IRQ
VOLUME 4, NUMBER 4


# IR Eyes Capital Markets



niri *Investor Relations Quarterly*
NATIONAL INVESTOR RELATIONS INSTITUTE

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## FEATURES



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A JOURNAL OF CORPORATE VALUE

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*Investor Relations Quarterly*
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# *Editor's Note*

In the wake of the biggest corporate bankruptcy in U.S. business history, practically every aspect of financial reporting, financial community relationships, corporate governance, accounting practices, management practices, executive compensation and fiduciary responsibility has come under the microscope. Such analysis will provide grist for investor relations conversations for some time to come.

Early on, the developments led pundits to wonder about the impact on the capital markets themselves. Investor relations practitioners probably were less concerned on that score. After all, we interact with the capital markets on a regular basis. To varying degrees, we're familiar with the functions of the exchanges on which our companies' stocks trade and the trends that soon may demand decisions. However, we also understand that we shouldn't take the functioning of the capital markets for granted. That reality was the impetus for making capital markets the theme of this issue of *IRQ*, which was well on its way when Enron imploded.



For this issue we talked with a top executive at a leading specialist firm and sought out the expertise of decision-makers who deal with the capital markets from the points of view of corporate positions, portfolio management and trading systems. We included a 30-year timeline of major capital market events to keep things in perspective, especially in this time of rapid-fire, headline-grabbing, unprecedented events. These days the everyday subjects of investor relations lead not only the business media but also daily-paper headlines and television's Sunday talk-show topics. If we needed verification of just how dynamic a profession we have chosen, we are surrounded by evidence.

Just where these developments take us is yet to be seen. Indeed, as investor relations professionals we bear some responsibility for setting that course. A well-grounded understanding of the capital markets and related IR topics is a good place to start. This issue of *IRQ* contributes to that conversation.

Connie S. Harrison
February 4, 2002

**WHITE PAPER**

# Interactions With the Capital Markets



*For IROs the capital markets are a constant—so much a part of the landscape that absent a crisis, discussions of capital market topics generally get put off under the press of following specific equities or the direction of the daily averages. In the three segments that make up this* IRQ*'s white paper, our contributors look at how the equity markets operate, the impact of new technological capabilities on the markets' future and events that moved the markets during the last three decades. These viewpoints together remind us that, as compelling as recent events have been, the markets have dealt successfully with other shocks and significant trends and are likely to absorb future change as well. For that very reason, IROs should be conversant enough with the topic to manage it rather than have the pace of change shrink their options.*

# Understanding the Equity Markets

**BY MARGE WYRWAS**

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With more than 18,500 equity securities trading in the United States alone, in the best of times it is difficult to get investors to focus on a particular stock and feel comfortable with owning it. A bear market makes those tasks seem next to impossible.

The investor's dilemma magnifies the role of the investor relations officer whose job, according to NIRI's definition, is to use the disciplines of finance, communication and marketing in order to manage the content and flow of company information to financial and other constituencies to maximize relative valuation. Recent market trends put even more emphasis on the practice of investor relations as an exercise in strategic communications.

To most effectively court investors and promote price stability, companies must consider who trades the stock and how those investors likely will react to market developments. Few investor relations professionals realize the extent to which sophisticated investors make buy and sell decisions by applying technical research along with their fundamental research. Institutional investors might add a stock to their buy list based on investment fundamentals, but technical analysis is what frequently determines when and how many shares they buy. Investment company sales traders, who carefully scrutinize data on trading alpha and market impact, usually make such decisions.

Giving analysts and investors the data to support fundamental research is essential. Fostering understanding of the stock's trading characteristics is important because it promotes liquidity. And because trading dynamics are among the most important drivers of share price, it is important that the company's senior management understand these factors as well.

## Technical Analysis Becomes More Important

Technical analysis — the study of a stock's trading characteristics — has grown increasingly important in recent years as the U.S. stock market has undergone its own version of *The Perfect Storm*. Market leadership has shifted from DJIA old-economy stocks to Nasdaq new-economy stocks and now to "the now-economy." It has made a transition from bull to bear market, and it has been altered permanently by globalization, market consolidation, regulatory change and new technologies. These changes have made buy and sell decisions more complicated, with many stocks experiencing decreased liquidity and increased price volatility.



Technical analysis may have been less critical when the stock market had fewer participants and was dominated by large block traders enjoying ample liquidity and trading anonymity. The market has grown far more complex with the emergence of hedge funds and day traders and the introduction of order disclosure rules and decimal pricing.

While order disclosure rules make trading anonymity more difficult to protect, the effect of decimal pricing has been profound. Decimalization has reduced liquidity in almost every stock at a given price point. With stocks' minimum price variation being reduced from a sixteenth of a dollar — 6.25 cents — to a penny, market makers and specialists, whose job is to provide investors with enhanced liquidity, have significantly less incentive to participate and still maintain appropriate returns on committed capital. According to Nasdaq, the introduction of decimal trading and the one-penny minimum price variation have caused quoted and effective spreads for its listed stocks to fall 51 percent — with the greatest decline, 71 percent, occurring in the most active, lower-priced securities.

Faced with reduced liquidity, traders have become ever more sensitive to trading alpha, market impact and the need for anonymity. Many now eschew block trades, preferring to break down their buy and sell orders

into smaller, more digestible lots — even though these smaller lots usually increase trading costs and slow execution. These developments make it all the more important for the IR professional to know the company's investor base, even though these changes make that task more difficult.

## Challenges in Keeping Track of the Investor Base

Most IR programs rely on stock surveillance firms to keep track of the investor base. The surveillance firms compile information by combing through T+3 data. Unfortunately, they usually limit data to trades of 5,000 shares or more — a reasonable approach in the days before decimal pricing, but no longer.

Increasing numbers of large, influential investors are trading stock in small lots that fall well below the surveillance firms' radar. The industry needs a new form of surveillance to identify large institutions trading in small lots. Until it emerges, however, IR professionals have to gather their own intelligence — by getting to know the specialists, market makers and traders who handle their stocks and by becoming familiar with the many new alternative trading systems. The people who actually execute stock market trades — the exchange specialists and market makers — are in the best position to know who is buying and selling, especially when they take the other side of trades and commit their own capital.

The New York Stock Exchange, the world's largest auction market, has a specialist assigned to each listed stock, while dealer markets like Nasdaq rely on market makers at a variety of firms. NYSE specialists execute only about 30 percent of the trades in their stocks, with the rest being handled electronically or on regional exchanges. As a result, the NYSE specialist's knowledge of who is trading a stock at any given moment often is incomplete. Nasdaq market makers act as principals in some 70 percent of all Nasdaq

trades. While it is important to know a particular stock's specialist or market makers, IR professionals must also cultivate relationships with institutional traders and sell-side trading desks, whose knowledge is often superior.

With an alternative trading system, computers execute trades without human intervention, although the nature of a particular system often provides a clue to the order's origination. It is important to understand the varieties of alternative trading systems and who uses them. Some alternative trading systems are execution destinations. Others route order flow. Still others are hybrids of the two. ATS has become a catchall term encompassing different functions.



It is also important to distinguish between investors and traders. Investors pick stocks and design investment portfolios. The trader's job is to accumulate and dispose of positions.

Studies have shown that institutional traders prize anonymity above all else in their choice of market venue because it allows them to buy and sell without unduly disrupting the market price. Some forms of alternative trading systems have proliferated in recent years because they maintain anonymity better than systems with human intervention. As an example, following the introduction of limit order handling rules in 1997, large market makers that previously had disposed of unwanted inventory through Instinet, the first ATS, wanted a new alternative to disguise their activities better. In order to manage inventory risk, many securities firms created joint ventures — electronic communications networks — to provide multiple anonymous execution destinations. Still another example is Island ECN, which is a router of order flow, not an execution destination. Then there is Archipelago, which functions as a Small Order Routing System (SORT) as well as an exchange since its acquisition of the Pacific Stock Exchange.

The technical distinctions among alternative trading systems — ECNs, SORTs and exchanges — may seem arcane. What matters from an IR perspective

is what kind of investor uses them. Trades handled by Island most likely come from retail day traders. Brut and Instinet handle orders primarily for institutions. Archipelago handles orders for both institutions and individuals.

## Targeting Investors

Just as the variety of trading paths makes it harder to know who owns a company's stock at any given time, these emerging options affect how companies determine what kind of investors they should seek and how to target them.

Ideally, a company should have a diversified blend of institutional, retail and employee investors that will lend stability to the stock price. Companies should target investors with a mix of investment and trading styles, but the optimal blend varies with the company, the industry, market conditions and other factors. Here are some examples.

- Company X is a fast-growing enterprise that has been reporting annual earnings increases of 100 percent or more. Nearly all of its shareholders are aggressive growth investors who turn over their portfolios several times a quarter. Unless the company can cultivate new investors with slower portfolio turnover, its stock will plummet the moment it reports a disappointing quarter.

- Five years ago Company Ywas perceived as a strongly managed enterprise and a leader in a strong-growth industry. A third of its stock was in employee hands, it had strong appeal for retail investors, and its institutional investors tended to be long-term growth players. Today, Company Y's industry is in turmoil and the company itself is overextended and laying off employees. Not surprisingly, its management is in transition. Its stock no longer can be marketed as a long-term growth story. Its new IR strategy, therefore, should be to sell value

investors on the quality of the new management and the strong, underlying fundamentals of the franchise. Such a strategy calls for shifting ownership of the stock to a new set of investors, who should be fully apprised of the stock's changed trading dynamics.

- Company Z is a promising young technology company that has managed to survive the market shakeout. However, its stock price has fallen below $5 a share, making it off-limits for most institutional investors. Company Z's long-term strategy should be to cultivate a balanced mix of investors, but for now it might want to market the stock to hedge funds and professional traders because they can provide much needed liquidity.



## Diversifying the Investor Base

For some time companies have prized retail investors for their stability and staying power. This still may be true of the average Charles Schwab customer, who tends to buy and hold. It is less true of the average professional trader, who is maybe a day trader. And it is not necessarily true of the Merrill Lynch customer. With Merrill Lynch's new marketing strategies, its retail customer could be either a loyal buy-and-hold type or a day trader.

Institutional investors are equally varied. Some are long-term value players like Warren Buffett; others are hedge funds and momentum players.

The variety of investment styles and trading preferences offers further proof that a company should develop a mix of investors and not concentrate on only one investment style. It is especially important to cultivate ownership by investors that turn over their portfolios at varying frequencies so that the stock won't be unduly affected by market and business cycles.

Moreover, no set of investors lasts indefinitely because the stock market and its listed companies are always in a state of flux, along with market

perceptions of what constitutes acceptable performance. Since the markets' only constant is the ever-present tension between bull and bear sentiments, it is critical for companies to communicate strategically with a diverse group of investors who might want to own the stock for different reasons. Helping the stock's trading dynamics, along with company fundamentals, can be a valuable tool in getting and holding their attention.

## The Electronic Markets Revolution

**BY JEFF ZILKA**

*Managing Principal*
The Weiser Group



It has become fashionable for investor relations professionals to think of themselves as their stocks' brand managers. In that role, they should be as concerned with the distribution channels for their companies' shares as with the product itself. Too often, however, practitioners focus on micro-finance — the investment management process — and take for granted the macrostructure of the financial markets in which shares trade.

Fundamental changes have occurred in the structure of U.S. securities markets during the last five years, with potentially enormous impact for the investor relations profession. Several developments illustrate the magnitude of that change.

For one, alternative trading systems and electronic communications networks now account for 30 percent to 35 percent of the volume in Nasdaq-listed shares, compared with 20 percent in 2000. One ECN, Archipelago, received Securities and Exchange Commission approval to become a full exchange in partnership with the Pacific Exchange while Nasdaq's application to become an exchange was still pending with the SEC. An alternative trading system, Liquidnet, now operates an institution-to-institution trading network that allows institutions to bypass broker-dealers and the two major

primary market centers, the New York Stock Exchange and Nasdaq.

From the IRO's perspective as brand manager for the company's stock, the rise of the electronic markets represents nothing less than a revolution in how their shares trade — with the opportunities and disruptions that such revolutions bring.

Among the considerations these developments raise are: a greater choice in where shares are listed, competition among market centers that may reduce the cost of listing fees, trading mechanisms that can reduce institutional transaction costs and encourage interest in relatively illiquid small-cap and midcap equities, and migration of volume from the New York Stock Exchange that could make it more difficult for specialists to provide a picture of what is affecting trading in particular issues.



## The Basis for Electronic Markets

Many in the investor relations industry focus on Regulation FD as the most significant action of Arthur Levitt's tenure as SEC chairman. However, easily as significant as that regulation are the order handling rules which took effect in 1997. They gave the SEC's stamp of approval to ECNs, which essentially are matching engines that electronically pair bids and offers. In essence the order handling rules forced Nasdaq dealers either to execute limit orders or send them to an ATS or ECN for execution. The effect was electric.

By 2000, limit orders accounted for two-thirds of Nasdaq order volume as investors took advantage of the ECNs' transparency and the accompanying ability to see all bids and offers — the so-called depth of the book — information that previously had been available only to dealers. ECNs also offered anonymity, which made it possible for large investors to trade without disclosing their identity.

ECNs were much less successful in gaining market share among NYSE-listed stocks, however, because they lacked a reliable electronic mechanism

for ensuring the timely interaction of their customers' bids and offers on the floor. Further, although ECNs offer anonymity and innovative order types that, for example, give institutions hidden reserves and thereby accommodate trading of large blocks of stock, their institutional order flow is visible to day traders, limiting the efficacy of the institutions' trading.

Even so, ECNs proliferated to nine by 2001, many with cross-ownership from major trading firms. That set the stage for the consolidation now taking place.

Concurrent with the order handling rules and emergence of ECNs came structural changes in the market itself.

One was growing imbalance between the size of trades that institutions require and the liquidity available through the NYSE and Nasdaq, the major market centers. Thirty years ago, specialists and the capital of the upstairs traders adequately supplied the liquidity needs of major institutional investors. Since then institutional assets under management have exploded as a result of ERISA standards for pension funds, which became law in 1974, and as the bull market of the 1980s and 1990s sucked consumers' dollars into mutual funds.

Furthermore, SEC changes that were designed to promote best execution for individual investors often had the effect of penalizing institutions. Institutions need to trade size, and their need for size increased as their assets under management rose, making trades of hundreds of thousands of shares a common occurrence. However, reducing the average increment from eighths to sixteenths and then to hundredths—literally pennies—decreased liquidity increment by increment. Today, average order size is approximately 1,100 shares on the NYSE and Nasdaq and fewer than 300 shares for ECNs.

Plexus, one of the leading execution cost consultants to institutional investors, estimates that the cost for an institution to execute a trade is

39 cents a share — not in commissions, which rarely exceed 5 cents a share and are 2 cents or less in many electronic markets, but in market impact and delay costs. To the extent that institutions have alternative means for executing trades, their ability to invest in what are now less-liquid stocks will increase, and the hidden cost to the nation's pension fund beneficiaries and mutual fund holders will be reduced.

Among institutional investors, the predictable result of these developments is renewed focus on best execution. The Association for Investment Management and Research promulgated guidelines for what constitutes best execution, recognizing that how an investor buys a stock and its purchase price can be as important as the initial decision to buy. The concept of best execution becomes increasingly relevant to IR practitioners as they embrace the role of brand manager for their companies' stocks.



Academic researchers have concluded that maximizing market quality should be the objective of market design for listed companies because lower trading costs and sharper price discovery reduce the cost of equity capital and thereby have a direct and positive impact on the bottom line.

One commentator likened best execution to good cooking. It comes, he said, in many flavors, and what is good food to an institution might not appeal to an individual investor.

In general, institutions value consistency, low cost and anonymity, because it reduces market impact. Individuals in many cases want reliability and fairness — the best price then available in the marketplace, generally called the national best bid or offer. Day traders and other high-velocity traders want speed and autonomy so as to be able to send orders with assurance to market centers that offer the promise of best execution at that moment in time.

## For IROs, What Next?

Arthur Levitt's eight-year tenure as head of the SEC produced one of the most exciting and creative periods in market structure reform since the agency's formation in the early 1930s. Technological innovations such as the Internet, ATSs, ECNs and other forms of electronic trading combined with substantial regulatory reforms such as order handling rules and Reg FD. Given these far-reaching developments, from the perspective of the investor relations practitioner, where do we go from here?

First, we must all recognize the fierce competition among market centers for execution volume, not only between the Nasdaq and NYSE but also among them and the new electronic markets. One consequence is that an increasing portion of NYSE trading will be executed not on the exchange floor but on Liquidnet, Archipelago or another mechanism that prints in the third market.

Second, companies will have greater choice among listing venues, each of which has radically different structures. The New York and American stock exchanges have their venerable specialist system. Nasdaq has its own market makers. Archipelago has announced that it intends to seek primary listings and, although the structure has not been fully announced, that it will use electronic market makers.

As a critical differentiator of its service, Archipelago is stressing openness in which all investors — not just the specialists or dealers — see the depth of its book. NYSE specialists, who traditionally have guarded their book as part of their profitable exclusive franchise, for the first time, are making their limit order book information available. Nasdaq has SuperSoes and is moving toward SuperMontage, which observers have called Nasdaq's ECN because it reportedly will offer many of the same depth-of-book visibility features as the electronic networks with which it competes.

A third effect of the electronic market revolution and changing market

structures is the impact on the distribution system for companies' stocks. Although institutional investors account for 30 percent of the orders, they account for 70 percent of the dollars invested. Alternative trading systems that permit institutions to trade among themselves, such as MilleniumFIX, Posit and Liquidnet, enable them to achieve substantially reduced transaction costs and more easily accumulate positions in small-cap and midcap stocks.

Electronic trading, which typically represents less than 5 percent of major institutions' total volume, will increase because institutions have economic incentives to reduce transaction costs, in addition to SEC pressure and AIMR encouragement to seek best execution. IROs of small-cap and midcap companies are wise to ask portfolio managers and buy-side analysts with whom they meet to investigate block-trading tools as ways to accumulate meaningful stakes in their companies.



