competitors. Given the impact of specific disclosures, he points out that the release of timely, accurate and relevant corporate information ought to increase allocative efficiency.

Of course, the information that is publicly available to investors may not be all that they desire. A survey of 508 US analysts found that only half considered existing disclosure levels adequate (CPA Journal 1994). They favoured inclusion in annual reports and accounts of some verifiable statement on competitive position, industry trends, long-term corporate objectives, plant capacity, dividend policy, pricing policy, management quality, and sales and eps forecasts, as well as 5 year budget estimates. This is broadly consistent with the findings of Epstein and Palepu (1999), that over 85% of US sell-side analysts would like more information on risk, liquidity, competition, individual business units and strategy.

Post-Enron, few can resist calls for greater regulation of disclosures. However, the extent and quality of disclosure is always likely to have a high element of discretion. In a study of the content of voluntary public disclosure by technology companies in conference calls, Tasker (1998) reported that 15% of the questions related to financial and non-financial data, about one third to management's qualitative observations, 20% to management's strategic plans, and 20% to management's expectations of future performance. In their study on the efficacy of disclosing bad news, Kasznik and Lev (1995) found that half of the managers they surveyed preferred to keep silent on large earnings surprises for fear of immediate overreaction by investors, although the other half claimed they increased the flow of information, particularly harder quantitative information, in those circumstances, fearing the longer-run effects of generating a knowledge gap.

Disclosure is, of course, not cost-free. Conformance to a number of different standards regimes, principally US GAAP, significantly increases reporting costs (Bhushan and Lessard 1992). An experimental study by Bricker and DeBruine (1993) examined the relationship between information cost and investment risk reduction. They found the quantity of investment and the cost of information to be inversely related. Variation in extent and content of disclosures may also be related to size, rate of return and/or earnings margin, stockmarket listing (Singhvi and Desai 1971), industry (Sprouse 1967), number or type of shareholders (Bushee and Noe 2000), or the existence of effective alternative monitoring mechanisms such as recognisably independent non-executive directors (Leftwich *et al.* 1981). Malone *et al.* (1993) tested these empirically by examining a specific sector, the US oil and gas industry, and found positive correlations between debt/equity ratio, size of shareholder base, and stockmarket listing.

Disclosure need not be one-way. Fund managers need not be just passive recipients of corporate disclosure but can themselves provide information that influences corporate strategy. In other words, they could be active investors, whereby their role is not just independent valuation and investment but is also endogenized within their valuation models. The evidence suggests, however, that institutions only rarely intervene in investee companies, as they tend to perceive the costs to be greater than the benefits (Pozen 1994), so justifying a state of 'rational ignorance' (Buchanan and Tullock 1962). But in fact, even the most activist US institutions spend less than 0.005% pa on interventions (Black 1998).

In any case, just a '*credible threat* of voice' (Kang 2000) may serve to predispose managements to focus on enhancing long-term shareholder values, and to discuss controversial proposals with their shareholders (Pozen 1994). Others claim more tangible benefits from intervention. Hoskisson and Turk (1990) argued that in the absence of adequate monitoring by shareholders firms tended to diversify excessively, to their detriment, and Parthiban *et al.* (2001) showed that R&D spend increased in targeted companies, an indication that institutional intervention moved such companies to focus on long-run returns (see also Baysinger *et al.* 1991 and Graves 1988 on the positive and negative effects of institutional ownership on R&D). In the UK Holland (1998c) concluded from the case studies discussed above that 'core shareholders employed close corporate relationships to identify problems, to intervene early, to prevent a company from sliding into poor performance and to make adjustments at an early stage. This possibility indicated that UK financial institutions had developed an early warning system that was similar in substance but different in practice to the German lead or Haus Bank' (1998c: 262).

In summary, while the literature provides considerable evidence relevant to corporate-fund manager meetings, there is very little direct evidence on the meetings themselves. In particular, there is little evidence on either the motivations of FMs and CFOs with respect to the meetings or on the role that the meetings play in investment decision-making.

Research Method

A defining characteristic of corporate-fund manager meetings is that they are private. When coupled with their importance, it is perhaps no surprise that they have proved inaccessible to researchers. The research method in this paper is semi-structured interviews with a representative sample of both parties to the meetings. Although inevitably subjective to some degree, this approach allows the researcher to get as close as practical to the object of study, with the added benefit that interviewees can articulate their views on the aims of the meetings, including whether and when these are met (which would not be directly observable from the meetings themselves). Moreover, by interviewing both FMs and CFOs, and by asking similar questions of each, some form of additional reliability is given to the findings. Finally, a semi-structured approach is suitable to an under-researched area, because in contrast to a narrower approach of formulating and testing hypotheses, it enables the emergence of hypotheses that might not have been apparent in advance.

The first series of interviews was carried out in mid/late 2002, with eighteen finance and investor relations directors from fourteen FTSE100 companies. A second phase of the research in early/mid 2003 involved interviewing nineteen senior managers (chief investment officers, senior fund managers and buy-side analysts) from eleven asset management companies. All bar three of the latter agreed to recorded interviews. These interviews averaged eighty minutes in length. In addition we observed (but were not allowed to record) eight meetings hosted by fund managers with CEOs and CFOs of large investee companies. While too few in number to provide reliable inference, these meetings nevertheless provided a useful ‘reality check’ for the findings from the interviews; they were found to be highly consistent and so added additional reassurance.