## IR in the Electronic World

There's no question that on a day-to-day basis these changes have less immediate impact than, say, an earnings guidance release, shift in management or announcement of a significant new product. However, these trends soon will resemble ocean volcanic islands in the process of being created, growing and becoming increasingly visible above the water line.

The wise IRO understands that the terrain is changing. The two-horse-race paradigm of the NYSE vs. Nasdaq already has begun to yield to new electronic capabilities. Institutions, the IRO's biggest customers, will accelerate the migration to electronic markets.

# Market Milestones

**BY RAYMOND LAU, PH.D.**

*Co-Founder*
iPhrase Technologies, Inc.

Over the past three decades, the equity markets have experienced major advances but also have absorbed a fair number of unexpected shocks. The events in this list of memorable times in the capital markets generally fit in three categories: major shocks to or turning points in the markets, significant innovations and noteworthy changes in the landscape. While there is some commonality in the events — such as financial intermediary failures and speculative collapses — they also feature unique aspects. Together they demonstrate the strength and resiliency of the U.S. capital markets.

**September 21, 2001.** The Dow ended the worst week since the fall of France in 1940, plunging 14.3 percent in the aftermath of terrorist attacks in the United States. Nasdaq declined 16 percent and the Standard & Poor's index 11.7 percent. The U.S. equity market lost $1.4 trillion for the week.

**September 17, 2001.** The U.S. equity markets reopened after being closed for three and a half days following the September 11 terrorist attacks that demolished the World Trade Center towers and badly damaged the Pentagon. Despite the Federal Reserve's 50-basis-point rate cut, the Dow registered its largest point loss ever, closing 684.81 points or 7.1 percent below the previous close after being down more than 700 points during the trading session. Nasdaq registered a similar percentage loss, its second-largest ever for a single trading day.

**January 3, 2001.** After a surprise 50-basis-point rate cut by the Federal Reserve, Nasdaq surged 14 percent, its largest one-day percentage gain to date.

**December 29, 2000.** Ending a year that included the dot-bomb implosion, Nasdaq fell 39 percent, surpassing the previous record of a 35 percent decline in 1974. Nasdaq declined 51 percent from its March 10, 2000, high. Bellwether Internet stock Yahoo! declined 86 percent for the year. The Dow Industrials was down 6.2 percent for the year, its first year-over-year decline since 1990.

**April 14, 2000.** Nasdaq dropped 355.49 points or 9.67 percent after announcement of a 0.7 percent increase in the CPI, primarily due to rising oil prices. For the week ending April 14, Nasdaq fell 25.3 percent.



**April 3, 2000.** Nasdaq fell 349.15 points, or 7.6 percent, attributed to a 14 percent decline in Microsoft's stock price and fear that was sparked by the anticipated antitrust ruling against the company, which was announced after market close.

**March 29, 1999.** After flirting several times with the 10,000 mark, the Dow finally closed above that level for the first time.

**November 6, 1998.** As a sign of the loss of confidence in the Japanese banking sector, government bill yields turned negative for the first time in modern history in Japan—or anywhere else. It was an indication that people would rather give money to the government for safekeeping than to the banks.

**September 20, 1998.** After weeks of market turbulence—as evidenced by the nearly 20 percent decline in the Dow Jones Industrial Average—precipitated by a Russian debt default, the Federal Reserve Bank of New York coordinated a rescue package of Long-Term Capital Management, a multibillion-dollar hedge fund run by the legendary John Meriwether that also counted among its management team two Nobel laureates, Myron Scholes and Robert Merton. Fifteen banks contributed a total of $3.5 billion to the rescue, which was considered necessary because Long-Term's failure was thought to pose a serious systematic risk to the financial system,

including jeopardizing the launch of the Euro in January 1999. The largest hedge fund failure to date, Long-Term's $4.8 billion in capital, at that time supporting positions in excess of $80 billion, down from $100 billion, was reduced another 90 percent in the market turmoil.

**October 28, 1997.** Despite a 13 percent drop in Hong Kong following a rout in New York during the previous trading session, the U.S. market rebounded with a vengeance, with the Dow rising 337 points on record volume of more than 1.2 billion shares on the NYSE and more than 1.3 billion shares on Nasdaq.

**October 27, 1997.** Following turmoil in Asian markets, the DJIA plunged more than 350 points, triggering NYSE Rule 80B for the first time since its inception, which shut down the market for 30 minutes. At about 3:30 PM Eastern time, the DJIA had dropped 554 points, halting trading for the rest of the day in the largest one-day point decline ever.

**November 20, 1996.** For the first time in the recorded history of the U.S. equity markets, the total capitalization of U.S. stocks exceeded the value of U.S. gross domestic product. Historically stock value had averaged about 48 percent of GDP.

**March 8, 1996.** A stronger-than-expected employment report sent the 30-year T-bond skidding. Long-bond futures were down the limit before the equity markets opened, and they closed at the limit. The limit-down close, an incredible three points, marked the first time that had happened in the history of the T-bond contract. (In 1990 there had been an intraday limit that was down more but the bond contract closed off its low.) S&P 500 futures opened down 12 points, triggering an immediate limit. By the end of the day, the 30-year bond dropped 3.5 percent, the third-worst decline in recent history. The Dow and S&P 500 both declined just over three percent.

**November 2, 1995.** In an unprecedented move, the Federal Reserve ordered Daiwa's U.S. operations to close within 90 days. A bond trader at Daiwa, then Japan's 10th largest bank, incurred a loss of $1.1 billion from 1983 through 1995, and senior management officials apparently took part in a cover-up.

**July 19, 1995.** Technology bellwethers Intel and Microsoft took the wind out of the high-flying sector, at least temporarily, with a respective disappointing earnings report and forecast after the market's close on what has come to be known as Technology Tuesday. The Nasdaq Composite dropped 3.6 percent the next day.



**December 6, 1994.** Orange County, California, filed for bankruptcy, the largest municipal bankruptcy in U.S. history. Orange County was unable to meet a $1.25 billion margin call due that Tuesday following a bet on leveraged interest rate derivatives that went sour to the tune of a $1.5 billion paper loss.

**September 22, 1994.** D. Blech & Co.'s brokerage arm fell below capital requirements and was shut down by regulators, triggering a slide in many biotech issues supported by D. Blech in what came to be known as Blech Thursday.

**February 14, 1994.** Treasury prices plunged in the week of the St. Valentine's Day Massacre, 10 days after the Federal Reserve raised the fed funds rate by 25 basis points, reversing a five-year trend. The 30-year bond jumped from a 6.2 percent yield to 6.62 percent four days later. Hedge fund managers who had racked up huge profits the preceding year suffered serious losses.

**October 1993.** The 30-year bond hit a 30-year low with yields at 5.75 percent.

**April 2, 1993.** Price cuts announced by Philip Morris led to a sell-off in consumer non-durable stocks on Marlboro Friday.

**April 1992.** Real estate giant Olympia and York filed for bankruptcy, succumbing under the weight of Canary Wharf.

**August 1990.** U.S. military units invaded Iraq, leading to the so-called Saddam sell-off. August 6 marked the first time that the T-bond futures contract made a three-point limit-down move, although it closed off its lows.

**October 19, 1987.** The DJIA declined 23 percent on Black Monday. Further declines occurred on Terrible Tuesday, but the market more or less recovered by year-end.

**July 1986.** Spot oil prices hit a modern-era low of less than $7 a barrel.

**September 22, 1985.** The G5 group of nations agreed on a dollar-reduction plan, known as the Plaza Accord.

**May 9, 1984.** A run on Continental Illinois, then the seventh-largest U.S. bank, started in Tokyo money markets. The largest bank run in U.S. history ended with a federal bailout eight days later after a capital infusion of $4.5 billion from the FDIC and the Federal Reserve's extension of $8 billion in emergency loans. No depositor lost a dime. The precedent that large banks will not be permitted to fail thus was firmly established.

**August 13, 1982.** Mexican officials informed the U.S. government on that Friday that Mexico's reserves had dwindled to $200 million. With capital fleeing the country at the rate of $100 million a day, the nation would be broke by the following Monday and would likely default on more than $80 billion in debt mostly owed to U.S. and European money center banks. Negotiations spearheaded by Federal Reserve Chairman Paul Volcker resulted in an unprecedented $3.85 billion bailout package. Close Federal Reserve supervision of banks with loan-to-developing-country, or LDC, loans on their books continued until early 1987 when the affected banks, led by Citicorp, set aside reserves to cover potential loan losses.

**December 19, 1980.** The prime rate hit an all-time high of 21 percent.

**December 1980.** Spot oil prices rose above $40 a barrel, setting records.

**March 27, 1980.** On what was later dubbed Silver Thursday, the attempt by the Hunt Brothers of Texas to corner the silver market ended. The price of silver plunged to $10.80 an ounce from $21.62 an ounce the day before. Two months earlier silver had changed hands at a high of $52 an ounce. The silver crisis touched off the Panic of 1980, which sent the Dow from 903.84 in February down to 759.13 in April.

**January 20, 1980.** The price of gold hit an all-time high, exceeding $850 an ounce.



**August 23, 1976.** The price of gold hit a modern-era low of under $104 an ounce.

**October 1975.** The Chicago Board of Trade pioneered trading of exchange-listed futures based on a fixed-income instrument, opening the door to a variety of such investment vehicles.

**October 22, 1973.** The Arab oil embargo was put in place.

**April 26, 1973.** The Chicago Board of Options Exchange commenced trading, establishing the options market.

**August 15, 1971.** The United States pulled out of the 1946 Bretton Woods system of fixed exchange rates. No longer could the dollar be converted to gold.

**ONE-ON-ONE**

# Comprehending the Capital Markets

## Necessity or Convenience?

*Andrew Cader keeps an eye on the capital markets from his position as co-chief executive officer of the securities firm Spear, Leeds & Kellogg, which has been part of The Goldman Sachs Group since 2000.* IRQ *interviewed Mr. Cader December 19, 2001.*

**IRQ:** How would you assess the changes in the market environment in the past year or so?

**MR. CADER:** The markets are in constant change, and the environment is always changing. Naturally there are periods when the rate of change is accelerated and changes can be dramatic, as they have been recently. I have learned that there is no such thing as a static environment.

Recently we had to contend with a surprisingly quick change in the macro-economic environment. Over time, this period probably won't appear markedly different from other periods of economic slowdown and business-cycle fluctuations. This one was characterized by valuations that became far too high and then came down so quickly that when combined with a

slowdown in economic activity, the result was a real lack of investor confidence and a lack of visibility in the operating environment. What was cause and what was effect is still too early to tell. All of these issues quickly converged on Wall Street — quite noticeably — since supply and demand and the level of capital market activity drive the Street.

Then came September 11. The markets turned extremely volatile and went down quickly. And, as they often do, they reversed themselves and came back. In the final analysis, I don't think the terrorist attacks caused great fundamental changes in the markets.

**IRQ:** What issues do you think are most likely to affect companies' relationships with the market in the next one to three years?



**MR. CADER:** Whatever those issues are, I don't think they really will be much different from what they were last year or the year before. Corporate managers will need to be aware that in the last few years, dramatic price swings have become more commonplace. IR professionals will need to keep a close watch on what is driving the market as a whole and, more important, on what is affecting their companies specifically. For our part, we will keep an eye on the ebb and flow of business, pricing and competition — the usual things that drive managers' decision-making. We will also be vigilant in keeping our companies well-informed of developments that are affecting the markets in their individual stocks.

**IRQ:** From your perspective, what are the primary issues facing the capital markets?

**MR. CADER:** From the perspective of Spear, Leeds & Kellogg and Goldman Sachs, I think a lot about the stock exchanges, ECNs and Nasdaq. What I follow particularly closely are volume trends as they move from one market to another. I also watch the changes in the structure of certain markets, new competitors, changes in rules — those kinds of things.

**IRQ:** Let's focus on electronic communications networks for the moment.

**MR. CADER:** For a number of years I have maintained that ECNs are commodity providers of the same service, even as they try to differentiate themselves. Some have different bells and whistles or pricing structures, but essentially they all do exactly the same thing.

Because the New York Stock Exchange has many of the same features as an electronic network, I think it will be challenging for the ECNs to compete effectively. The NYSE has an order book, which routes orders electronically. Those orders arrive at the specialist's book, are executed and then returned to the sender. It's not exactly the same process as an ECN because the orders aren't paired electronically. Instead, they are exposed to a public auction that includes agent representatives. In the end, theoretically — and I believe realistically — this process leads to better pricing.

It is not an accident that ECNs have not gained traction in the listed world. The ECNs offer transparency and coherent electronic access, two elements that the stock exchanges already have. Consequently, I do not think the ECNs will take business from the New York Stock Exchange, especially since it continues to add features like those offered by ECNs, such as different kinds of auto execution and the ability to take a look at the whole book.

**IRQ:** In this fragmented market, what do you think IR officers and their companies should be doing?

**MR. CADER:** The pieces of the market structure are in place. The markets exist in the first place because their customers want an efficient way to find one another. Without this efficiency, buyers and sellers do not tend to appear at the same time and place and — importantly — with the same quantity of shares to trade at the same price.

Technology is making it possible for customers to make these kinds of matches without an intermediary. The good news for Wall Street is that such activity happens only a modest percentage of the time. The rest of

the time customers either need an agent to help them execute the order more efficiently or they need a principal to take the other side of the order. The current array of markets and opportunities covers the gamut as far as finding the other half of an execution is concerned.

Given all of those factors, I think that IR professionals must understand the market mechanism and stay on top of change.

**IRQ:** Recognizing that where a company trades can affect its visibility and perception among investors, what factors should it take into consideration in making decisions about whether and where to list?

**MR. CADER:** Every company has different needs. I understand those companies that consider an exchange to be just a place where shares trade. Their question is why pay money to be part of it when there are alternatives. Shares exist and people will trade them regardless of place, their reasoning goes.



I think, however, that every large company will continue to want to be listed on the New York Stock Exchange or Nasdaq, even if its shares are traded somewhere else to a certain extent. There are regulatory, public relations and shareholder value considerations to being part of an organized exchange that does its best to ensure that trading is equitable.

Then the question boils down to New York Stock Exchange versus Nasdaq. Both do an excellent job with providing liquidity on either market. The New York Stock Exchange has some features that Nasdaq does not offer, such as the specialist's affirmative obligation and the ability to provide insight from a trading floor where 85 percent of the action is taking place. By contrast, a Nasdaq-listed company may be speaking to someone who trades 15 percent to 20 percent of the shares. The New York Stock Exchange is slightly more expensive, and some companies care a lot about that.

**IRQ:** What about volatility and certain other characteristics that are not company-specific?

**MR. CADER:** Volatility is a fact of life to a certain extent because stocks go up and down no matter what system you have.

Investors do care about volatility, however. A subset of investors prefers volatility because it creates opportunities. Even so, when U.S. equity markets are the subject of discussion at the congressional or SEC level, it is generally agreed that volatility is something you would rather have less of than more of.

If anything were going to scare people out of the market, it would have been Nasdaq going from 5000 to 1500 with huge volatility and consequent losses. On balance, that did not really scare investors away from the market. It scared certain people, but it created opportunities for others. Interestingly, participants are not necessarily driven away from the market by volatility.

Institutions for sure and individuals to a greater extent than one might think accept the fact that volatility is part of market behavior. Understanding why there is more or less volatility during any given period is certainly a part of what we all do, whether we are analysts, traders, IR practitioners or CEOs. Usually the reasons are not too hard to figure out because they are either industry-, news- or market-related.

**IRQ:** Could you summarize your perspective now compared with what you saw dominating the capital markets conversation five or 10 years ago?

**MR. CADER:** Looking at secondary market trading over my 20-year career, I've seen that every year it gets less expensive for the clients because technology, competition and scale all allow the secondary markets, including the exchanges and the capital providers, to deliver more for less cost. The good news for Wall Street is that the same reasons that bring costs down are the ones that encourage our clients to trade more often. It is simple. When you make something cheaper and better, people will consume more of it.

One area that we must watch is that we have been spoiled by volume,

which has been going up and up for so many years in a row. We have to remind ourselves that there will be periods when it does not, and we must ready ourselves to respond.

**IRQ:** What do you see as IR officers' responsibilities as far as their companies' market experience is concerned?

**MR. CADER:** Part of an IR professional's responsibility is to understand what factors are making the company's stock move and how that is likely to change. They must also set the expectations of their specialist, market makers, bankers and so on as their roles relate to market movement. IR practitioners need an up-to-date understanding of the markets, the players and who is doing what to whom in the marketplace.



There is a wide range of familiarity with these issues in the IR community. I find that most IR practitioners are really savvy about what a specialist or market maker does, what a block desk does, what the third market is, etc. An IR officer has to work hard at being informed about the various market constituents and how they can help or hurt trading efficiency.

**IRQ:** What developments do you see taking place in the relationship between the American markets and foreign exchanges?

**MR. CADER:** Technology has made it possible for markets to be open 24/7, but trading patterns thus far suggest that there really is not enough liquidity to spread trading over that many hours. The more hours the market in a stock is open, the more difficult it is to match orders efficiently. It does not appear likely that there will be as much U.S. trading outside of U.S. market hours as many have predicted. And if there is, U.S. markets will react by expanding their hours to respond efficiently.

In the meantime, the fairly small number of market participants who actually want to buy or sell a stock at three o'clock on a Saturday morning can find a place to do that. The truth of the matter is that there are not many other people trading at the same time, so unless investors have a

deep urgency to trade then, they are not likely to get as good an execution as if they trade when more orders are represented in the marketplace.

**IRQ:** That takes us back to the earlier description of the exchange as providing market convenience.

**MR. CADER:** Every attempt to open the markets longer in order to accommodate a great deal more trading has been met with a yawn. I do not see that changing in the near future.

European and Asian institutions that hold U.S. stocks have U.S. subsidiaries. It does not appear to be a hardship for them to do their trading during U.S. hours. Even for non-U.S. equities that have ADRs listed on U.S. exchanges, with a few exceptions the trading activity still seems to be taking place mostly in the home market.

The market is neither more nor less than a group of participants. Because of the history of time and place and the facility of the exchanges and intermediaries, there has evolved what seems to be a fairly successful set of ideas as to how many hours and how many days the market should be open.

# Learning Curve

## Investors Apply Evidence of How Earnings Surprises Affect Returns



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THE APPARENT PREDICTABILITY OF STOCK RETURNS FOLLOWING quarterly earnings announcements remains one of the most significant and perplexing capital market anomalies uncovered to date. More than 40 studies have documented a post-earnings-announcement drift in stock returns — the tendency of share prices to rise during the nine months after the announcement of a large positive quarterly earnings surprise or to fall after a negative one.

Taken at face value, this drift presents a serious challenge to capital market efficiency because it means that pure economic profits in the form

of abnormal stock returns can be earned by trading on publicly available information such as quarterly earnings announcements. Although it contradicts traditional notions of market efficiency, the post-earnings-announcement drift has become scientifically indisputable. The phenomenon has been replicated consistently, and with increasing precision, since its discovery in 1968 by Ray Ball and Phillip Brown.

Programming errors, chance variation and potential research-design flaws, including failure to control fully for risk, cannot explain the drift. Nor can it be traced entirely to transaction costs or liquidity and trading-mechanism effects. Indeed, the apparent source of the drift is the failure of share prices to reflect fully what current earnings surprises generally imply about earnings surprises in subsequent quarters.

Research conducted by Ball and Eli Bartov in 1996 showed that investors underestimate the serial correlation in quarterly earnings surprises by about 50 percent. As a result, when subsequent quarters' earnings are announced, share prices appear to reflect a certain amount of surprise that should have been predictable in advance.

Ball offers a second plausible explanation for the drift anomaly. Rather than being a true market inefficiency traceable to investors' use of earnings information, the drift could instead be due to substantial costs of implementing the trading strategies simulated by researchers. Whatever the cause, he concludes that the drift is likely to be an enduring feature of the relation between earnings surprises and post-announcement stock returns.

This paper is based on research completed in 2000, which replicated earlier research in order to calibrate our data collection and analysis procedures and extended the investigation for 1991 to 1997, the latest period for which all necessary data were available. Our results showed that profit opportunities that previously were associated with trading strategies designed to exploit the drift anomaly have been substantially eliminated. That is

consistent with a 1999 study by Lawrence Daniel and Sheridan Titman that allows for the existence of profit opportunities in historical data but shows that those profit opportunities dissipate once they become widely apparent to investors.

Our research also demonstrated that the results could not be attributed just to increased earnings noise from transitory items or to structural changes in the serial correlation of earnings surprises. We found that the serial correlation in quarterly earnings surprises has remained relatively stable even though transitory income statement items were more frequent in the 1991-1997 period than in the past.



Transitory items introduce noise into the simple trading strategies that we investigated, but this noise does not explain our results. Instead, it appears as though investors no longer underestimate the serial correlation in quarterly earnings surprises to the degree documented previously. It appears that as investors learn about earnings-surprise profit opportunities, they tilt their portfolios toward strategies that are designed to arbitrage the opportunities, and this alters the behavior of post-earnings-announcement stock returns. Implementation costs continue to play an important role by limiting the extent of arbitrage.

Finally, our research showed that post-announcement drift persists among small New York and American Stock Exchange firms, firms with little or no analyst coverage and firms with low stock prices. These profit opportunities do not appear to be large enough to exploit.

## Previous Research

In what is perhaps the best-known study of post-earnings-announcement drift, Victor Bernard and Jacob Thomas in 1990 documented the phenomenon for a sample of approximately 85,000 quarterly earnings announcements by NYSE and AMEX firms between 1974 and 1986.

They assigned firms to 10 portfolios on the basis of their standardized unexpected earnings. To determine the appropriate decile, a firm's SUE for a given quarter was compared with the distribution of all sample firms' SUEs from the prior quarter. Abnormal, or size-adjusted, daily stock returns for each portfolio were cumulated beginning the day after the earnings announcement in order to estimate the post-announcement drift.

Several key features of the drift phenomenon are illustrated in Figure 1. Over the four quarters (about 250 trading days) beyond the earnings announcement, a combined zero investment long position in firms with extreme

**FIGURE 1: POST-EARNINGS-ANNOUNCEMENT DRIFT 1974–1986**


Source: Bernard and Thomas, 1990.

Portfolio CAR is the percentage cumulative abnormal return over holding periods beginning after the earnings announcement day for quarter Q0, for a portfolio invested long (short) in the highest (lowest) decile of SUE that quarter. Earnings announcements are assigned to deciles based on the standing of SUE relative to the prior quarter SUE distribution. SUE represents forecast errors from the Foster 1977 first-order autoregressive earnings expectation model (in seasonal differences) scaled by their estimation-period standard deviation. Size-adjusted returns are the sums over the post-announcement holding periods of the difference between daily returns and returns for all NYSE and AMEX firms of the same-size decile, based on January 1 market values of equity. Holding periods are obtained by splitting the period between adjacent quarterly earnings announcement dates into a three-day preannouncement window (day –2 today 0) and an interannouncement window. While the actual interannouncement windows vary in length, the main value of 60 trading days is used to illustrate the differential price responses occurring in the two windows.

positive earnings surprises and a short position in firms with extreme negative surprises generated an abnormal return of approximately 8.6 percent.

The magnitude of this post-earnings-announcement price movement is both economically and statistically significant, especially for small and medium-sized firms. Their cumulative abnormal returns were about 10 percent over the four quarters. Moreover, for companies of all sizes, the estimated post-announcement abnormal returns are nearly two-thirds as large as the returns that occurred during the quarter leading up to and including the earnings announcement.

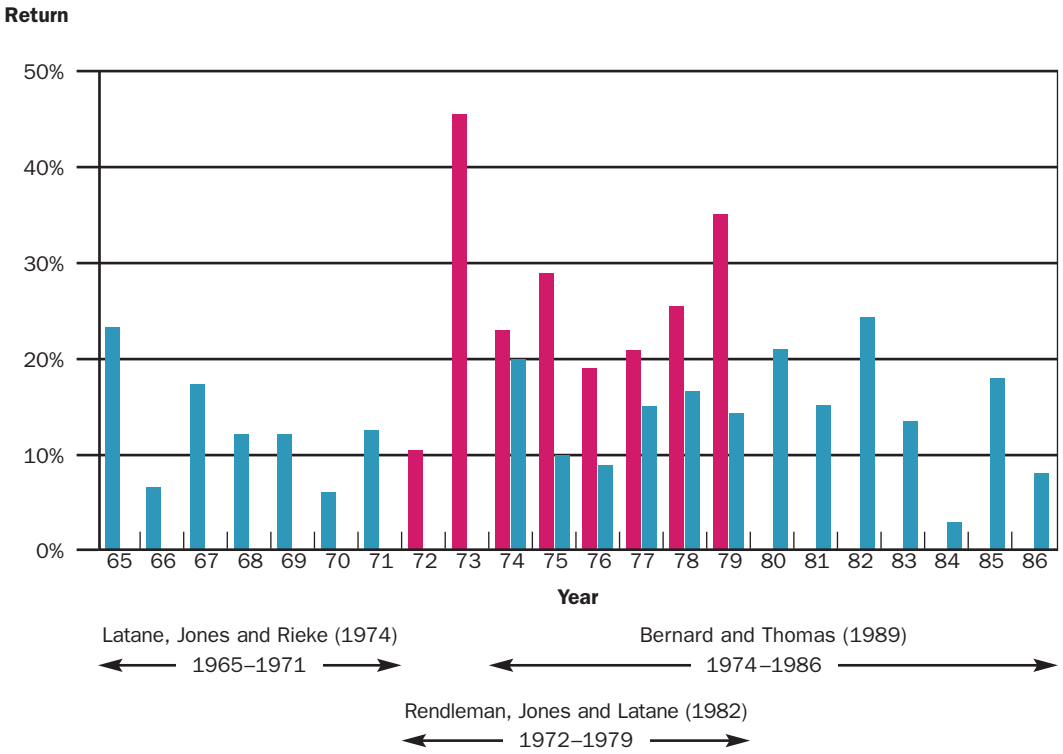


A second important feature of the drift phenomenon is that about 25 percent of the overall share price movement occurred when the next four quarterly earnings announcements were released. Earnings surprises tend to include both permanent and temporary components, and about 40 percent of the initial earnings surprise would typically persist as an earnings surprise one quarter later, with progressively smaller amounts persisting in the second and third subsequent quarters.

Even though investors should be aware that, on average, an earnings surprise in one quarter will be followed by three additional earnings changes in the same direction, the market seems surprised when such a pattern occurs. The market also seems surprised that, on average, there is a partial reversal of the earnings trend in the fourth quarter out, even though this pattern also is to be expected.

A third feature of the drift phenomenon is its remarkable stability over time. Figure 2 combines the evidence from three prominent studies of post-earnings-announcement drift that disclose returns to an SUE trading strategy on a year-by-year basis. These studies indicate that portfolios with long positions in extreme-positive SUE stocks and short positions in extreme-negative SUE stocks generated positive estimated abnormal returns in each year from 1965 though 1986.

## FIGURE 2: EARNINGS SURPRISE TRADING STRATEGY ANNUAL RETURNS




Sources:

Latane, Jones and Rieke (1974).

Long (short) positions in stocks with SUE greater than (less than) 1.5 are taken two months after the end of the fiscal quarter and held for six months. Returns are not adjusted for risk. Returns shown above are calculated first by annualizing six-month returns taken each of the four quarters. Annualized returns from each quarter are then summed to arrive at the calendar-year portfolio return. The return for 1971 is based on the sum of only two six-month positions.

Rendleman, Jones and Latane (1982).

Long (short) positions are taken in 20 stocks with the highest (lowest) SUEs among a universe that grows from 170 to 972 stocks. The universe includes only stocks announcing earnings within one month of the fiscal quarter close. Market-neutral positions are taken at the beginning of the next month and held for three months. Returns from four three-month holding periods are summed to arrive at the calendar-year portfolio return.

Bernard and Thomas (1989).

Long (short) positions are taken in stocks among the top (bottom) quintile of SUE, relative to the prior quarter SUE distribution. Each $1 long position is always offset by a $1 short positions in stock(s) of similar size. Returns are not adjusted for risk. Returns are reported for calendar quarters and summed to arrive at the annual return. The return for 1986 is based on only nine months. Adapted from Bernard (1993).

The drift phenomenon is largely unaffected by changes in macro-economics of the sort that occurred during those years. Nor does seasonality appear to influence the drift. Over the 50 calendar quarters from 1974 to 1986, the estimated abnormal returns for a zero investment portfolio of extreme SUE stocks were positive 46 times, and the gains in those quarters exceeded the cumulative losses by a factor of 35-to-1, according to Bernard and Thomas' 1989 research.

Therefore, the profit opportunity associated with an SUE trading strategy appears to be significant economically and to be available nearly every quarter.



The demonstrated predictability of stock returns after quarterly earnings announcements is a troubling contradiction to theories of capital markets efficiency.

The reasoning goes as follows. Market efficiency is a simple application of the theory of competition in which there are returns to economic activity. Because investors are presumed to make optimal decisions based on the information available to them, opportunities to earn extraordinary returns arise only from private information. Public information about a company, such as a significant earnings surprise, is quickly and accurately incorporated into its share price as investors buy and sell on that information. If stock prices are efficient and correctly incorporate all public information, opportunities to earn extraordinary returns from an SUE trading strategy are precluded.

One efficient markets explanation for the drift anomaly argues that the higher returns that are available from an SUE trading strategy must be compensation for higher systematic risk. Indeed, extreme positive or negative earnings surprises are accompanied by risk increases or decreases that persist into the post-announcement period. But these shifts are far too small to explain fully the magnitude of the drift. Nor are extreme SUE

portfolios risky along any of the dimensions commonly associated with tests of arbitrage pricing theory.

A second market efficiency argument is that the drift occurs because researchers use a flawed proxy for expected earnings and thus inaccurately gauge the earnings surprise. Using a better earnings expectations model — one that more accurately reflects the earnings forecast embedded in stock price — presumably would mitigate the drift. Earnings forecasts by security analysts are more accurate than those produced by time-series models. However, the post-announcement drift has been found to be about 50 percent larger when earnings surprises are measured relative to analysts' forecasts rather than statistical forecasts. Moreover, professional analysts also are prone to underestimate the serial correlation in quarterly earnings surprises when revising their earnings forecasts for subsequent quarters.

In short, various studies have shown that post-earnings-announcement drift cannot be explained as a byproduct of programming errors, chance variation or research design flaws such as an inappropriate adjustment for risk or use of the wrong model of expected earnings.

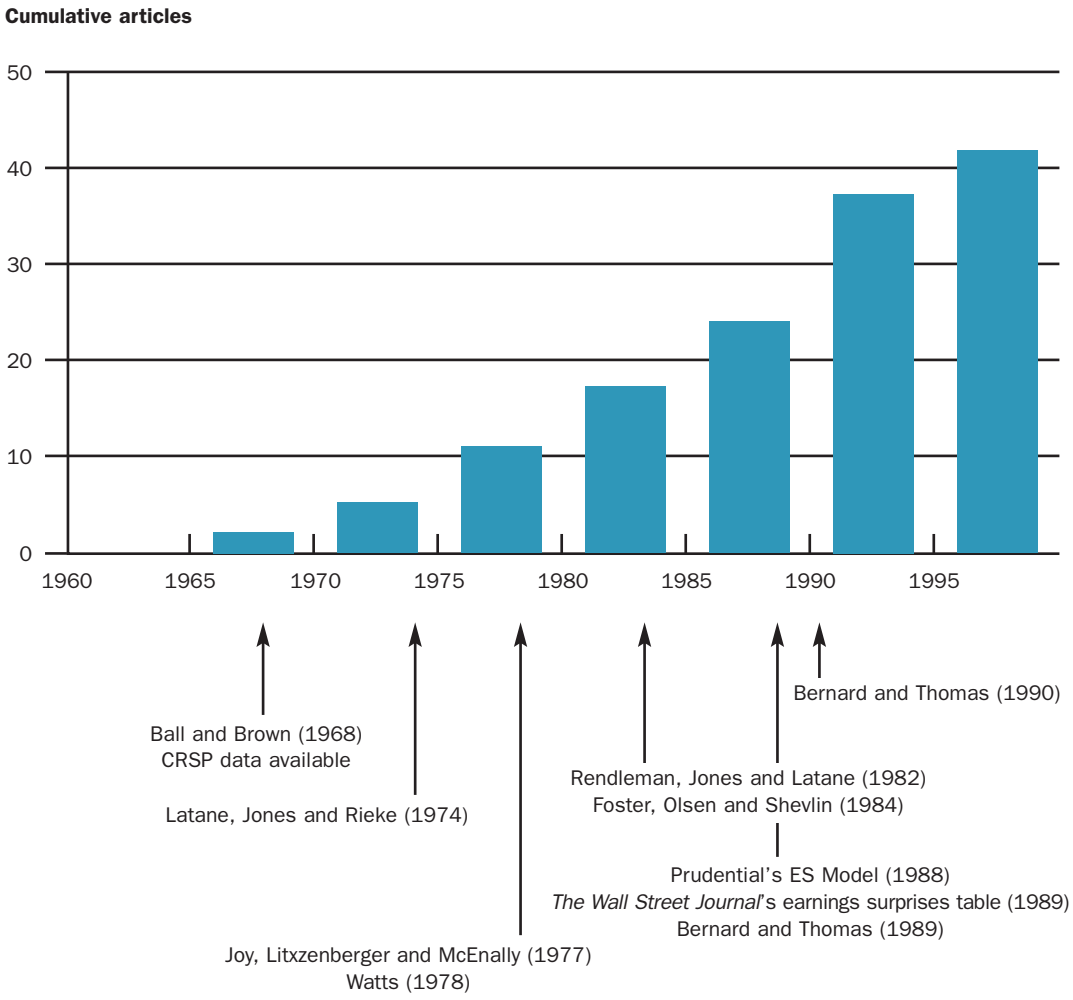
Ball offers two plausible explanations for post-earnings-announcement drift, both of which imply that the anomaly may be a permanent feature of the capital market. One possibility is that market participants routinely use earnings information inefficiently, leaving unexploited the pure economic profit opportunities documented in Figures 1 and 2. Why this occurs is not clear. A second possibility is that it is just not cost-efficient for investors who are aware of the post-announcement drift to arbitrage the profit opportunity.

In either case, if the drift is an enduring feature of the capital market, the post-announcement stock return pattern depicted in Figure 1 will persist beyond 1986, the stopping point for many other studies of the drift phenomenon.

Real-world investors, like academics, can learn only imperfectly about pricing anomalies like the post-announcement drift from the past pattern of stock returns and thus are likely to eliminate the anomalies only after some lag. Before the mid-1960s it would have been extremely costly for real-world investors to undertake the type of analysis that is required to detect and quantify the behavior of post-earnings-announcement stock returns. Few, if any, investors had access to the powerful computers, asset

**FIGURE 3: EMPIRICAL RESEARCH ARTICLES**





return data or analytical tools that are necessary to evaluate the risks and returns of earnings surprise portfolios. By the late 1980s, however, post-earnings-announcement drift was well-established in the academic and professional literature.

Figure 3 traces the evolution of post-earnings-announcement drift research from 1960 through 1999 and identifies key dates during that period. Twenty-five research articles on the topic were published by the end of 1989. These articles uncovered the phenomenon, calibrated its profit potential, provided rigorous empirical validation, and described how to implement SUE trading strategies for economic gain.

In August 1989 *The Wall Street Journal* began publishing a table of earnings surprises, because, it said, "earnings surprises are perhaps the most important type of new information that can quickly change investor expectations about a stock." About the same time, Prudential Securities introduced its quantitative earnings surprise investment model. Based on what was then described as the cockroach theory of earnings surprises — because like cockroaches, there is rarely just one — the model was developed specifically to exploit the serial correlation in quarterly earnings surprises relative to analysts' consensus forecasts.