The interviews were recorded and transcribed. They were then coded into distinct themes, and the themes from each of the interviews were drawn out and interpreted. The sections that follow report the resulting ‘picture’ that emerged, first from the CFOs, then from the FMs and, finally, from an interpretation of the aggregated findings.

Evidence from CFOs

When asked what constitutes a successful meeting with fund managers, most CFOs responded that their primary objective was to ensure that the FM understands the company. The CFO must ask whether the FM understands the company’s strategy, its historical performance and its expected future performance. The CFO must then also ask whether this understanding carries over into a well-informed valuation of the company. CFOs cannot view meetings with FMs as successful if the understanding they attempt to convey is not ultimately reflected in the share price.

Most CFOs promote understanding by means of repeatedly delivering simple, understandable, key messages, focused on the strategic goals and performance targets of the company. These messages are very carefully formulated. They flow directly from Board-level decisions on the company’s strategy. There are distilled and made simple because of the perceived need to make them understood. Extraneous information is controlled so as not to distract from the central messages, as the following quotes illustrate.

> ‘You've got to position your company quite clearly and in very, very, simple sound bites, very consistently . . . You sit down and quite deeply think about the expectations, what are you capable of doing, and you package them up into an expectation the City or Wall Street can understand.’

> ‘You should never underestimate the need to explain the simple stuff to the market. I think if we look back on what we've got wrong over the last five years . . . explaining what the market is all about and how different it is in America from the UK, and what drives it, and who pays for the stuff, and why the growth rates are what they are, and what role technology is going to play, in a simple way, time and again, relentlessly, is what we should have done.’

The specific messages that CFOs seek to convey will in practice depend upon a variety of underlying determinants. For example, if investors are perceived to have a low level of understanding of a particular business, then the messages are particularly simple and focused, but also much more likely to be supported by an information campaign designed to bring investors ‘up to speed’. This campaign could involve site visits and dedicated presentations, in addition to time at one-on-one meetings. A need to ‘educate’ investors in this way can arise for a number of reasons, for example: when there is significant M&A activity; when overseas investors take an initial interest in the company and they are not familiar with it; when new technology creates a market or business model that investors do not understand; when the company is followed by sector-specific analysts and one or more of their businesses falls outside the analysts’ sector expertise. For example, the following quote illustrates a communication strategy following a major merger.

> ‘It was important for us to make sure that we could explain, in the beginning, the coherence of our business strategy. Now in almost 100% of cases it's questions and answers because people understand well enough what the company is about.’

A further determinant of messages to FMs is the current stage of the company’s economic cycle. For a given period of time the messages might be focused on recovery strategies, perhaps involving cost-cutting and the disposal of under-performing assets. Over time, the messages might then be expected to evolve towards, for example, strategies for meeting targets for growth and margin expansion. The following quote illustrates this.

> ‘We're in a position where the market has given us a big tick for recovering the business and therefore there is a lot of credibility and credit to the management team for that, and therefore . . . I know when we go into the City this time, there will be a lot of questions on, “Well, what next?”’

In designing the appropriate messages for FMs, CFOs have in mind an implicit understanding of the fund mangers’ approach to valuation. Valuation models are generally perceived to comprise only a short period (typically not longer than two years) of detailed forecasts, followed by a relatively subjective estimation of longer term performance and terminal value. The information that CFOs convey is therefore of two types. The first is detailed and relatively objective information relating to historical financial performance and short term financial forecasts. The second relates to the estimation of longer term performance and terminal value and is higher level, wider ranging and less precise. The difference between these two types of information is of great importance, as the following quotes illustrate.

> ‘Who’s to say what's the right share price? . . . I think what you're doing therefore is sort of making sure that certainly within the forecast and numbers over the next two years you're working really hard.’

> ‘Provided the information in the market as regarding our financial performance is not miles out of line, as far as we're concerned, that is our obligation to explain to the market. How people want to use that to determine a price, we think that's entirely up to the market, nothing to do with us.’

There was a general perception that CFOs have, in effect, an obligation to explain clearly historical and near-term performance, but that beyond this they can at best only provide qualified and uncertain information. Alternatively stated, relatively objective information must be communicated reliably, consistently and accurately, but beyond this the CFO’s information is as good as it can be but is issued with a caveat emptor.

There were mixed views about the validity of the relatively uncertain, longer term information. Some CFOs took the view that models of future performance are necessarily and reasonably driven by assumptions relating to a few key parameters, implying that the communications role of the CFO is to channel appropriate messages relating to these parameters. For example,

> ‘We, probably like most companies, [have] no more than a dozen things that really influence the company's value over the mid term.’

On the other hand, several CFOs were less sanguine. They expressed scepticism about the market's ability to estimate terminal value. In their view, although the market might well have reliable information relating to short term, forecastable performance, the FMs were perceived to be inherently limited in their ability to model longer term business performance. This was because of the lack of reliable data and also because of the lack of in-depth business knowledge required to make such projections. The following quotes illustrate these views.

> 'I think that they do build fairly accurate short-term sales and profit models looking at a couple of years, but thereafter, I don't know what we are doing in three years time, so nor do they.'

> 'To them it's just like well, you've bought your machine, you switch it on, profits go up, and as long as you guys don't screw it up it will go on up forever.'

> 'Unless you tell them very explicitly, they will tend to model that almost into perpetuity.'

If FMS rely on CFOs for information and guidance concerning future business performance, and if information about the future is uncertain and subjective, then the credibility of the CFO as an information provider assumes considerable importance. In other words, the use that FMs choose to make of information supplied by a given CFO will depend upon the extent to which the CFO is regarded as trustworthy and well-informed.

Accordingly, CFOs go to great lengths to ensure that any given message is delivered consistently, by different people within the company and across meetings with different groups of FMs, both at a given point in time and over time. One CFO made this point succinctly, as follows.

> **'T**he basic message has to be consistent, whatever the audience.'

It is of great importance to be consistent over time. For example, once a CFO has committed to a message regarding future performance, such as the effects of a restructuring or the expected market share from a new product, then FMs will monitor for a considerable period to see whether the company actually delivers against the expectation it has created. One way to help ensure message consistency is to manage carefully the level of disclosure in order to manage and possibly minimize this scrutiny. CFOs also generally prefer to keep the news flow conservative. In effect, this amounts to retaining some slack and to avoiding possible inflation of the share price. There will always be some inherent uncertainty in expected business performance, and conservatism allows scope to absorb bad news while leaving open the possibility of positive surprises. Above all is the avoiding of bad news, because nothing damages trust more than delivering a loss having promised a profit. Several CFOs echoed the following comment.

> ‘It’s very, very clear that institutions will distrust the companies a lot once they fail to deliver on a promise.’

If the CFO is credible and trustworthy, then FMs are more likely to be willing investors. Indeed, the issue of trust can transcend that of valuation-relevant information itself. In the presence of uncertainty about the future, FMs need not have reliable information about expected future performance if, instead, they can rely on trustworthy management. Viewed in this way, the issue of trust does not so much affect FM’s valuations directly (for example, through the discount rates that they apply) as it affects the FM’ willingness to invest. This is illustrated by the following quote.

> ‘I don't know what the plans are in detail yet, I can't put them in my model, [but] these guys clearly know what they're doing, what they tell me sounds sensible . . . I trust that they are going to deliver on that . . . and that’s clearly going to be keeping the p/e up, if nothing else, with events, or up where it is.’

In the absence of trust, and thereby in the absence of a willingness to invest, a company’s investment plans might go unfunded through a lack of shareholder support. It is almost incidental whether or not the investment plans are expected to generate positive net present value. The expectation is unavoidably uncertain, and it is dominated in the FMs’ minds by an over-riding unwillingness to invest, as the following quotes illustrate.

> ‘We earn that right (to make investment choices) through shareholders being confident in our ability to deliver what we say we are going to deliver. You can't perpetually say, ‘Don't worry it's all going to come in the future,’ if you’ve got no track record.’

> ‘Are we looking at large acquisitions at the moment? No. Why not, we haven’t earned the right. We spent a lot of money on acquisitions two\three years ago. It caused huge problems . . . We

> have not earned the right to make acquisitions. Lets say we are a year hence from now and we believe that we've started to earn that right, our ratios are all pretty good and we believe there's a value enhancing acquisition, I'll make up a number, half a billion pounds, how would we approach that? We would have to start to test the water and start to send feelers out that we are thinking about these things, because you couldn't suddenly just do it, we wouldn't have acceptance.'

It is therefore of great importance to CFOs to understand FMs' willingness to invest. This is especially true when the implementation of the company's strategy requires the FMs' support.[1] For example, the CFO will use meetings with investors to determine the likely market reaction to significant corporate activity. Frequently cited examples were the likely stock market reaction to a proposed merger, IPO, or debt issue. In each of these examples, if FM support is absent, then the CFO has no option but to shelve the strategy and to work instead on building trust and, eventually thereby, the 'right' to execute the strategy in due course.

Generally, there was a perceived need to understand the investment philosophy/house style of any given FM. If, for example, successful delivery of corporate strategy leads the company beyond being attractive for a value or a growth investor, then demand for the company's stock is likely to fall away unless investor relations activities are directed towards a new set of investors. Likewise, unless the company is sure that it has a significant number of investors who will tolerate a decline in share price, or has identified potential investors who would be willing to buy on signs of share price weakness, it faces potentially a steep decline in share price. In effect, issues such as these amount to the company understanding the demand curve for its own stock. An objective of investor relations is to know who will buy, sell and hold at what price, and to manage the portfolio of investor meetings (and so the shareholder base) accordingly. This is especially important because of a perception that the turnover in a company's shares can be high. Although most CFOs described their ideal investor is one who holds reliably for the long term, it was acknowledged that such an ideal could not be relied upon. As one CFO put it,

> 'You've got to keep stimulating demand because you are going to get churned.'