## Application to Investing Strategies

Consider the investment behavior of a hypothetical investor who possesses the sophistication and perseverance to read, digest and assimilate the post-announcement drift literature as it becomes available in print. Suppose the investor started trading in the late 1980s after learning about the drift and had a tendency to tilt the portfolio toward strategies that exploit the anomaly. By doing so, the investor would benefit from an SUE trading strategy if the excess returns persisted. If the investor aggressively tilted toward an SUE strategy and if the previous performance indeed persisted,

profits could be quite large. If the investor tilted only cautiously toward the SUE strategy, realized profits could be modest, even if the strategy itself earned large excess returns since the late 1980s.

Unfortunately, it is difficult to determine how aggressively the investor should tilt the portfolio toward SUE strategies that performed well in the past. On the one hand, our investor is persuaded by the research evidence on post-earnings-announcement drift and calculates that the past profit opportunities from an SUE trading strategy exceed implementation costs. On the other hand, the investor might be less certain about why the drift occurred in the past, whether it will persist in the future, and whether other knowledgeable investors also have begun to trade on the anomaly. If all informed investors attempt to exploit the post-announcement drift, they can push prices to a level where the SUE profit opportunity disappears.



In determining how aggressively to tilt a portfolio toward an SUE trading strategy, our investor would need a theory of inefficient markets that helps explain the extent to which the irrational behavior that is causing the pricing errors is likely to persist. Our investor would also need to have some idea of the extent to which other rational investors are uncovering the same pricing anomaly and altering their portfolios to exploit the phenomenon. Investors who believe that they are the only ones doing this sort of analysis would strongly tilt their portfolios toward the SUE strategy because it has performed well in the past. However, investors who believe that SUE-related pricing inefficiencies are being corrected by other active investors might choose not to tilt at all toward the historically better SUE strategy.

It is difficult to predict how quickly investor competition will dissipate the post-announcement drift profit opportunity once it becomes widely apparent to investors. Implementation costs and other limits to arbitrage also make it difficult to predict the extent to which the drift anomaly will be eliminated by investor competition.

The dashed line in Figure 1 illustrates one possibility. Here, the drift is smaller in magnitude and concentrated in just a few trading days immediately after the initial earnings announcement. Both features are consistent with investor learning and decreased arbitrage costs. Complete elimination of the drift would result in post-announcement abnormal stock returns indistinguishable from zero.

## Potential Reasons for Post-Earnings-Announcement Drift

As part of our research project, we made empirical predictions to establish boundary conditions for interpreting possible results. As such, our predictions are derived from three different but not mutually exclusive explanations for post-earnings-announcement drift.

One explanation is that market participants use earnings information inefficiently, perhaps because the cognitive heuristics they employ are prone to systematic error.

A second explanation is that arbitrage costs, defined broadly to include information acquisition and implementation costs, exceed the expected returns to SUE trading strategies as simulated by researchers. According to Ball's 1992 research, both factors — inefficient use of earnings information and costly implementation of simulated SUE trading strategies — are likely to be permanent features of the capital market.

Our third explanation for the drift relies on the notion of an adaptive-efficient market where pricing anomalies can be observed in historical data but are reduced or eliminated once they become apparent to investors.

If the post-announcement drift is an enduring market inefficiency, stock returns will continue to exhibit the pattern documented by Bernard and Thomas and illustrated by the solid line in Figure 1. Returns for a hedged portfolio of extreme earnings surprises will increase about 8.6 percent

over the 250 days following the initial earnings announcement, and a substantial portion of that increase will occur at the time of subsequent quarterly earnings announcements. Moreover, the magnitude of the post-announcement drift will be larger for small and medium-sized firms than for large firms.

On the other hand, if investors do indeed learn from published research, the magnitude and duration of the post-announcement drift in stock returns will be substantially diminished, as illustrated by the dashed line in Figure 1, or perhaps eliminated. Investor learning seems quite plausible in this setting, especially when the chronology of published research shown in Figure 3 is considered.



## Research Data and Procedures

To be included in our research, a firm had to be listed on the daily files of the Center for Research and Security Prices, and its earnings before extraordinary items and discontinued operations had to be available for at least 10 consecutive quarters on the Compustat primary, supplementary or tertiary industrial files. Compustat was also the source for earnings announcement dates. Our sample included 97,040 firm-quarters of data for 2,981 NYSE and AMEX firms for 1974 to 1986, the period examined by Bernard and Thomas, and 51,539 firm-quarters of data for 2,928 NYSE and AMEX firms in 1991 through 1997. We did not include the period from 1987 though 1991 because we cannot predict how quickly investors learn about the drift anomaly or, once they are aware of the drift, how quickly they implement strategies to arbitrage the SUE profit opportunity. Both 1989 and 1990 appear to have been pivotal years in the evolution of the post-announcement drift literature and in the ease with which earnings surprise trading strategies could be implemented using *The Wall Street Journal* tabulations or brokerage firm client research reports.

Applying our definition of standardized unexpected earnings as the

change in earnings before extraordinary items and discontinued operations relative to the equivalent quarter the previous year, detrended and scaled by the standard deviation of SUE over the trend estimation period, we assigned each quarterly earnings announcement to an earnings surprise decile based on its SUE ranking in the sample distribution of all announcements for the prior quarter. Announcements with the lowest SUE values were assigned to earnings surprise decile 1, those with highest SUE values to decile 10. Hedged portfolio returns were formed by taking

**TABLE 1: POST-EARNINGS-ANNOUNCEMENT DRIFT, 1974**

**Panel A: Market reactions to future earnings announcements based on current earnings surprise information.**

| SUE portfolio formed in quarter t | Holding period relative to earnings announcement for quarter t | Percentage abnormal return in quarter t+k for earnings surprise portfolios formed in quarter t | | | |
|---|---|---|---|---|---|
| | | t+1 | t+2 | t+3 | t+4 |
| ***Panel A.1:*** *Bernard and Thomas [1990, Table 2] – 84,792 firm quarters* | | | | | |
| Decile 10 (positive SUE) | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.76* | 0.44* | 0.13* | -0.22* |
| Decile 1 (negative SUE) | Three-day [-2, 0] CAR | -0.56* | -0.26* | 0.09 | 0.43* |
| Hedged portfolio | Three-day [-2, 0] CAR | 1.32* | 0.70* | 0.04 | -0.66* |
| Hedged portfolio | Sum of three-day announcement CARs | 1.32 | 2.02 | 2.06 | 2.72 |
| Hedged portfolio | CAR from the day after quarter t announcement | 5.69 | 7.48 | 8.10 | 8.61 |
| Hedged portfolio | Ratio of summed three-day CARs to total CAR | 23% | 27% | 25% | 31% |
| ***Panel A.2:*** *Replication results – 97,040 firm quarters* | | | | | |
| Decile 10 (positive SUE) | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.90* | 0.54* | 0.21* | -0.20* |
| Decile 1 (negative SUE) | Three-day [-2, 0] CAR | -0.45* | -0.30* | 0.18* | 0.54* |
| Hedged portfolio | Three-day [-2, 0] (CAR) | 1.36* | 0.84* | 0.03 | -0.74* |
| Hedged portfolio | Sum of three-day announcement CARs | 1.36 | 2.20 | 2.23 | 2.97 |
| Hedged portfolio | CAR from the day after quarter t announcement | 6.10 | 7.88 | 8.11 | 8.61 |
| Hedged portfolio | Ratio of summed three-day CARs to total CAR | 22% | 28% | 27% | 34% |

CARs are sums over specified holding periods of the difference between daily returns and returns for NYSE-AMEX firms of the same size decile. SUE represents forecast errors from a seasonal random walk with drift earnings expectation model, scaled by their estimation-period standard deviation. Portfolios are formed by grouping earnings announcements into deciles based on the distribution of SUE for the previous calendar quarter. The hedged portfolio involves a zero investment long position in stocks with extreme positive earnings surprises (SUE decile 10) and an offsetting short position in stocks with extreme negative earnings surprises (SUE decile 1). Following Bernard and Thomas (1990), long and short portfolio positions are reversed after quarter t+3 in panels A and B. Small, medium and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms. Day 0 is the quarterly earnings announcement date. An * denotes statistical significance at the 0.01 level, two-tailed tests. Bernard and Thomas (1989, 1990) do not report test results for all summary statistics in their tables.

## TABLE 1: POST-EARNINGS-ANNOUNCEMENT DRIFT, 1974 (CONT.)

**Panel B: Market reactions to future earnings announcements for high and low earnings surprise portfolios by firm-size group.**

| SUE portfolio formed in quarter t | Holding period relative to earnings announcement for quarter t | Percentage abnormal return in quarter t+k for earnings surprise portfolios formed in quarter t | | | |
|---|---|---|---|---|---|
| | | t+1 | t+2 | t+3 | t+4 |
| ***Panel B.1:*** *Bernard and Thomas [1990, Table 4] – 84,792 firm quarters* | | | | | |
| Small firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 1.92* | 0.82* | 0.10 | -1.15* |
| | Sum of three-day announcement CARs | 1.92 | 2.74 | 2.84 | 3.99 |
| | CAR from the day after quarter t announcement | 7.58 | 9.79 | 10.52 | 11.40 |
| Medium firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 1.46* | 0.98* | 0.21 | -0.44* |
| | Sum of three-day announcement CARs | 1.46 | 2.44 | 2.65 | 3.09 |
| | CAR from the day after quarter t announcement | 6.64 | 9.04 | 9.81 | 9.97 |
| Large firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.84* | 0.48* | 0.04 | -0.31* |
| | Sum of three-day announcement CARs | 0.84 | 1.32 | 1.36 | 1.67 |
| | CAR from the day after quarter t announcement | 3.23 | 4.26 | 4.25 | 4.91 |
| ***Panel B.2:*** *Replication results – 97,040 firm quarters* | | | | | |
| Small firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 1.99* | 1.00* | 0.00 | -1.40* |
| | Sum of three-day announcement CARs | 1.99 | 2.99 | 2.99 | 4.39 |
| | CAR from the day after quarter t announcement | 8.27 | 10.81 | 11.38 | 12.50 |
| Medium firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 1.43* | 1.03* | 0.25* | -0.36* |
| | Sum of three-day announcement CARs | 1.43 | 2.46 | 2.71 | 3.07 |
| | CAR from the day after quarter t announcement | 6.92 | 9.27 | 9.81 | 9.45 |
| Large firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.81* | 0.53* | -0.06 | -0.46* |
| | Sum of three-day announcement CARs | 0.81 | 1.34 | 1.28 | 1.74 |
| | CAR from the day after quarter t announcement | 3.71 | 4.39 | 4.25 | 4.79 |

CARs are sums over specified holding periods of the difference between daily returns and returns for NYSE-AMEX firms of the same size decile. SUE represents forecast errors from a seasonal random walk with drift earnings expectation model, scaled by their estimation-period standard deviation. Portfolios are formed by grouping earnings announcements into deciles based on the distribution of SUE for the previous calendar quarter. The hedged portfolio involves a zero investment long position in stocks with extreme positive earnings surprises (SUE decile 10) and an offsetting short position in stocks with extreme negative earnings surprises (SUE decile 1). Following Bernard and Thomas (1990), long and short portfolio positions are reversed after quarter t+3 in panels A and B. Small, medium and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms. Day 0 is the quarterly earnings announcement date. An * denotes statistical significance at the 0.01 level, two-tailed tests. Bernard and Thomas (1989, 1990) do not report test results for all summary statistics in their tables.

an equally weighted long position in the portfolio of stocks assigned to SUE decile 10, the extreme positive earnings surprise firms, and a short position in stocks assigned to SUE decile 1, the firms with extreme negative earnings surprises.

## Research Results

Our research was designed to replicate prior results with our sample, to explore whether post-announcement drift had become less pronounced and, if that were the case, to consider whether that result could be explained by transitory earnings components that might contaminate our SUE portfolio assignment or by possible changes in the serial correlation of earnings surprises. Finally, we investigated whether analyst following and trading costs partially explain the small but persistent post-announcement drift that continued through 1997.

Table 1 verifies that prior results hold in our sample for the 1974-1986 period. Panel A reports market reactions to future earnings announcements for high (decile 10) and low (decile 1) earnings surprise portfolios and for a hedged portfolio that is long in SUE decile 10 and short in SUE decile 1. Our results, shown in Panel A.2, closely replicated those reported by Bernard and Thomas which are reproduced in Panel A.1.

Table 1's Panel B presents evidence for firms classified as small, medium and large, based on market values of equity for all NYSE and AMEX firms. Once again, our results closely replicate earlier findings, as shown in Panel B.2. The pattern is present in all three size-groups. Moreover, the four-quarter compound annual return for large firms (4.79 percent) is about one-half as large as that for medium-sized firms (9.45 percent) and nearly one-third as large as the compound annual return for small firms (12.50 percent).

Table 2 documents the substantial decline in post-announcement drift

## TABLE 2: POST-EARNINGS-ANNOUNCEMENT DRIFT, 1991-1997

| SUE portfolio formed in quarter t | Holding period relative to earnings announcement for quarter t | Percentage abnormal return in quarter t+k for earnings surprise portfolios formed in quarter t | | | |
|---|---|---|---|---|---|
| | | t+1 | t+2 | t+3 | t+4 |
| ***Panel A:*** *Market reactions to future earnings announcements based on current earnings surprise information (51,539 firm quarters)* | | | | | |
| Decile 10 (positive SUE) | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.52* | 0.47* | 0.29* | 0.20 |
| Decile 1 (negative SUE) | Three-day [-2, 0] CAR | 0.08 | 0.31* | 0.42* | 0.55* |
| Hedged portfolio | Three-day [-2, 0] CAR | 0.44* | 0.16 | -0.13 | -0.35* |
| Hedged portfolio | Sum of three-day announcement CARs | 0.44 | 0.60 | 0.47 | 0.82 |
| Hedged portfolio | CAR from the day after quarter t announcement | 4.35 | 5.27 | 5.47 | 5.70 |
| Hedged portfolio | Ratio of summed three-day CARs to total CAR | 10% | 11% | 9% | 14% |
| Hedged portfolio summed three-day CARs relative to 1974–1986 sample period | | 32% | 27% | 21% | 27% |
| Hedged portfolio total CAR relative to 1974–1986 sample period | | 71% | 67% | 67% | 66% |
| ***Panel B:*** *Market reactions to future earnings announcements for high and low earnings surprise portfolios by firm-size groups (51,539 firm quarters)* | | | | | |
| Small firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.95* | 0.18 | 0.09 | -0.51 |
| | Sum of three-day announcement CARs | 0.95 | 1.13 | 1.22 | 1.73 |
| | CAR from the day after quarter t announcement | 6.94 | 8.00 | 6.64 | 7.16 |
| | Summed three-day CAR relative to 1974–1986 | 48% | 38% | 41% | 39% |
| | Total CAR relative to 1974–1986 | 84% | 74% | 58% | 57% |
| Medium firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.29 | 0.22 | -0.21 | -0.35 |
| | Sum of three-day announcement CARs | 0.29 | 0.51 | 0.30 | 0.65 |
| | CAR from the day after quarter t announcement | 4.28 | 6.13 | 7.42 | 6.24 |
| | Summed three-day CAR relative to 1974–1986 | 20% | 21% | 11% | 21% |
| | Total CAR relative to 1974–1986 | 62% | 66% | 76% | 66% |
| Large firms—hedged portfolio | Three-day [-2, 0] cumulative abnormal return (CAR) | 0.01 | 0.07 | -0.30 | -0.25 |
| | Sum of three-day announcement CARs | 0.01 | 0.08 | -0.22 | 0.03 |
| | CAR from the day after quarter t announcement | 1.36 | 1.21 | 1.62 | 2.56 |
| | Summed three-day CAR relative to 1974–1986 | 1% | 5% | -13% | 2% |
| | Total CAR relative to 1974–1986 | 37% | 28% | 38% | 53% |

CARs are sums over specified holding periods of the difference between daily returns and returns for NYSE-AMEX firms of the same size decile. SUE represents forecast errors from a seasonal random walk with drift earnings expectation model, scaled by their estimation-period standard deviation. Portfolios are formed by grouping earnings announcements into deciles based on the distribution of SUE for the previous calendar quarter. The hedged portfolio involves a zero investment long position in stocks with extreme positive earnings surprises (SUE decile 10) and an offsetting short position in stocks with extreme negative earnings surprises (SUE decile 1). Following Bernard and Thomas (1990), long and short portfolio positions are reversed after quarter t+3 in panels A and B. Small, medium and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms. Day 0 is the quarterly earnings announcement date. An * denotes statistical significance at the 0.01 level, two-tailed tests. To maintain comparability with Bernard and Thomas (1989, 1990) and Table 1, we do not report significance levels for all summary statistics in the table.