The FMs' willingness to invest is enhanced to the extent that the CFOs communicate their knowledge of the FM to others in the company. These others must be made to understand which investment strategies the market will accept and why, as well understanding how and why the actions of those within the firm affect the FMs' level of trust and willingness to invest. As one CFO put it:

> 'What good IR (investor relations) becomes is almost the voice of the investor, but inside the business.'

Evidence from Fund Managers

All FMs, at any point in time, have an established set of views about the companies in which they are invested. These views form the backdrop and the agenda for company meetings. The FM uses the meetings to test whether or not his or her views are correct, or whether they need to be revised.[2] These views form the justification for the investment. Typically, the FMs describes them in the form of 'value drivers' – primary determinants of the value of the company's equity. By so doing, they make explicit the link between the views and the investment case. The following quotes from three of the FMs illustrate this approach.

> 'The way our investment process works, is you first figure out the value drivers. 'Is this a good or bad company.' We are actually fairly explicit in saying good or bad company is measured along 3 criteria, the ability to return a profit over your cost of capital, the ability to grow the business, and risk surrounding this forecast.'

> 'We have a research process and framework that every analyst operates under. When they are analysing a company they are all using the same framework. We look at the fundamentals of the business which is basically what sort of industry does the company operate in, how consolidated, how competitive, etc., what is the company position within the industry, is it a strong no. 1 or a weak no 4 etc. etc., how historically has the management of the company performed and what is their strategy given the industry and their position in the industry.'

> 'You characterise a company. You say, I understand, this is a steady return business. It gets returns a bit above the cost of capital. You build a picture of a company like that so a good meeting is something that helps you understand whether you are on the right track or not. A bad meeting is where you go in thinking that you have got this picture of the company and come out and the picture is fuzzier.'

In some cases, the description of the FM's valuation methodology was clear and explicit, while in other cases it was imprecise. Different FMs tended to described their overall approaches to valuation and investment somewhat differently. Indeed, most went further and regarded their own particular approach (or, more broadly, their 'investment philosophy') as a source of competitive advantage. In spite of this, however, there were very considerable commonalities in the types of information that FMs seek to support their investment analyses. In all cases, there were looking for reassurance that they 'understood' the company and for new information that caused them to revise and update their views. A meeting could be satisfactory if it simply confirmed prior views. It could be successful if it provided that extra bit of information and insight, for example allowing greater confidence in a central forecasting assumption. However, a meeting would generally be considered unsuccessful if it generated too much noise – i.e. if it caused the FM to revise his or her views to the point at which they began to question the validity of their model or of the underlying assumption. The FM does not want to emerge from the meeting unsure of the value of the investment and unclear what to do about it. The following quotes illustrate these points.

> 'A successful meeting is when you can look at your investment thesis and say the meeting helped me reinforce my view or is making me rethink my view.'

> 'Generally these are always update, reassurance meetings, in the main.'

> 'We always want to make sure that companies in which we invest have a sensible strategy that we understand, and they understand.'

> 'At the majority of the company meetings, it is important that this isn't just a single one off meeting, it is part of a series of meetings which we as long term investors will be having with the company in which we are invested. It's about changes as much as anything. It's to check that there is consistency of message or if there isn't consistency of message there is an explanation as to why things have changed.'

The FMs' need to provide data for their models or, more generally, to increase their level of confidence in their projections, leads to the FMs wanting to control the agenda for the meetings. They do not wish the company to talk about something that is already understood. Neither do they want to spend their limited time on areas not relevant to the primary value drivers. Rather, they want to take the opportunity to complete the gaps in their models, and to test and probe the company on issues that the FM feels the need to understand better. The following view was typical.

> 'One of the things we don't do is let companies present to us. That they come with a one size fits all presentation is the problem.'

The need to provide reassurance in the investment position is typically satisfied by regular meetings, held once or twice per year after the announcement of the company's results. However, there can be occasions when additional meetings are required. These arise when there is a shock to the system – something that threatens the FM's confidence in the investment position, something that makes him or her feel that the company is no longer understood. This could be a significant event, such as a takeover or the departure of top executives, or else unexpected changes in market conditions. One FM described the motivation for ad hoc meetings in the following way.

> 'We have if you like a sort of base position in every company so we know where we are positioned, what our recommendation is and what the key drivers are behind that. The ad hoc meetings tend come about because there is something in the key drivers that has changed or we think there is something in the industry or whatever, and therefore we need to verify that position and just check that our base position is as we perceived it to be.'

Although relatively infrequent, ad hoc meetings can be particularly important in the FM's relationship with a company. This is because they are more likely to provide an opportunity for FMs to play an active role, in contrast to the more typical role of being passive recipients of information. Consider the following

> 'We have 5 questions that all major investment decisions must answer, what are the key drivers for that asset stock or whatever? What's changing? What's in the price, which is kind of the analysis? Why will the market change it's mind, which is actually the difficult bit, and then what's the trigger, because we want to be pro-active investors. So, once we've got the first 4 questions, we identify a trigger . . . So some of the stuff at the company meetings might be focussing on understanding what's changing

> some of the key drivers, some of the stuff might be understanding what happens next, some of the meetings might be us trying to ensure that the trigger we want to see is pulled.'