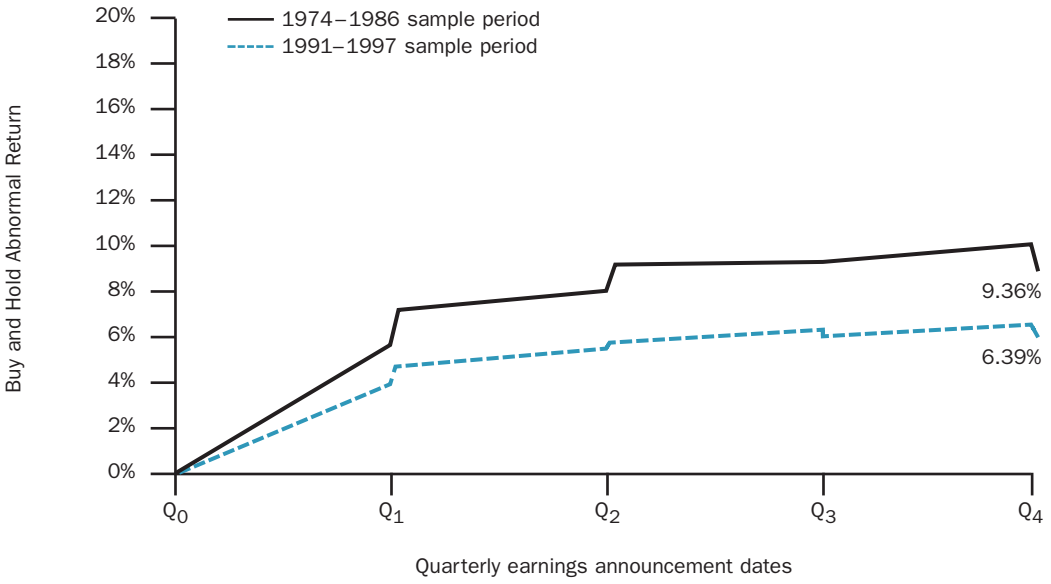
for the 1991-1997 period. Panel A shows that the hedged portfolio four-quarter abnormal return has fallen to 5.70 percent, or about two-thirds of its former magnitude. The signs of the hedged portfolio three-day announcement returns still exhibit the familiar pattern, but the cumulative return for all four subsequent earnings announcements is now only 0.82 percent compared with 2.97 percent during 1974-1986. Results for small, medium and large firms, shown in Panel B, exhibit similar declines in post-announcement abnormal returns for 1991-1997 relative to 1974-1986. The diminution of post-announcement returns is greatest for large firms as evidenced by only 53 percent of the abnormal return remaining in the 1991-1997 period. For large firms the cumulative return for all four subsequent earnings announcements for 1991-1997 is 2 percent of its former magnitude.

Figure 4 illustrates the differences in the magnitude of the post-earnings-announcement drift for the two sample periods. The figure plots the cumulative four-quarter hedged portfolio buy-and-hold abnormal return for 1974-1986 and 1991-1997 for all firms in Panel A and for the three firm-size groups in Panel B. Both panels clearly illustrate the substantial decline in post-announcement drift that has occurred since 1990. Consistent with the results presented in Table 2, Figure 4 documents the four-quarter cumulative hedge portfolio abnormal return (BHAR) of 6.39 percent in 1991-1997 compared with 9.36 percent in the earlier period, or about two-thirds as large. Most of the 1991-1997 BHAR is now concentrated in quarter t+1, before the earnings announcement for that quarter.

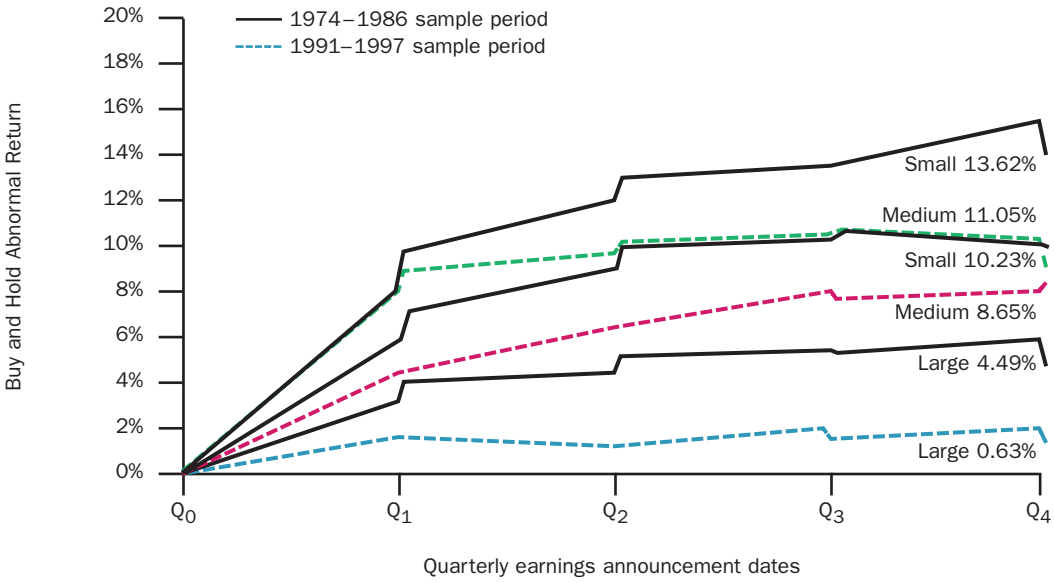
Panel B of Figure 4 presents evidence that all three size-categories exhibit a diminished post-earnings-announcement drift. The results are most pronounced for large firms where the BHAR falls to 0.63 percent for 1991-1997 compared with 4.45 percent previously. This represents a decrease in the BHAR of 85 percent for large firms. For small and medium firms the 1991-1997 return again is concentrated in quarter t+1. Medium

## FIGURE 4: CUMULATIVE HEDGE PORTFOLIO ABNORMAL STOCK RETURNS

**Panel A: All Sample Firms**




**Panel B: Sample Firms by Size Group**




This figure plots the four-quarter cumulative hedge portfolio abnormal return (BHAR) following an extreme earnings surprise in 1974–1986, the Bernard and Thomas (1990) replication period, and in 1991–1997. The hedge portfolio takes a long position in the highest decile SUE stocks and a corresponding short position in the lowest decile SUE stocks. Small, medium, and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms.

firms also exhibit significant returns for quarters t+2 and t+3.

Results from Table 2 and Figure 4 show that post-earnings-announcement drift has declined since 1990. This result is consistent for portfolios formed across all firms as well as for portfolios based on size categorizations.

Next we turned our attention to whether this decline in returns can be attributed to changes in standardized unexpected earnings metrics.

Special items represent nonrecurring components of income as defined by Compustat. Among them are nonrecurring items such as current-year results of discontinued operations, natural disasters, repurchase of debentures, and the profit or loss on sale of assets, investments and securities. Prior research has documented an increase in the relative frequency and magnitude of special items over time and has shown that special items are less value-relevant than more persistent components of income. Furthermore, income-decreasing special items are more prevalent than income-increasing special items.

David Burghstahler, James Jiambalvo and Terry Shevlin in 1999 reported a dramatic increase in the number of firm observations with nonzero special items reported in Compustat starting in 1982. This suggests a reporting bias exists with respect to special-item coverage by Compustat for the periods 1974-1986 and 1991-1997. The SUE metric employed in this paper and by Bernard and Thomas in their 1989 and 1990 research is based on earnings before extraordinary items and discontinued operations but includes the effects of special items. The inclusion of special items could result in misclassification errors with respect to SUE decile assignment. Specifically, firms with positive special items — nonrecurring gains — could mistakenly be classified as high-SUE firms and firms with negative special items — nonrecurring losses — may be coded erroneously as low-SUE firms. If these classification errors have become more prevalent since 1990, the markets' natural tendency to discount special items could partially explain

the observed decrease in abnormal returns to the SUE trading strategy.

To investigate this possibility, we estimated two pooled cross-sectional regression equations to provide benchmark results for the investigation of the effect of special items and isolate the impact of special-item contamination on abnormal returns.

## TABLE 3: TEST OF SPECIAL ITEM CONTAMINATION

**Panel A:** $BHAR_{t+4} = \beta_0 + \beta_1 SUE_t + \beta_2 D_T + \beta_3 (D_T \times SUE_t) + \varepsilon_t$

**Panel B:** $BHAR_{t+4} = (\beta_0 + \beta_1 SUE_t)(1+\lambda_1 D_{SI}) + (\beta_2 D_T + \beta_3 (D_T \times SUE_t))(1+\lambda_2 D_{SI}) + \omega_t$



| Coefficient (t-statistic) | All firms | Firm-size group | | |
|---|---|---|---|---|
| | | Small | Medium | Large |
| ***Panel A:*** *Abnormal returns without controlling for special item contamination* | | | | |
| Abnormal return for 1974–1986 ($\beta_1$) | 9.16<br>(22.02) | 14.70<br>(15.63) | 9.21<br>(13.66) | 3.98<br>(9.08) |
| Change in abnormal return for 1991–1997 ($\beta_3$) | -3.56<br>(-5.02) | -6.49<br>(-3.99) | -1.75<br>(-1.62) | -2.93<br>(-3.77) |
| Adjusted $R^2$ | .004 | .005 | .006 | .002 |
| Sample size | 145,342 | 52,671 | 44,676 | 47,993 |
| ***Panel B:*** *Abnormal returns after controlling for special item contamination* | | | | |
| Abnormal return for 1974–1986 ($\beta_1$) | 9.50<br>(22.33) | 15.64<br>(16.17) | 9.35<br>(13.56) | 4.05<br>(9.08) |
| Special item impact for 1974–1986 ($\beta_1\lambda_1$) | -7.57<br>(-3.67) | -16.90<br>(-4.05) | -3.38<br>(-1.00) | -1.43<br>(-0.59) |
| Change in abnormal return for 1991–1997 ($\beta_3$) | -3.45<br>(-4.64) | -6.57<br>(-4.05) | -1.65<br>(-1.45) | -2.81<br>(-3.43) |
| Change in special item impact for 1991–1997 ($\beta_3\lambda_2$) | 2.64<br>(0.90) | 6.41<br>(1.00) | -0.94<br>(-0.20) | 1.56<br>(0.48) |
| Adjusted $R^2$ | .004 | .006 | .006 | .002 |
| Sample size | 145,342 | 52,671 | 44,676 | 47,993 |

$BHAR_{t+4}$ is the cumulative hedge portfolio abnormal return over the period beginning one day after the announcement of earnings for quarter t through the day of the announcement for quarter t+4. $SUE_t$ is the scaled decile rank earnings surprise for quarter t, based on the forecast error for a seasonal random walk model with drift. The hedge portfolio takes a long position in the highest decile SUE stocks and a corresponding short position in the lowest decile SUE stocks. The indicator variable $D_T$ takes on a value of one for 1991 though 1997 and zero otherwise. The indicator variable $D_{SI}$ takes on a value of one when quarterly earnings for the highest (lowest) decile SUE stocks is contaminated by a positive (negative) special item, and zero elsewhere. Small, medium and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms.

Panel A of Table 3 presents results from the base line regression of the first of those two equations. The BHAR for the hedged portfolio is 9.16 percent for 1974-1986 and 5.6 percent (9.16 –3.56) for 1991-1997. The pattern of abnormal returns to the trading strategy for all firms and by separate size categorization is consistent with the results presented in Figure 4.

Panel B documents the BHAR for firms that are not contaminated with special items — 9.5 percent for 1974-1986 and 6.05 percent for 1991-1997. These results are consistent with findings that the presence of special items results in a downward bias in estimated BHAR. Furthermore, after removing the effect of special-item contamination, the BHAR for all firms subsequent to 1990 still exhibits a decrease of roughly one-third relative to 1974-1986. Results for large and small firms for the two time periods are again consistent with Figure 4. The BHAR for medium firms is not statistically different for the two time periods. The impact of special items is not statistically different across the two time periods; however, this result must be interpreted with caution because prior evidence documents a potential bias in Compustat coverage regarding special items.

Evidence from Table 3 indicates a decrease in the post-earnings-announcement drift since 1990 after controlling for special-item contamination. This result holds for portfolios formed across all firms as well as portfolios formed within large and small firms. Furthermore, the results indicate a downward bias in the BHAR due to the contaminating effects of special items on SUE.

Previous empirical research documents a positive relation between abnormal returns and the persistence of earnings. A second potential explanation for the diminished post-earnings-announcement drift subsequent to 1990 is that earnings surprises have become less persistent since then than was the case from 1974-1986.

A decrease in the persistence of earnings surprises could be due to

heightened competition in product and factor markets, changes in investment and operating decisions, or changes in accounting regulations or the application of accounting principles.

To investigate changes in the persistence of earnings surprises, we examined the serial correlation in quarterly earnings surprise using a pooled regression. Panel A in Table 4 pertains to serial correlation for 1974-1986, and the results demonstrate the familiar pattern. Furthermore, the magnitude of the coefficients is nearly identical to those reported in Bernard and Thomas in 1990 and Ball and Bartov in 1996. For 1974 to 1986, the coefficients from the regression on all firms imply that a $1 earnings surprise in quarter t translates into $0.603 (0.397 +0.136 +0.070) in earnings surprise over the next three quarters and a negative $0.299 earnings surprise in quarter t+4. In other words, a $1 earnings surprise produces a predictable $0.603 surprise over the next three quarters.



The key insight from Panel A is the uniformity of the results for all firms and across size partitions with respect to magnitude of the coefficients and statistical significance.

The results in Panel B of Table 4 document a decline in SUE persistence over time. The coefficients imply that subsequent to 1990 a $1 earnings shock in quarter t translates into $0.483 (0.603 –0.142 –0.002 +0.024) in earnings surprise over the next three quarters and a negative $0.339 (-0.299 – 0.040) earnings surprise in quarter t+4. This means that the persistence of a $1 earnings surprise for quarters t+1 to t+3 has decreased 20 percent compared with its 1974-1986 level.

Previous results indicate the BHAR has been virtually eliminated for large firms. Focusing on the results for large firms from Panel B of Table 4, a $1 earnings surprise from 1974-1986 translates into a $0.639 earnings surprise over the next three quarters. Subsequent to 1990, a $1 earnings surprise implies a $0.505 earnings surprise for the following three quarters.

**TABLE 4: PREDICTION OF FUTURE SUE ON THE BASIS OF CURRENT SUE**

**Model:** $SUE_t = \alpha_0 + \sum_{k=1}^{4} \alpha_{1,k} SUE_{t+k} + \alpha_{2,} D_T + \sum_{k=1}^{4} \alpha_{3,k} (D_T \times SUE_{t+k}) + \xi_t$

| | Quarter | | | | Adjusted | Sample |
|---|---|---|---|---|---|---|
| | t+1 | t+2 | t+3 | t+4 | $R^2$ | Size |
| ***Panel A:*** *SUE serial correlation for 1974-1986* ($\alpha_1$) | | | | | | |
| All firms | 0.397* | 0.136* | 0.070* | -0.299* | 25.3% | 135,345 |
| Small firms | 0.338* | 0.122* | 0.072* | -0.339* | 23.1% | 49,105 |
| Medium firms | 0.406* | 0.143* | 0.069* | -0.294* | 26.6% | 37,785 |
| Large firms | 0.440* | 0.136* | 0.063* | -0.268* | 26.8% | 48,444 |
| ***Panel B:*** *Change in SUE serial correlation for 1991-1997* ($\alpha_3$) | | | | | | |
| All firms | -0.142* | -0.002 | 0.024* | -0.040* | | |
| Small firms | -0.118* | -0.003 | 0.004 | -0.037* | | |
| Medium firms | -0.132* | 0.007 | 0.023 | -0.031* | | |
| Large firms | -0.174* | -0.004 | 0.044* | -0.057* | | |

Consistent with Bernard and Thomas (1990), $SUE_t$ is the forecast error in quarter t from a seasonal random walk model with trend, scaled by its estimation-period standard deviation. The values of all SUE variables are constrained to fall between ± 5.00 to reduce the impact of extreme observations. The indicator variable $D_T$ takes on a value of one for 1991 though 1997 and zero otherwise. Small, medium and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms. An * denotes statistical significance at the 0.01 level, two-tailed test.

This 21 percent decrease in the persistence of earnings surprises is not nearly large enough to account for the substantial decrease in BHAR for large firms. At least for large firms, the decrease in persistence of earnings surprises does not appear to entirely explain the decrease in post-earnings-announcement drift.

This evidence suggests that a decrease in the persistence of earnings surprises is at least partially responsible for the diminished BHAR associated with the SUE trading strategy. However, the decreased persistence of earnings surprises for large firms is not large enough to fully account for the diminishment of the BHAR. The decrease in the persistence of earnings surprises appears to explain some, but not all, of the decrease in the BHAR drift.

## Implications for Investors

The simulated SUE trading strategy entails substantial investor expertise and resources. Investors who are aware of the post-earnings-announcement drift and seek to profit from the SUE trading strategy would need to maintain a database of quarterly earnings forecasts and historical SUEs, monitor corporate press releases on a daily basis for quarterly earnings announcements, scrutinize those announcements for nonrecurring special items that might contaminate SUE decile classification and estimate the expected profit from trading on the SUE information. Once the decision to trade has been made, these investors would need to assemble and rebalance a portfolio of offsetting long and short positions in hundreds of individual securities.



The arbitrage costs associated with the SUE trading strategy — the costs incurred in deciding to trade and in executing the trade — are not trivial. Consequently they limit how much of the post-earnings-announcement drift abnormal return can be profitably captured by following the SUE trading strategy. In the presence of arbitrage costs, knowledgeable investors will trade only if the anticipated SUE trading profits exceed the cost of arbitrage. Of course, uninformed traders will continue to trade SUE securities for other exogenous reasons.

Profit-maximizing investors seeking to capitalize on the SUE trading strategy would focus their attention on trading opportunities that offered the greatest net reward. For example, although small firms have a larger post-announcement abnormal return than do medium or large firms, SUE-related arbitrage costs may also be higher for small firms. Investors may face higher information acquisition costs, liquidity costs or margin requirements.

The presence of significant arbitrage costs implies that the post-1990 drift should dissipate the most where arbitrage costs are low. Conversely,

the drift should show less dissipation where arbitrage costs are high. We investigated the impact of arbitrage costs on drift dissipation in two ways. First, we estimated a pooled regression in which the significant variable is whether four or more Zacks-listed analysts follow the company.

Analyst coverage from Zacks Investor Research served as a proxy for reduced arbitrage costs for three reasons. First, analyst coverage results in more visible earnings announcements, thereby reducing investors' information acquisition costs. Second, analysts are likely to examine earnings releases for nonrecurring transactions and evaluate their financial statement impact. Third, analysts tend not to cover illiquid stocks. Increased liquidity results in lower trade execution costs.

Our second approach to arbitrage costs involved imposing a $5 minimum stock price constraint on the sample. This price screen represented a proxy for lower trade execution costs due to the bid-ask spread and margin account requirements. We re-estimated a key research equation on a reduced sample of stocks where share price is greater than $5.

Table 5 presents the results for analyst coverage in Panel A and for the reduced sample where share price is at least $5 in Panel B. Panel A shows that the dissipation for 1991-1997 in post-announcement drift returns is concentrated in firms with analyst following. The BHAR declines to 1.08 percent (9.16 –0.33 –7.75) for all firms with analyst following in years after 1990. Moreover, the BHAR firms not covered by analysts during 1991-1997 are statistically indistinguishable from the 1974-1986 BHAR.

Firm-size results in Panel A document the elimination of post-announcement drift abnormal returns among large firms. The 1991-1997 BHAR for large firms covered by analysts is a negative 0.25 percent (3.98 +2.93 –7.16). The post-1990 BHAR for medium firms with analyst following is also substantially reduced from earlier levels. Analyst coverage has no impact on the BHAR of small firms.

## TABLE 5: IMPACT OF ANALYST FOLLOWING

**Model:** $BHAR_{t+4} = \beta_0 + \beta_1 SUE_t + (\beta_2 D_T + \beta_3 (D_T \times SUE_t))(1 + \gamma D_{AF}) + \omega_t$

| Coefficient (t-statistic) | All firms | Firm-size group | | |
|---|---|---|---|---|
| | | Small | Medium | Large |
| ***Panel A:*** *Abnormal returns without price screen* | | | | |
| Abnormal return for 1974–1986 ($\beta_1$) | 9.16<br>(22.02) | 14.70<br>(15.63) | 9.21<br>(13.67) | 3.98<br>(9.08) |
| Change in abnormal return for firms without analyst following for 1991–1997 ($\beta_3$) | -0.33<br>(-0.38) | -6.14<br>(-3.721) | 0.49<br>(0.377) | 2.93<br>(1.82) |
| Analyst following impact for 1991–1997 ($\beta_3 \gamma$) | -7.75<br>(-6.68) | -7.72<br>(-1.22) | -5.78<br>(-3.31) | -7.16<br>(-4.21) |
| Adjusted $R^2$ | .004 | .005 | .007 | .002 |
| Sample size | 145,342 | 52,671 | 44,676 | 47,993 |
| ***Panel B:*** *Abnormal returns for firms with price greater than $5* | | | | |
| Abnormal return for 1974–1986 ($\beta_1$) | 8.77<br>(23.39) | 15.40<br>(16.67) | 9.47<br>(14.17) | 4.11<br>(9.39) |
| Change in abnormal return for firms without analyst following for 1991–1997 ($\beta_3$) | -0.74<br>(-0.93) | -8.04<br>(-4.94) | -0.37<br>(-0.29) | 2.87<br>(1.79) |
| Analyst following impact for 1991–1997 ($\beta_3 \gamma$) | -6.87<br>(-6.68) | -8.94<br>(-1.65) | -4.75<br>(-2.78) | -7.23<br>(-4.26) |
| Adjusted $R^2$ | .006 | .010 | .007 | .002 |
| Sample size | 124,557 | 33,782 | 42,926 | 47,847 |

$BHAR_{t+4}$ is the cumulative hedge portfolio abnormal return over the period beginning one day after the announcement of earnings for quarter t through the day of the announcement for quarter t+4. $SUE_t$ is the scaled decile rank earnings surprise for quarter t, based on the forecast error for a seasonal random walk model with drift. The hedge portfolio takes a long position in the highest decile SUE stocks and a corresponding short position in the lowest decile SUE stocks. The indicator variable $D_T$ takes on a value of one for 1991 though 1997 and zero otherwise. The indicator variable $D_{AF}$ takes on a value of one when there are four or more Zacks analysts following the company. Small, medium and large firms are in size deciles 1 to 4, 5 to 7, and 8 to 10, respectively, based on January 1 market value of equity for all NYSE and AMEX firms.



Results for the reduced sample of firms where stock price is greater than $5 are consistent with those in Panel A. The diminished drift after 1990 is concentrated among firms with analyst following. This result holds for the entire smaller sample as well as for medium and large firms. Again the post-1990 drift is statistically smaller for small firms not covered by

analysts, and the coverage variable is not statistically significant.

Evidence from Table 5 shows that the decrease in post-announcement drift is concentrated in firms covered by analysts. This result is consistent across medium and large firms. Furthermore, for large firms covered by analysts the drift abnormal return is not statistically different from zero. This evidence is consistent with investors implementing SUE trading strategies to capture the post-announcement drift where the implementation costs are lowest. Additionally, the evidence shows the drift abnormal returns persist where the implementation costs are greatest.

Our research suggests that investors have implemented cost-effective trading strategies to capture the post-announcement abnormal returns after learning about the drift anomaly from academic research. Future empirical work should examine anomalies in cases where reduced implementation costs and investor learning are likely. Technological advancements, more readily available data and decreasing trade execution costs reduce the arbitrage costs of simple trading strategies. ■

# GAAP vs. the Street

## Pro Forma Earnings Fill a Reporting Vacuum



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EARNINGS HAVE LONG PROVIDED THE KEY SUMMARY MEASURE of corporate performance. Traditionally investors have focused on earnings computed in accordance with generally accepted accounting principles. However, recent years have brought a dramatic increase in the use of alternative definitions of earnings, known by such names as pro forma, core or cash earnings.

While not permitted in SEC filings, these new definitions of earnings frequently appear in corporate news releases and are disseminated widely

in the financial press. We refer to these alternative earnings definitions as Street earnings.

Our research provides evidence of the growing gap between Street earnings and GAAP earnings as well as the leading role of corporate managers in promulgating Street earnings. Our study also shows that investors interpret Street earnings as a better measure of corporate performance than GAAP earnings.

The first question we addressed was why Street earnings are becoming more important. Even though some SEC officials' comments seem to suggest that the popularity of Street earnings is primarily due to a decline in corporate managers' ethical standards, our analysis suggests that important structural shifts in the corporate reporting environment provide a more complete explanation. The second issue we addressed was the pros and cons of the increasing use of Street earnings. On the pro side, Street earnings can allow management to provide investors with a better indication of recurring earnings and hence long-run cash flow. On the con side, however, management also may exclude recurring expenses from pro forma earnings, which may lead to inflated investor expectations. We concluded that the objectives of Street earnings need to be more clearly defined and that rules for the consistent preparation and presentation of Street earnings need to be established and enforced.

## The Street Earnings Phenomenon

There is no standard set of rules or principles to guide the preparation of Street earnings.

For purposes of our research we defined Street earnings as the actual reported earnings number promulgated by the analyst tracking services—I/B/E/S, First Call, and Zacks. These services sometimes disagree among themselves as to the appropriate number for reported earnings. We adopted

the earnings number reported by I/B/E/S in our research because it has the most complete historical database.

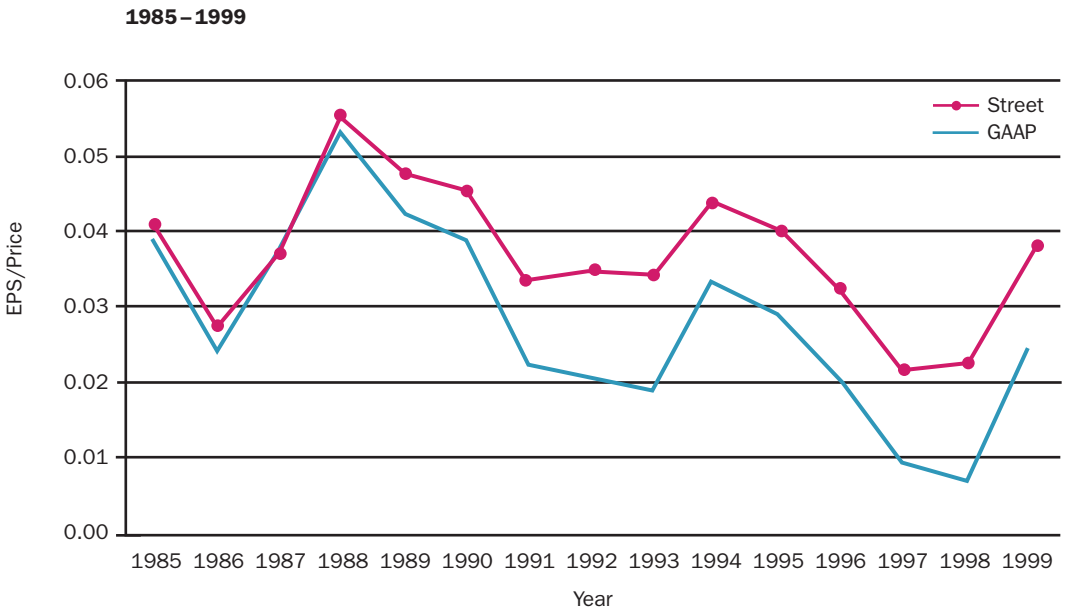
Through the early 1990s, differences between Street earnings and GAAP earnings generally were restricted to special or nonrecurring items such as asset impairments, restructuring charges and other nonoperating items. I/B/E/S's glossary explaining its terms and conventions acknowledges the exclusion of such items and explains that the tracking service "receives an analyst's forecast after discontinued operations, extraordinary charges and other nonoperating items have been backed out. While this is far and away the best method for valuing a company, it often causes a discrepancy when a company reports earnings. I/B/E/S adjusts reported earnings to match analysts' forecasts on both an annual and quarterly basis. This is why I/B/E/S actuals may not agree with other published actuals; i.e., Compustat."



As the recent earnings reporting trend took hold, companies started to exclude more items from Street earnings. The vast majority are expenses and losses, so their exclusion has the effect of increasing Street earnings relative to GAAP earnings. The exclusion of these items often is justified on the basis that they are noncash charges. Examples include amortization and depreciation charges, stock compensation expenses, deferred tax charges and losses at affiliated and subsidiary companies. However, only a subset of accruals is reversed, so the resulting Street earnings number will not correspond to the cash from operations reported in the cash flow statement. Some additional cash items also are excluded on the basis that they are not relevant to evaluating the firm's performance. Examples include costs related to mergers and acquisitions, R&D, interest and taxes. Due to the nonstandardized nature of such reporting, investors are subject to a dizzying array of earnings numbers.

Figure 1 illustrates the growing gap between Street and GAAP earnings. It presents annual Street and GAAP earnings yields (annual earnings per

**FIGURE 1: STREET vs. GAAP EARNINGS PER SHARE (SCALED BY PRICE)**




share scaled by stock price) averaged across all U.S. equities covered by I/B/E/S for the years 1985-1999. We defined GAAP earnings before extraordinary and discontinued operations so that these GAAP-defined nonrecurring items do not contribute to the results. We also included firms for which Street earnings and GAAP earnings are the same, which had the effect of understating the average differences for firms with differences between Street and GAAP earnings.

The figure shows a large and growing disparity between Street and GAAP earnings since the late 1980s. The items excluded from Street earnings are almost universally expenses and losses, so Street earnings exhibit a substantial upward bias relative to GAAP earnings. In recent years, the disparity has been so great that average earnings yields using Street earnings have been about 3 percent, double the 1.5 percent rise in average earnings yields using GAAP earnings.

A more detailed examination of the data emphasized two key factors in the growing difference between the two numbers. First is the increase in the proportion of firms for which Street earnings differ from GAAP earnings. Second is the steady expansion of the list of items that are excluded from Street earnings.

## Management's Role in Promulgating Street Earnings

We have defined Street earnings as the earnings number reported by the analyst tracking services. These services and the sell-side analysts whose earnings forecasts they track represent financial intermediaries who do not work for the companies that are reporting earnings. The evidence discussed thus far indicates that securities analysts and the tracking services are responsible for the production of Street earnings. Companies reporting earnings are still required to comply with GAAP in their formal financial statement filings with investors and the SEC. However, our research gathered systematic evidence that corporate managers promulgate the use of Street earnings by defining and emphasizing the particular earnings definition that they would like the analysts and analyst tracking services to adopt.



Corporate managers use press releases containing their quarterly earnings announcements to inform analysts of the definition of Street earnings they wish to promulgate. We conducted our empirical analysis by reading through a large sample of press releases. Our analysis was restricted to earnings announcements in which the Street earnings number reported by I/B/E/S differed from the GAAP earnings number reported by Compustat.

We divided our sample into two subsamples, each consisting of 200 quarterly earnings announcements. The first was selected randomly from earnings announcements in 1986-1987, during which there were few differences between GAAP and Street earnings. The second subsample was

**FIGURE 2: EARNINGS PER SHARE PRESENTATION**

**Order of earnings per share presentation**

| Period | GAAP only | GAAP then Street | Street then GAAP | Street only | All |
|---|---|---|---|---|---|
| 1986-1987 | 165 *(82.5%)* | 22 *(11.0%)* | 13 *(6.5%)* | 0 *(0.0%)* | 200 *(100%)* |
| 1998-1999 | 57 *(28.5%)* | 56 *(28.0%)* | 84 *(42.0%)* | 3 *(1.5%)* | 200 *(100%)* |
| Total | 222 | 78 | 97 | 3 | 400 |

selected randomly from earnings announcements in 1998-1999, by which time the disparity between Street and GAAP earnings had become substantial.

If corporate managers had taken a proactive role in promulgating Street earnings, then we expected to observe a substantial increase across these two subsamples in both the proportion of press releases that define and report a distinct Street earnings number and in the relative emphasis placed on that number. We therefore identified whether management reported a Street earnings number, a GAAP earnings number or both. Further, if management reported both Street and GAAP earnings numbers, we identified the order in which the two numbers were presented.

Figure 2 summarizes our findings and highlights corporate management's role in promulgating Street earnings. More than 80 percent of the earnings announcements in the 1986-1987 period reported only GAAP earnings, but this figure dropped to less than 30 percent by 1998-1999. Moreover, the frequency with which Street earnings represented the first number reported in the earnings announcement rose from 6.5 percent in 1986-1987 to 42.0 percent in 1998-1999.

We also found a growing tendency for GAAP earnings to be relegated toward the end of the earnings announcement. During the 1998-1999

period, the Street earnings number typically appeared in the first or second paragraph, whereas the GAAP earnings number on average was delayed until the fourth paragraph.

## Relevance of Street Earnings to Investors

The previous evidence highlights the popularity of Street earnings among managers and analysts but is silent on the question of whether investors use Street earnings.

We looked at the relationship between the two competing definitions of earnings and contemporaneous stock prices. First, we examined the sensitivity of stock returns to earnings. Sensitivity measures the magnitude of the stock price response to earnings surprises. A higher sensitivity indicates that investors view the reported earnings measure as more indicative of long-run recurring trends in firm performance. Second, we examined the ability of earnings surprises to explain stock returns. Higher explanatory power can be attributable to providing better information about both long-run recurring firm performance and short-run innovations in firm performance.

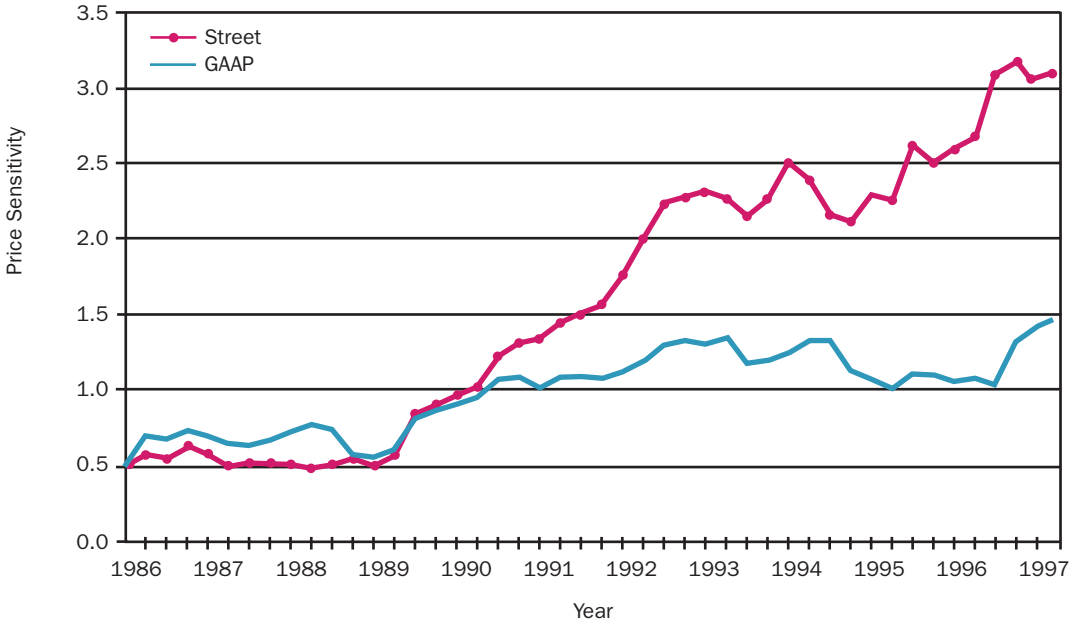


Figure 3 plots trends in the average sensitivity of stock prices to both Street and GAAP earnings over the last two decades. Through the early 1990s, when there was little divergence between Street earnings and GAAP earnings, the sensitivities were similar. However, during the 1990s, when Street earnings diverged significantly from GAAP earnings, there was dramatic improvement in the sensitivity of stock prices to Street earnings relative to GAAP earnings. Investors clearly interpret Street earnings to be a better indicator of long-run recurring firm performance.

Figure 4 plots the explanatory power of Street earnings versus GAAP earnings over the last two decades. We again found that the ability of Street and GAAP earnings to explain variation in stock prices was similar

**FIGURE 3: PRICE SENSITIVITY OF SRTEET AND GAAP EARNINGS**

**1985–1999**




until the early 1990s, while afterward there was a clear shift in favor of Street earnings. This evidence indicates that investors view Street earnings as more relevant than GAAP earnings and that the increased relevance arises from investors' perception that Street earnings provide a better indication of long-run recurring firm performance.

At first glance, it may appear that our stock price results provide a ringing endorsement of Street earnings. Despite the ad hoc and unregulated manner in which Street earnings are produced, they seem to be of greater relevance to investors than GAAP earnings.