To the extent that ad hoc meetings arise at stress points in a company's life, and at times perhaps when the support of FMs is required, the opportunity to 'pull the trigger' is greater. If the valuation is sensitive to the trigger, and if the FM has a significant holding, then the payoff to such an approach can also be significant. In general, though, most FMs conceded that their influence is small, both by choice and by circumstance. By choice because most FMs did not consider that their role could or should be to manage the company. By circumstance because they invariably have little or no effective means of enforcing their will. A typical approach to influencing corporate strategy is based necessarily upon persuasion and argument rather than upon direct control, as the following quote illustrates.

> 'I think the first action is to give it a go. I find these easy issues to address. I say, 'Look, actually this business looks as if it's a millstone. Why don't you sell it or can't you sell it?' I think get that message across. There comes a point where you can sense in their statements and behaviour whether they are receiving that message and are thinking about it or not.'

When there is an impasse and management is not 'receiving the message' then the FM has little option but to sell stock. Ideally, however, the relationship between the FM and the company is closer than this.

> 'I think once you establish a relationship with a company and you have proven to them as an investor that you understand the company and the issues, then the meetings move to a different level. This doesn't happen overnight. It's something that can take a couple of years to get into this situation. But I have been sat opposite management teams who've told me things not overtly, and you have to work it out and you have to ask the right question, and if you do you push on doors, you actually you find out things about the way they're thinking about the business. And that deep relationship does take a lot of time to establish. That sort of relationship can be very, very rewarding.'

A generally-held view was that meeting the management was vital, ideally as a way of building an effective working relationship, but also sometimes as a means of making investment decision-relevant judgements and of signalling alarm bells.

> ‘Just thinking through the company meetings that I have attended over the years, the key thing is there is no substitute for sitting across the table from somebody.’

> ‘Some companies are always too optimistic, it’s as simple as that, and you must be aware of that. Other people are naturally cautious, but a lot of the, ‘That’s guy’s good, that guy isn’t good,’ is experience. I normally see 3 or 4 companies a week and have done for a long time and therefore a lot of that is experience. That guy’s not answering the question. He should be able to answer that question. He’s trying to avoid that question. That guy’s really sharp. He knows what he’s doing, his point by point comment.’

> ‘My experience tells me that this company is stuffed full of serial optimists who when it comes to the day of telling the city what’s going on, they got it wrong. They have no concept of understanding what expectations are out there, and managing the business against the expectations that they have set.’

> ‘I have seen situations where . . . (we) come out of a meeting and sit down on the basis of a 10 minute conversation and we would decide to halve the holding or to get out altogether because we knew enough or we had heard enough to know that as the company went around with this particular message and strategy the shares were only going one way. And I can spot today in the market place when the company, having published its figures, then starts to see investors.’

In support of the assessment of management made during one-on-one meetings, FMs employ additional information sources. For example, the credibility of the management’s message is affected by the evidence of financial performance in previous years and by the ability of the management to control information flow against market expectations.

> ‘I think there’s still a tendency on the part of companies to think that if something is a bit bad, by the time you have to report your

> results it would have gone away . . . And genuinely there are times when the management didn't realise, which is probably the most worrying aspect. The reason you had a profit warning is that they had no clue themselves, and that is when you absolutely hit the panic button.'

> 'Well I would say if it is a cyclical business, why have you never had an annual profit statement in the last 10 years which has been free of provision of one sort or another, and why do the cumulative provisions that you have taken over the last 10 years account for 1.5 times the value of the company as it stands today. I would say the past record doesn't suggest that there have been good times and bad times; it suggests that there have been bad times and bad times.'

Interpretation and Conclusions

Valuation is usually understood in the context of the discounted cash flow (DCF) model. The DCF model can be summarised briefly as follows. First, the user of the model must forecast the future cash flows attributable to the asset in question. Second, the user must select an appropriate discount rate to express those cash flows in terms of their present value (PV). Third, investment activity is value-creating if the cost of an investment, expressed as a PV, exceeds the PV of the expected cash inflows. Alternatively stated, there is positive net present value (NPV) if the internal rate of return on an investment (IRR) exceeds the cost of capital. Fourth, PVs are additive. The PVs of individual shareholdings in a company sum to the PV of the company's total equity, and the sum of total equity for all listed companies equals the value of the stock market.

The theory of efficient markets can be laid over the DCF model in order to characterise the role of the CFO. Stock market prices are semi-strong form efficient if they impound publicly available information. They are strong form efficient if they also impound privately available information. If the CFO is viewed as the holder of private information, and the FMs as the users of public information, then the effectiveness of the CFO in investor communications could be measured in terms of the gap between semi-strong and strong form share prices.

The evidence presented in this paper can be set against this (briefly described) theoretical framework. Consider first the forecasting of future cash flows. It is striking that the CFOs (i.e. the holders of private, presumably superior information) are seemingly less confident than the FMs about their ability to predict future performance. The CFOs characterise their role as providing simple and understandable messages, and they seem to recognise the inherent limitations of the resulting dataset. In contrast, the FMs seem to interpret this data as providing the essence of their valuation models, which in turn generate usable estimates of value. The CFOs do not place great weight on information relating to periods beyond short-term forecasts. The FMs contrast this with claims regarding their own 'investment philosophies' and their ability to understand relative value. The contrast between the knowledge base of the CFO and the FM is all the more striking when one considers that the former is immersed in the company and the latter can only afford the company as much attention as its size in the portfolio deserves. This was illustrated starkly by one FM who, relatively unusually, manages funds passively and meets companies only infrequently.

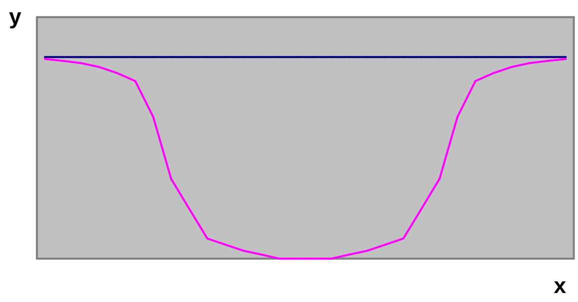
> 'What you get is the Chief Executive and the Investor Relations person and maybe the Finance Director, and they're on some City PR offensive and literally you've got an hour, they're seeing six firms in a day . . . they're talking about something that they know a hell of a lot about and you don't. Assuming that they're pretty good in the first place, its going to be pretty unusual where you trip them up on something that is their specialist subject, and it's not yours.'

In this context, the FMs contrast the CFOs in two ways. First, they have only limited time and resources available to value the company. Second, they must generate an ostensible valuation that they feel they can support, because without it they have no credible basis for portfolio investment decisions. The combination of these factors makes a relatively simple valuation model attractive to FMs, and it explains a focus on simple, understandable value drivers. The depth and complexity of information familiar to the CFO would be unwelcome to the FM.

Within the CFO-FM relationship, the concept of risk is captured inadequately by a theoretical framework where cash flows are discounted to their PV. If the range of possible future cash flows is too subjective and uncertain to attract meaningful probability distributions, and if this difficulty is compounded by the 'informational risk' that CFOs are more or less reliable providers of information, then there is little scope for precise adjustments to discount rates. The concept discussed earlier of 'willingness to invest' describes a practical means of dealing with risk. In contrast to the standard DCF model, investments are not routinely supported whenever the IRR exceeds the cost of capital, because the IRR is not knowable with sufficient reliability. Rather, a company is supported if it inspires confidence.

These conclusions are consistent with the theoretical framework proposed by the economist George Shackle, whose work challenges the application of probability theory to decision making under uncertainty. It is in the nature of investment decisions, he argues, that circumstances are always different; the logic of repeated experiment, text-book probability games, where the parameters of the problem are known for certain, simply does not apply - 'knowledge and uncertainty are mutually exclusive … objective, actuarial probability has no relevance for the analysis of decision in the face of uncertainty, because when objective probabilities can be applied there is no uncertainty.' (Shackle 1961). Instead, he proposes that decision-makers first rule out what they consider beyond the realm of possibility, leaving a (possibly wide) range of plausible outcomes. Within this range, Shackle (1955) defines a 'potential surprise' function, which is central to his model of decision-making behaviour. Potential surprise, *y*, is a function of potential investment gain, *x*, as estimated by the decision-maker at the time of the investment decision. The potential surprise function can be illustrated as follows.

Potential Surprise Function



When y(x)=0, there would be no surprise arising from the realised value of x. When y(x)=y*, the value of x is beyond the realm of possibility, as judged by the decision-maker. For values of x where y*>y(x)>0, greater or lesser outcomes for x would be increasingly surprising, yet still plausible. The narrower the distribution of y(x), the narrower the range of outcomes envisaged by the investor and so the more certain is the feeling he or she has about the outcome of the investment. Viewed against this model, the FM's aim is to narrow the distribution of the potential surprise function. This is evident in both desire to plug the gaps in the valuation model (so capturing variables that influence outcomes) and to ensure the trustworthiness of investee management (so giving confidence in the veracity of input data). If the distribution cannot be narrowed sufficiently, then the range of plausible outcomes is too wide, with the result that the FM becomes unwilling to invest. Shackle (1955) notes that if news (i.e. information) 'seems to provide internally inconsistent or conflicting evidence … or is for any reason difficult to interpret, the consequence would be to inhibit some kinds of business activity; not because the news was regarded as *bad* … but because it is *unintelligible*.' This outcome arises either when the business is not understood (hence the demand for simple, consistent messages from CFOs about the business model) or when management has lost credibility, so making the range of plausible outcomes seem wider from the FM's perspective (hence the high penalty for CFOs who inflict a negative surprise – a widening of the distribution – on the unsuspecting FM).

A practical consequence is that whenever a company needs the support of FMs, for example when new investment requires new equity, the FMs have a direct influence on investment decisions. It might be noted, however, that this influence need not be of great consequence in the grander scheme of things. If a company has the support of its investors, then it can fund investments whether or not they add value. And even if the company is not supported, it can still pursue its investment strategy independently just so long as it can provide funding from internal cash flows. In any event, if trust is built on past performance, then there is limited reason to suppose it is an effective guide to future performance.