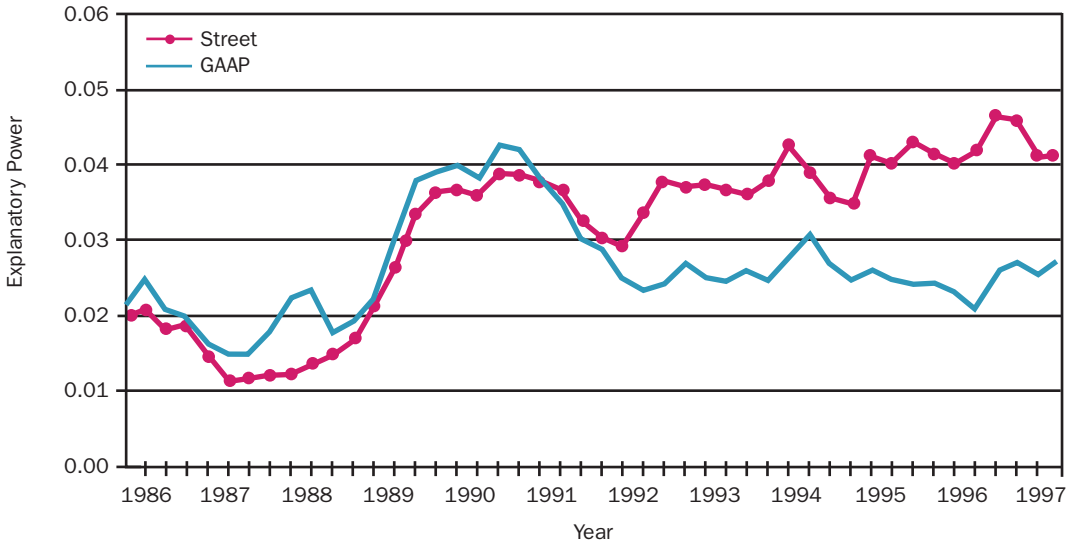
However, this presumes that investors correctly interpret the implications of Street earnings for firm value. An alternative theory is that investors are getting hoodwinked into relying too heavily on Street earnings. After all, these are the earnings numbers that managers highlight and analyst tracking

services and the business press use as they disseminate information on earnings surprises. It is possible that investors simply don't dig deeply enough into the earnings announcements and SEC filings to figure out the differences between Street earnings and GAAP earnings.

The latter interpretation is worrisome, since Street earnings ignore so many expenses and losses. These expenses and losses usually represent very real operating costs that are associated with past, present or future cash outflow. If investors naively are pricing companies based on inflated Street earnings numbers, significant overvaluation may result. Such overvaluation will not correct itself until investors realize that Street earnings do not coincide with the long-run cash-generating ability of the firm. GAAP earnings generally preserve the long-run correspondence between earnings and cash flow and so are less susceptible to this problem.



**FIGURE 4: ABILITY OF STREET AND GAAP EARNINGS TO EXPLAIN STOCK PRICES**



## Key Factors Giving Rise to Street Earnings

Overall, our findings suggest that the rise of Street earnings is attributable to corporate management, security analysts and the analyst tracking services. Regulators and business journalists have suggested that the rise of Street earnings is indicative of growing lack of good faith on the part of these parties. However, two concurrent structural shifts in the financial reporting environment have helped legitimize the rise of the Street earnings phenomenon.

The first is dramatic advances in information technology that have made it possible for earnings announcements to be widely disseminated to investors long before the formal dissemination of the required SEC filings. These earnings announcements and the conference calls that often accompany them now are the most important financial reporting events for many large companies.

However, these events take place largely outside of regulations pertaining to the preparation of the financial statements, so managers have considerable latitude with respect to the information reported. In this essentially unregulated environment, it is inevitable that a small number of aggressive managers push the envelope in trying to put their firm's performance in the best possible light. Other firms then feel pressure to follow suit in order to remain competitive in the capital markets. For these reasons, the outdated SEC-mandated financial reporting framework may need updating to encompass the fair and consistent reporting of earnings announcements.

The second key shift in the financial reporting environment is the Financial Accounting Standards Board's move away from an income statement approach and toward a balance sheet approach in setting GAAP. The increased emphasis on the balance sheet can be traced to the introduction of SFAC No. 6 in 1985 and is clearly evident in subsequent accounting

standards such as SFAS No. 109, SFAS No. 121, SFAS No. 142 and SFAS No. 144. The balance sheet approach shifts attention from trying to match costs to revenues on the income statement toward trying to appropriately value assets and liabilities on the balance sheet. However, the realization principle is retained, so the balance sheet still fails to capture the most important asset from an investor perspective—cash flow associated with anticipated future sales.

The essence of this shift is that instead of amortizing many assets to the income statement in a systematic manner, firms are encouraged to take occasional impairments to assets or adjustments to valuation allowances. The result is that income statements are now routinely peppered with nonrecurring special charges associated with these balance sheet adjustments.



Figure 5 illustrates the increasing importance of special items. The first graph reports trends in the proportion of firms reporting negative special items. The second graph reports trends in the magnitude of special items as a proportion of total expenses. The first graph shows that the frequency of negative special items has more than doubled from less than 10 percent to more than 20 percent, while the second graph shows that they have increased in magnitude from less than 1 percent to more than 2 percent of corporate expenses.

Investors who are interested in the long-run recurring performance of a company clearly wish to back out these nonrecurring special items. The evolution of Street earnings represents an attempt by managers and security analysts to assist in that task. However, this process can be gamed by unscrupulous managers. In what is described as the big-bath phenomenon, large pools of recurring costs occasionally are charged to the income statement under the guise of a nonrecurring balance sheet adjustment. With these costs out of the picture, the company can report a larger Street earnings number on an ongoing basis.

**FIGURE 5A: PERCENTAGE OF COMPANIES RECORDING WRITE-OFFS**

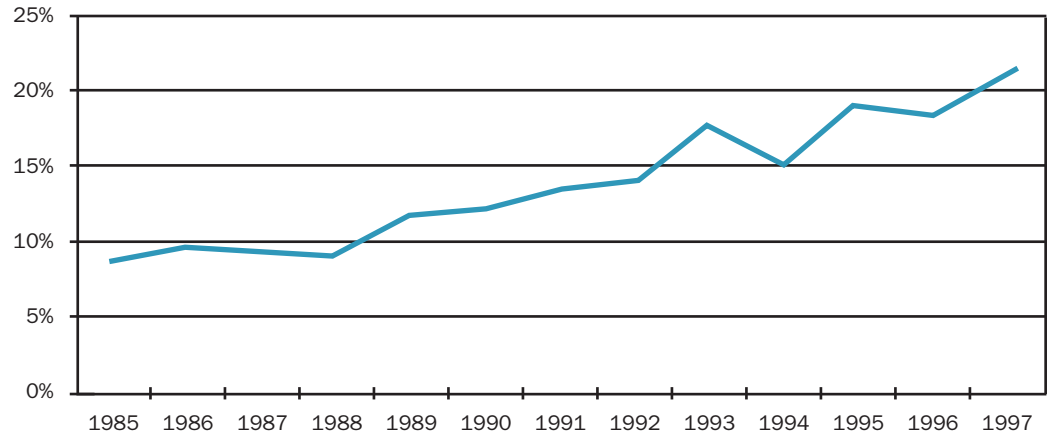
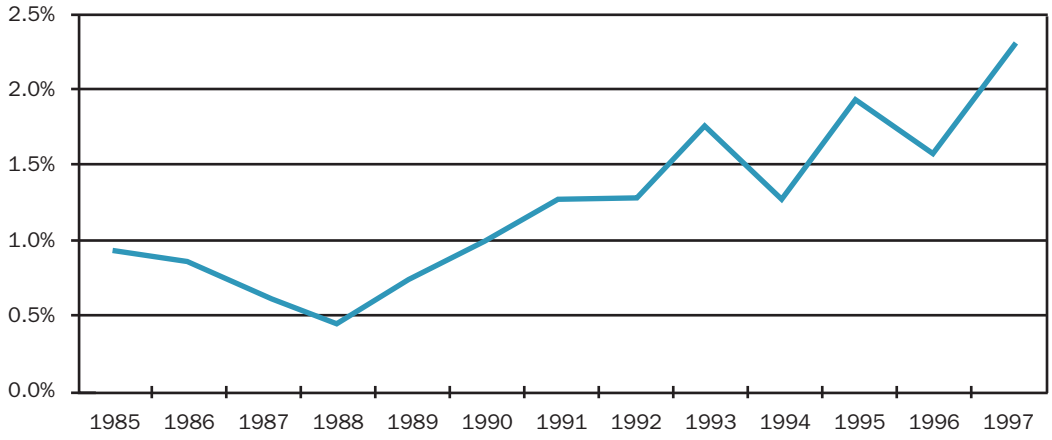



**FIGURE 5B: AVERAGE WRITE-OFFS AS A PERCENTAGE OF TOTAL OPERATING EXPENSES**




## The Pros and Cons of Street Earnings

The key advantage of Street earnings is that they focus on the recurring components of firm performance. Investors typically value companies by discounting the expected future cash flow, and a measure of recurring earnings

most frequently is used as a basis for that forecasting. To the extent that Street earnings are purged of the nonrecurring special charges that now pervade GAAP earnings, they provide investors with a key valuation input.

However, it is important to remember one key advantage of GAAP earnings. They typically satisfy clean surplus, meaning that over the long run, GAAP earnings and cash flow are equal. In other words, timing represents the only difference between GAAP earnings and cash flow. This property of GAAP earnings provides a clear theoretical link between earnings and firm value and an important practical limitation on the extent to which GAAP earnings can deviate from the underlying cash flow. This property is lost with the move to Street earnings. The systematic exclusion of expenses and losses means that in the long run Street earnings will exceed cash flow. The extent to which long-run Street earnings exceed long-run future cash flow is limited only by managers' ingenuity in taking big baths and excluding other costs from Street earnings.



## Conclusion

Investors demand an earnings number that provides a good basis for forecasting recurring future cash flow. The proliferation of special items in GAAP earnings has made it an increasingly irrelevant indicator of future cash flow. Street earnings represent an attempt to restore some of this relevance. However, the wide latitude open to management and analysts in defining Street earnings can result in an unreliable number that most likely significantly overstates recurring future cash flow.

The timely dissemination of a relevant and reliable measure of periodic operating performance is crucial to the efficient operation of capital markets. To this end, we hope that the SEC and the accounting profession will work with management and analysts to provide a more reliable and unbiased alternative to the current Street earnings situation.

# *Disclosure Topics and Issues*



## SIDE LETTER MOVES FRONT AND CENTER

BORIS FELDMAN

Imagine that you are the CEO or CFO of a public company. The director of credit and collections comes into your office one day, closes the door and says: "I think we have a problem. We've been trying to collect a $1.5 million receivable from customer Doe Corp. for five months. Today, when we told them we would have to put them on credit hold, they faxed us this." She hands you a copy of a letter, signed by your vice president of North American sales, which purports to amend the license agreement so that Doe need not pay the $1.5 million until it resells the product to an end-user. "We never saw this in Finance before today," she informs you. "What should we do?"

This article sets forth a model — not necessarily the only model — for responding to evidence of accounting fraud at a public company. How you respond will influence the outcome for your company.

### *THE WALL STREET JOURNAL* TEST

Before diving into specific action items, allow me to suggest a framework for how you should approach the crisis — what I call "*The Wall Street Journal* test." Throughout your handling of the investigation, ask yourself: If everything I did from now forward were recorded accurately and in detail and then published on the front page of *The Wall Street Journal*, would I be proud of it? Would a fair observer conclude that I had acted ethically and honorably? Or would people conclude that, even though I was not responsible for the original wrongdoing, I had participated in covering it up?

As students of Watergate learned decades ago, the cover-up is usually worse than the crime. If you uncover an impropriety at your company and remedy it, things will probably turn out all right; in any event, you will not be tainted by it. In cases of accounting fraud, executives who help cover it up are treated at least as harshly as those who engineered the fraud in the first place.

With the appropriate ethical mooring in place, let's turn to specific tasks. These are not listed in sequential order; many of them must take place simultaneously, often in the first few hours or day.

## Who's in Charge?

A threshold issue is establishing the chain of command. In most cases, the general counsel will be in charge of the process, reporting to the audit committee of the board of directors. Absent any indication that the CEO and CFO participated in the wrongdoing, they will be closely involved in the investigation as well.



In my opinion, the audit committee or a lead director on that committee must be looped in immediately. It is the audit committee that must make the key decisions with respect to involving the outside auditors, restating previous financials and issuing public disclosures. The CEO, CFO and general counsel will be involved in those decisions, provided that they clearly played no role in the fraud.

The other end of the spectrum is equally clear. If the general counsel has reason to believe that the CEO or CFO may have participated in the violations, then with the audit committee's assent she should exclude them from the investigatory process, at least until they have been exonerated. Obviously, this places the general counsel in a difficult position and is a decision that must be made by the audit committee. If the audit committee has any reason to believe that the general counsel may have acted improperly, it should exclude her from the process, relying instead on outside counsel to spearhead the investigation.

## Representation and Conflict issues

A threshold issue for the general counsel and the audit committee is which lawyers should conduct the investigation. Accounting-fraud investigations are complex, and previous experience in conducting them is essential. If the company's outside counsel is experienced in accounting investigations — and clearly understands that it owes its duties to the corporation in the form of the audit committee, not to individual members of management — then that firm may assume the role. If the audit committee has reason to believe that outside counsel may be beholden to management and protect them in the course of the investigation, the committee should select another law firm as special counsel to the board.

Those conducting the investigation must make clear to persons they interview that the lawyers are not acting as counsel for the individuals. The lawyers should disclose at the beginning of every interview that they are representing the company,

not the person being interviewed; that the privileges surrounding the interview belong solely to the company and may be waived by the company, at its discretion; that the information obtained may be provided to regulatory authorities, at the company's discretion; and that the person being interviewed is free to consult with his own counsel before proceeding. This is not to suggest that employees have the right to refuse to answer questions at the interview. I believe they do not, and that failure to cooperate can provide a basis for termination. Nevertheless, it is important that the investigators make clear what the process is about and the potential ramifications of the answers given.

## Securing Evidence

From the moment the general counsel learns of the potential accounting violations, she must move aggressively to secure potential evidence. She should meet immediately with personnel in the information technology department to preserve any backup tapes of electronic data. As soon as she has identified potential participants in the wrongdoing, she should copy their files that are on the network and on their local computers. Depending on the strength of the evidence against them, she may also want to lock them out of the computers. The general counsel also needs to secure relevant paper files in the finance department and sales organization. She should also secure files located in the offices of those who apparently are involved in the fraud.

I cannot overemphasize the urgency with which these steps must be taken. When a financial fraud starts to unravel, the perpetrators sometimes destroy evidence. Better to lock people out of their files and offices unnecessarily than to arrive a few hours after documents are shredded and hard drives reformatted.

An early branch in the road involves whether internal staff, forensic accounting consultants or the company's outside auditors will do the legwork. In general, I am reluctant to have internal finance department staff members perform the accounting aspects of the investigation. They either missed the problem to begin with or may otherwise be tainted by relationships with the perpetrators.

If the problem is at all significant, the company should turn to outsiders for help. My preference in most circumstances is to retain forensic accounting consultants. Independent consultants have only one objective: to ascertain the facts and help the audit committee

come to the right accounting decision. With the company's outside auditors, there is a danger that they may be influenced by personal relationships with those involved in the misconduct as well as by a desire to minimize their own firm's liability exposure.

Some believe that using forensic accountants from a firm other than the company's firm unduly delays the process because the auditors will redo the investigation once the forensic accountants present their report. This concern has some validity. On the other hand, I have seen many instances in which outside auditors have conducted an expedited review, based on information presented to them by the consultants.



## The Investigation

It is difficult to generalize about which documents to review and whom to interview. These decisions vary greatly depending on the nature of the apparent accounting violation. Your outside counsel and forensic accountants will guide you, but a few generalizations are appropriate.

First, rarely is there just one side letter or improper transaction. Treat with great skepticism assurances from the malefactor that "it only happened once." Occasionally that is true. Often, however, meeting the financial targets required more than one improper transaction. Sometimes, having borrowed revenue from future periods to make the initial quarter, the employee later had to book additional improper transactions to avoid detection. Second, it would be unusual if only one person knew about the fraud. In some restatements, the fraud involved only one or two transactions and was committed by one or two persons. More serious restatements — involving substantial portions of revenue and income, over multiple accounting periods — rarely are limited to one perpetrator. Your investigators will need to probe aggressively to determine whether those who turned a blind eye to the transactions may be culpable.

Third, don't assume that customers will blow the whistle. In some situations, an employee of the customer may have facilitated the improper transaction, perhaps as an accommodation to the sales rep who asked for a favor. Often the only way to learn the true state of events from the customer or obtain the actual transaction documents is through an SEC subpoena.

Fourth, restatements are seldom small. One reason is that the employee

who booked one improper transaction also booked others. Another reason is that in the ordinary course of business a company makes accounting judgment calls, and its outside auditors accept them as being within the zone of reasonableness. But once the company has detected a fraud and reopened its books for previous periods, auditors may revisit those prior judgment calls. In situations in which the outside auditors may share some culpability for the improper accounting, they may search out other problems, not attributable to them, in order to reduce their share of the blame.

Practices regarding creation of a paper trail vary greatly, but here is one approach. Although it is imperative that your investigation be thorough and genuine, that does not mean that it has to generate mounds of paper. In my opinion, creation of too many documents can present difficulties for the company down the road.

In all likelihood, your company will face an SEC and/or DOJ investigation into the restatement. As a condition of cooperation by the company, the government often will require that you turn over some or all of the investigatory work product. Plaintiffs in private securities actions will try to obtain those documents. Your company may be in a more difficult position when defending itself in the private litigation if plaintiffs can obtain a road map from the investigation.

If you do create documents during the course of the investigation, you should not discard them, even before announcement of the restatement. The risk of being found to have engaged in spoliation of evidence is significant.