Following on from the notion of FMs' willingness to invest is the observation that CFOs cultivate liquidity and support for their stock, by means of understanding the demand curves for different FMs and designing the investor relations programme accordingly. It is the subjectivity and uncertainty of valuation that allows the possibility of different FMs having significantly different views on the value of the company. The better a company is at understanding its FMs and 'placing' its stock accordingly, the greater support there will be for its share price. This is independent of the intrinsic value of the company. Hence, rather than viewing the PV of the company as simply the sum of the PVs of individual shareholdings, a more sophisticated picture takes into account the identity of the shareholders. Moreover, and following similar reasoning, the multiplicity of FMs' 'investment philosophies' is made possible because of uncertainty in valuation. One cannot tell, a priori, whether any given investment philosophy is likely to outperform any other. Given that relative performance is fundamental to FMs, if all adopt the same investment philosophy, then they are less likely to convince themselves or others that relative performance is achievable. Hence the uncertainty-induced opportunity for choice translates into a variety of investment philosophies in practice.

Notes

[1] One CFO noted that 'the time to have great relationships with your investors is when you aren't asking them for anything.'

[2] This is consistent with Barker (1998) who observes that 'the information service of analysts is more useful to fund managers when it consists of informed advice such as sensitivity tests of market valuations, rather than specific recommendation, or earnings forecasts,' concluding that the market for information is of greater importance than the market for analysis.

References

CPA Journal. (1994) Analysts Want More. New York: New York State Society of Certified Public Accountants. 69 (10): 10.

Arnold, J. and Mozier, P. (1984) A Survey of the Methods Used by UK Investment Analysts to Appraise Investments in Ordinary Shares. *Accounting and Business Research.* (Summer): 195-207.

Barker, R. G. (1998) The Market for Information - Evidence from Finance Directors, Analysts and Fund Managers. *Accounting and Business Research.* 29 (1): 3-20.

Barker, R. G. (2001) *Institutional Investors, Accounting Information and the ASB.* Edinburgh: Institute of Chartered Accountants of Scotland

Baysinger, B., Kosnik, R., and Turk, T. A. (1991) Effects of Board and Ownership Structure on Corporate R&D Strategy. *Academy of Management Journal*. (March): 205-214.

Bence, D., Hapeshi, K., and Hussey, R. (1995) Examining Investment Information Sources for Sophisticated Investors Using Cluster Analysis. *Accounting and Business Research.* 26 (1): 19-26.

Bhushan, R. and Lessard, D. R. (1992) Coping with International Accounting Diversity: Fund Managers' Views on Disclosure, Reconciliation, and Harmonization. *Journal of International Financial Management and Accounting.* 4 (2): 149-163.

Black, B. S. (1998) Shareholder Activism and Corporate Governance in the United States, in P. Newman (ed.) *The New Palgrave Dictionary of Economics and the Law (vol. 3*): 459-465. Basingstoke: Macmillan.

Bricker, R. J. and DeBruine, M. (1993) The Effects of Information Availability and Cost on Investment Strategy Selection: An Experiment. *Behavioral Research in Accounting.* 5: 30-57.

Buchanan, J. and Tullock, G. (1962) *The Calculus of Consent*. Ann Arbor: University of Michigan Press.

Bushee, B. J. and Noe, C. F. (2000) Corporate Disclosure Practices, Institutional Investors, and Stock Return Volatility. *Journal of Accounting Research.* 38 (Supplement): 171-201.

Byrd, J. W., Johnson, M. F., and Johnson, M. S. (1995) *Investor Relations and the Cost of Capital*. Ann Arbor, MI: University of Michigan. Working Paper.

Chaney, P., Devinney, T., and Winter, R. (1991) The Impact of New Product Introductions on the Market Value of Firms. *Journal of Business.* (October): 573-610.

Clarke, G. and Murray, L. W. (2000) Investor Relations: Perceptions of the Annual Statement. *Corporate Communications.* 5 (3): 144-151.

Day, J. F. S. (1986) The Use of Annual Reports by UK Investment Analysts. *Accounting and Business Research.* (Autumn): 295-307.

Diamond, D. W. and Verrecchia, R. E. (1991) Disclosure, Liquidity, and the Cost of Capital. *Journal of Finance.* 46 (4): 1325-1360.

Epstein, M. J. and Palepu, K. G. (1999) What Financial Analysts Want. *Strategic Finance.* (April): 49-52.

Firth, M. A. (1976) The Impact of Earnings Announcements on the Share Price Behaviour of Similar Type Firms. *Economic Journal.* (June): 296-306.

Foster, G. (1979) Briloff and the Capital Market. *Journal of Accounting Research.* (Spring): 262-274.

Frankel, R., Johnson, M. F., and Skinner, D. (1997) *An Empirical Examination of Conference Calls as a Voluntary Disclosure Medium*. Ann Arbor, MI: University of Michigan. Working Paper.

Gaved, M. (1997) *Closing the Communications Gap: Disclosure and Institutional Shareholders.* London: The Institute of Chartered Accountants in England & Wales

Golding, T. (2001) *The City: Inside the Great Expectation Machine*. Harlow: Financial Times Prentice Hall.

Graves, S. (1988) Institutional Ownership and Corporate R&D in the Computer Industry. *Academy of Management Journal.* (June): 417-428.

Holland, J. B. (1998a) Private Voluntary Disclosure, Financial Intermediation and Market Efficiency. *Journal of Business Finance & Accounting.* 25 (1&2): 29-68.

Holland, J. B. (1998c) Influence and Intervention by Financial Institutions in their Investee Companies. *Corporate Governance*. 6 (4): 249-264.

Holland, J. B. (2001b) *Qualitative Research in Finance and Accounting: Developing a Grounded Theory of the Market for Information and Governance*. Glasgow: Department of Finance and Accounting, University of Glasgow. Working Paper 2001/2.

Hoskisson, R. E. and Turk, T. A. (1990) Corporate Restructuring: Governance and Control Limits of the Internal Capital Market. *Academy of Management Review.* 15: 495-477.

Investor Relations Society. (2000) *A Brief Introduction to Investor Relations.* London: Investor Relations Society.

Kang, D. L. (2000) The Impact of Activist Institutional Investors on Performance in Public Corporations: A Study of the US Fortune 500, 1982-1994. *Academy of Management Proceedings* OMT: H1-6

Kasznik, R. and Lev, B. (1995) To Warn or Not to Warn: Management Disclosures in the Face of an Earnings Surprise. *The Accounting Review.* 70 (1): 113-134.

Kennedy, R. and Wilson, M. (1980) Are Investor Relations Programs Giving Analysts What They Need? *Financial Analysts Journal.* 36 (2): 63-69.

Lee, T. A. and Tweedie, D. P. (1981) *The Institutional Investor and Financial Information.* London: The Institute of Chartered Accountants

Leftwich, R., Watts, R. L., and Zimmerman, J. L. (1981) Voluntary Corporate Disclosure: The Case of Interim Reporting. *Journal of Accounting Research.* 19 (Supplement): 50-77.

Leuz, C. and Verrecchia, R. E. (2000) The Economic Consequences of Increased Disclosure. *Journal of Accounting Research.* 38 (Supplement): 91-124.

Lev, B. (1992) Information Disclosure Strategy. *California Management Review.* (Summer): 9-32.

Lev, B. and Thiagarajan, R. (1992) *Fundamental Information Analysis.* Berkeley, CA: University of California. Working Paper.

Maingot, M. (1984) The Information Content of UK Annual Earnings Announcements. *Accounting and Finance.* (May): 51-50.

Malone, D., Fries, C., and Jones, T. (1993) An Empirical Investigation of the Extent of Corporate Financial Disclosure in the Oil and Gas Industry. *Journal of Accounting, Auditing & Finance.* 8 (3): 249-273.

Marston, C. (1996) The Organization of the Investor Relations Function by Large UK Quoted Companies. *Omega, International Journal of Management Science.* 24 (4): 477-488.

Marston, C. and Shrives, P. (1996) A Review of the Development and Use of Explanatory Models in Financial Disclosure Studies. *European Accounting Association Conference* (Bergen, 2-4 May.) EAA.

Merton, R. (1987) A Simple Model of Capital Market Equilibrium with Incomplete Information. *Journal of Finance.* 15 (3): 483-510.

Parthiban, D., Hitt, M. A., and Gimeno, J. (2001) The Influence of Activism by Institutional Investors on R&D. *Academy of Management Journal.* 44 (1): 144-157.

Pound, J. (1993) Creating Relationships Between Corporations and Institutional Investors: An Introduction. *Journal of Applied Corporate Finance.* 6 (2): 32-34.

Pozen, R. C. (1994) Institutional Investors: The Reluctant Activists. *Harvard Business Review.* (January-February): 140-149.

Schipper, K. and Thompson, R. (1983) Evidence on the Capitalized Value of Merger Activity for Acquiring Firms. *Journal of Financial Economics.* (April): 85-120.

Shackle, G. L. S. (1955) *Uncertainty in Economics and Other Reflections*. Cambridge: Cambridge University Press.

Shackle, G. L. S. (1961) *Decision, Order and Time in Human Affairs (1969/e).* Cambridge: Cambridge University Press.

Singhvi, S. and Desai, H. B. (1971) An Empirical Analysis of the Quality of Corporate Financial Disclosure. *The Accounting Review.* 46 (January): 621-632.

Skinner, D. (1992) *Why Firms 'Voluntarily' Disclose Bad News*. Michigan, IL: University of Michigan. Working Paper.

Smiley, R. (1988) Empirical Evidence on Strategic Entry Deterrence. *International Journal of Industrial Organization.* (June): 167-180.

Sprouse, R. T. (1967) Discussion of the Return to Straight-Line Depreciation: An Analysis of a Change in Accounting Method. *Journal of Accounting Research.* 5 (Supplement): 184-186.

Sundaram, S., Ogden, W. A., and Walker, M. C. (1993) Wealth Effects of Corporate Presentations to the New York Society of Security Analysts. *Financial Analysts Journal.* 49 (2): 88-89.

Tasker, S. C. (1998) Bridging the Information Gap: Quarterly Conference Calls as a Medium for Voluntary Disclosure. *Review of Accounting Studies.* 3: 137-167.