## Confidentiality and Disclosure

Preventing leaks during the investigation is challenging. The deeper you probe, the greater the risk that rumors about an accounting problem will spread within and potentially outside the company. For that reason, you should bring as few people as possible within the tent and emphasize to them the importance of confidentiality.

When to go public with the potential restatement is a judgment call. Some lawyers advise putting out a press release as soon as the company realizes it is likely to restate, even if it has not determined the scope of the restatement. In general, I dissent from that view. Absent a triggering event, discussed later in this article, a company has some reasonable period

of time — measured in days or weeks, not months — to get its arms around the problem. If you must restate, the worst possible release says, "We have discovered a side letter. We may have to restate. We don't know what the magnitude will be." The best possible release provides precise financial impact, indicates that the investigation has been completed, and states that the company does not believe there are other accounting problems.



Several factors can trigger early disclosure. One is the pendency of a corporate transaction such as a securities offering or an acquisition. Another trigger is the need to issue an earnings release or make a periodic filing with the SEC. In some instances, rumors and press inquiries may force the company's hand. Finally, if the restatement appears likely to be large or to reflect widespread fraud at the company, your outside auditors may require an immediate announcement by threatening to withdraw their opinion on previously audited financials.

Assuming that those triggering events are absent and that you do not need to issue a release immediately, you must restrain your company's normal marketing and public relations efforts during the period when you are sizing up the problem. You will lose credibility in the market and potentially exacerbate your liability by saying things that drive your stock price up while you plan to announce a restatement.

When you do issue the announcement about the restatement, avoid "spinning" it too much. Your company will be in the credibility doghouse with the Street for some time. Don't make things worse by downplaying the significance of what has happened.

If you have chosen to have separate forensic accountants conduct the investigation, you need to be sensitive to the timing of bringing the auditors inside the tent. There are two basic approaches. Which is right depends on your company's relationship with its auditors.

One approach is to give the auditors a heads up at the start of the investigation. Explain how you and your consultants are going to conduct it. Assure the auditors that you will provide a complete transfer of information at its completion. The auditors may agree to stand back and await the results of your investigation. The risk is that they will insist on sending in their own team before you have time to complete your work.

The alternative approach, which I generally prefer, is to complete your own investigation before notifying the

auditors. You and your forensic accounting team then meet with the auditors to present the information you uncovered and the conclusions you reached. In many situations, the auditors will review the materials and accept them without redoing the entire investigation. The risk is that the auditors will start from scratch, consuming additional time at a point when you may feel great pressure to issue a release.

## Terminations and payments

In general, you will terminate those who were involved in the accounting fraud. There may be exceptions at lower levels, where the board concludes that certain employees were following orders and not personally culpable.

Do not act hastily in granting severance payments or promising indemnification to terminated employees. The board may later decide that in light of certain employees' involvement in the fraud, they should not receive payments to which they would otherwise contractually be entitled. It is prudent to hold back the payment until doubts have been resolved rather than trying to recoup payments later.

Note that, if the board has doubts as to a particular executive's culpability, it can insist on having its investigators interview that individual before agreeing to make any payment. In my opinion, refusal to submit to such an interview justifies rejecting a request for severance payment or indemnification.

## Handling Legal Actions

If your company restates, an SEC investigation almost certainly will ensue. Your board will want to cooperate in order to minimize any penalty levied against the company.

You may want to give your regional SEC office advance notice immediately before issuing the press release about the restatement. My experience has been that the regional offices tend to be less adversarial than the Washington office in dealing with companies trying to correct accounting violations. Moreover, your employees will then have their depositions taken locally, instead of in D.C.

If you provide the government with meaningful cooperation, your company is not likely to be punished for the accounting fraud. It may have to enter into a consent decree, committing not to engage in accounting violations in the future, but it probably will not have to pay any penalty or fine.

When you announce the restatement, your company will be sued early and often. It likely will face shareholder class actions as well as derivative suits naming the entire board. Merely typing the company's ticker into a search engine will pull up scores of press releases from lawyers trolling for plaintiffs. Try to keep these suits in perspective. Over the long run, the lawsuits will be less important to the company's recovery than market credibility and operational fundamentals. Don't let preoccupation with the lawsuits skew your business or investor relations strategy.



## Conclusion

The situation in which you find yourself when confronted with a potential restatement is not one that you created. When it occurs, however, you are in a position to make it better or to make it worse. If you approach the investigation with ethics, integrity and experienced assistance, you can ensure that the situation does not get worse than it already is and start a process that will enable your company to move beyond the problem.

# *Big Issues for Small Caps*



## STANDING OUT IN A CROWDED FIELD

GARY CAMPBELL, CFA AND RICHARD SINISE

Do you feel that investors neglect your company's stock? Frankly this experience is not uncommon for investor relations professionals, particularly at companies with smaller capitalizations —$1.5 billion or less for purposes of this discussion. Wall Street sell-side firms regularly ignore well-capitalized corporations that do not offer meaningful investment banking opportunities. Even so, many stocks that are underfollowed and underowned on Wall Street offer outstanding investment opportunities.

Because there are more than 6,400 publicly traded small-cap companies, it is easy for any single stock to be overlooked. Small companies are particularly susceptible to neglect because their liquidity characteristics make them inappropriate for many investors. However, there are many institutional small-cap investors with a keen interest in the prospects for investments in this category—especially, of course, in companies with outstanding management and superior fundamentals.

As portfolio managers who have sought out opportunities among small-cap stocks for more than 20 years, we have observed a number of techniques that companies use to attract the attention of institutional investors. From our perspective, the following actions, if implemented, will get these investors' attention.

**Keep existing institutional shareowners informed.** Many institutions that already own your stock have the ability to buy more shares or have other funds within their organizations that could own your stock. Yet it has been our experience at Kennedy Capital Management that we seldom receive unsolicited phone calls from companies whose shares we hold.

A few simple steps can help a small-cap company build a relationship with portfolio mangers. We suggest:

- Know who the institutional investors are
- Call the portfolio manager, unsolicited, once a year
- Send your annual report to the portfolio manager
- Return shareowners' calls

**Keep your shareholder communications simple.** Your annual report and Web site are key components of these communications.

Clear annual reports are essential. Even in the Internet era, an annual report that unambiguously shows or describes the types of products or services that are provided by the company is important. We find it helpful if the annual report:

- Shows your products in a picture or explains how customers use your services
- Describes the firm's direction in the marketplace
- Identifies and quantifies the size of potential markets for your products and services

It's important to keep your Web site updated with any recent conference call archives or video presentations that were made to shareowners. Your Web site also should expand on the market potential of your services or products.

**Attend conferences whenever possible.** Road shows to brokers do not yield long-term results. When you organize road shows for institutional investors, your invitations should concentrate on small-cap growth or small-cap value firms.

If your company is confident about its future and embarks on a road show, make sure the managers that you plan to see can actually buy your stock. You can screen the potential manager visits by looking at their Web sites to ensure that your stock fits within their selection criteria. You can also call existing large shareowners and obtain suggestions for potential institutional manager visits.

Another good way to reach portfolio managers who are likely to invest is to attend independently organized industry conferences or other conferences that are focused on small-cap stocks.

**Make the analysis of your stock as easy as possible.** Many portfolio managers make decisions to buy or sell a stock during earnings release periods. With thousands of companies releasing earnings reports, making yours as clear as possible will help that decision process. Here are some recommendations based on what we look for as we analyze the quarterly announcements.

- Avoid the annual fourth-quarter write-down of past earnings and assets. This practice, used by many small companies, diminishes the interest in and credibility of quarterly reports that were issued before the fourth quarter.
- Break out nonrecurring costs and gains in the earnings release text.
- Explain quarter-over-quarter sales gains or losses.
- Include a cash flow summary in your quarterly release to the newswires.

- Identify any problems with customers who buy or use your products.

**Make trading in your stock as easy as possible for shareowners.** Among the tactics we would like to see small companies avoid are Class A and B designations on stock and convertible preferred issues.

Small companies often issue convertible preferred stock to raise capital and avoid issuing common stock in a secondary offering. However, the institutions that buy the preferred stock are likely to sell the common stock short against the preferred, so the end result is a sloppy secondary that hurts your existing shareowners.

Here are some other techniques that affect how attractive your stock will be to portfolio managers.

- If insiders with substantial holdings must sell, communicate why they are selling and offer those shares to the market as blocks.
- Pay a stock dividend once a year as long as the stock price is above $10 and the stock trades under 10,000 shares a day.
- As painful as it may be in the market, keep your stock price above $3 a share, with a reverse split if necessary.

**Handle bad news thoroughly when all the facts are known.** If you have to announce bad news, also provide guidance about its impact on future results. The guidance does not have to be earnings guidance. It can be related to backlog, competitive sales position or impact on the balance sheet.

From a tactical point of view, portfolio managers prefer that you provide the complete reason for the news and identify an employee who can discuss the event and will be available to answer shareowners' questions when the release goes out. Moreover, it is a good idea not to release the news after 4 p.m. Eastern time on a Friday.

These actions can help with investor relations and potentially save the cost of hiring an investor relations firm. They can also help keep your stock price as strong as possible during volatile market periods.

As a final note, do not underestimate the positive effects of insider buying of your company's stock when it is cheap, especially if there were earlier insider sells at a higher price. IRQ

# *Technology and IR*

## A Report Card

Richard B. Higgins, Ph.D.



Corporate strategic and financial communications are being buffeted by a broad array of economic, institutional and technological forces perhaps unparalleled in the relatively brief history of U.S. investor relations. A softening economy, volatile security markets, Regulation Fair Disclosure and the emergence of new disclosure technologies are altering the character, content and quality of communications through which companies provide strategic and financial information to the investment community.

The full impact of the interplay of these forces on the practice of investor relations is yet to be determined, but it is likely to be significant. The longer-term consequences of Reg FD, both intended and unintended, are difficult to predict. Prospects for the economy and security markets likewise are cloaked in uncertainty.

However, the rapid emergence of the Internet, e-mail, conference calls and other electronic enhancements over the past several years provides an opportunity to make a preliminary assessment of the impact of these new communications technologies on the process of corporate information disclosure. Is the potential for enhancing financial communications being fully exploited? Is the promise of providing more timely, detailed, specific information being fulfilled? Are the interactive capabilities offered by these technologies being achieved?

To answer these and other questions, the Association for Investment Management and Research, with the assistance of Stratcom Associates of Grantham, N.H., in 2000 repeated a 1998 survey of AIMR's membership to identify the changes, if any, that had occurred in those two years of rapid technological evolution. Together the results of the two surveys provide a preliminary report card on how the companies that produce corporate strategic and financial information and the analysts who receive it use various disclosure technologies.

The surveys were designed to determine the extent to which companies that AIMR's members regularly follow were using conference calls, the Internet, e-mail and other technologies to provide information to the investment community. Analysts were asked to evaluate these technologies as a source of strategic and

financial information and to rate the quality, timeliness and specificity of that information. The analysts also were asked to suggest improvements in how the technologies were used and to specify their technology preferences.

In the year 2000 an initial and second mailing of 2000 questionnaires produced a total of 270 usable responses, a response rate of 13.5 percent. Of these 270 respondents, 14 percent were identified as buy-side analysts, 4 percent as sell-side analysts, 67 percent as portfolio managers and 15 percent as "other."

Among the major findings were the following:

**Analyst conference calls.** A comparison of the year 2000 results with analysts' 1998 evaluations reveals significant changes in the perceived value, quality, timeliness and specificity of strategic and financial information provided by companies to the investment community. Of the three major technologies included in this survey, conference calls continued to be rated as the most valuable source of strategic and financial information, although the margin of difference between conference calls, the Internet and e-mail appeared to be narrowing, primarily due to significant improvements in the perceived value of the Internet and e-mail since 1998.

In their 2000 ratings, 42 percent of analysts reported that conference calls were a very valuable source, 51 percent said they were somewhat valuable and 7 percent said they were not valuable.

Respondents rated the quality, timeliness and specificity of strategic and financial information in analyst conference calls superior to what was provided on the Internet, but here again, the margins appeared to be narrowing. In 2000, 27 percent of analysts rated the quality of information provided in conference calls as good or outstanding, 39 percent said that timeliness was good or outstanding and 17 percent reported specificity of information as good or outstanding

Among conference call enhancements, the ones mentioned most frequently were simultaneous audio webcasting, delayed audio webcasting and electronic copy in advance. Simultaneous video webcasts, delayed video webcasts and live questions were additional enhancements that analysts said they would use if companies offered them. However, these results should be interpreted with caution, because significant numbers of analysts also reported that they did not know what enhancements companies might already be providing.

Eighty-two percent of those surveyed

in 2000 requested that companies provide a breakdown of financials by business line when reporting quarterly earnings, basically unchanged from the 80 percent who made the same request in 1998.

**Use of Internet.** Eighty-four percent of respondents said that all or almost all of the companies they follow have investor relations sections on their Web sites. The remaining respondents reported Web site IR sections only for some of the companies they followed.



Sixty-three percent of analysts reported that it was very important for companies to provide strategic and financial information on their Web sites, 31 percent said it was somewhat important and 6 percent said it was not important.

Respondents identified annual reports, earnings news releases, quarterly reports, SEC filings, IR contact information and other news releases as being the most frequent types of information that companies provide on their Web sites. Most valuable to the analysts were SEC filings, transcripts of management presentations, annual reports, earnings news releases and downloadable data.

A majority of analysts (53 percent) rated the Internet as somewhat valuable as a source of strategic and financial information, 34 percent said it was very valuable and 13 percent considered it not valuable at all. On a scale in which six represents extremely valuable and one not at all valuable, the mean average rating for all respondents was 3.95, a statistically significant increase from the 3.57 rating in 1998 but still less than the conference-call rating of 4.28 in 2000.

Twenty-nine percent of analysts rated the quality of strategic and financial information provided on corporate Web sites as good or outstanding (compared with 23 percent in 1998), 25 percent evaluated the timeliness of information as good or outstanding (compared with 21 percent in 1998), and 16 percent of respondents rated the specificity of information provided on the Internet as good or outstanding (compared with 15 percent in 1998).

Thirty-three percent of respondents rated the convenience and ease of use of the Internet as good or outstanding, compared with a 58 percent rating for conference calls.

Among the most frequent frustrations with IR Web sites, 54 percent of analysts cited out-of-date information, 50 percent said difficulty in finding what they were looking for, 46 percent said insufficient information and 42 percent responded incomplete information.

The frequency of analysts' visits to corporate Web sites declined from 1998 to 2000. In 1998, 76 percent of respondents said they logged on to the Web sites of companies they followed at least once a month, but only 56 percent said they visited those sites monthly or more often in 2000.

Fifteen percent of respondents reported that the strategic and financial information provided on company Web sites is always available from other sources, while 52 percent said that this information is almost always available, 31 percent said that it is sometimes available and 2 percent said seldom or never available.

**E-mail.** Fifty-four percent of analysts said that e-mail is somewhat valuable as a source of strategic and financial information, 33 percent said it was very valuable, and 13 percent felt that e-mail was not valuable. While e-mail continues to be rated as the least valuable technology as a source of strategic and financial information, significant improvements since 1998 are closing the gap. The mean average rating for e-mail increased from 3.37 in 1998 to 3.87 in 2000, a statistically significant increase.

Moreover, analysts said that they prefer receiving notice of conference calls through e-mail. In the 2000 survey 63 percent expressed that preference versus 14 percent who favored faxes and 6 percent who preferred Bloomberg terminals.

**Large-cap versus small-cap companies.** Analysts reported that of the companies that make excellent use of technology in providing strategic and financial information, 73 percent were large-cap companies, described as having market capitalization of at least $1.5 billion. When asked what made these companies' use of technology effective, 82 percent of respondents said timeliness of information, 76 percent said quality of information and 67 percent said completeness of information.

Of the companies that were not very effective in their use of technology, 56 percent had market capitalizations under $1.5 billion. The reasons the analysts cited most often for these companies' lack of effectiveness included limited use of technology, lack of information, lack of timely information and incomplete information.

As the above findings suggest, definite progress toward more effective use of disclosure technologies was made in the two years between surveys. Particularly noteworthy are significant improvements in the perceived value, quality, timeliness and specificity of strategic and financial

information provided by companies on their Web sites. But while companies have come a long way since 1998, they still have a way to go.

AIMR said the survey results show that the investment community has accepted online communications as a means of distributing and gathering financial information, but it also believes that many companies could do a better job of providing financial information on their Web sites and through their conference calls. Moreover, whether analysts are willing to use company Web sites to gather information depends to a great extent on the continued improvement of the quality and timeliness of information available on those sites.



As the results of the 2000 AIMR survey indicate, analysts do have clear alternatives to corporate Web sites, and increasingly they appear to be using them. Seeking independent sources of information isn't necessarily a negative development. Rather, the activity probably should be viewed as an opportunity for analysts to gain a broader, more balanced assessment of the companies they follow. In the long run, a certain tension between corporate requirements and analysts' needs is probably a healthy thing. Indeed, if analysts were completely satisfied with the information provided by companies — an unlikely scenario — that congruent state of affairs likely would be viewed with justifiable suspicion.

Finally, a word of caution to companies that are moving aggressively to add even more sophisticated electronic enhancements to their disclosure technology arsenal. While many analysts in the 2000 survey said they would use simultaneous video if it were available with webcasts, many respondents admitted that they did not know if the companies they follow currently offer it. Even if analysts were to become more familiar with enhancements available at present, not everyone would find them compelling.

A broad range of communications technologies offers companies the opportunity to reach more people with high-quality, timely information at a cost-benefit advantage. The challenge, as always, is to use these technology tools wisely, to create and communicate messages that are relevant and to the point. An unfettered, unfiltered flow of information bombarding the investment community serves no one's purpose — not the company, analysts or investors.

Operating in a post Reg FD environment, analysts need to draw upon all available resources to gather information

on the companies they follow. New and emerging technologies have the potential to provide significant assistance in this task. And yet, as the results of the 2000 AIMR survey indicate, many analysts are not taking full advantage of technology enhancements that are already available. If companies have a way to go in improving their utilization of communications technologies, the same can be said for analysts, portfolio managers and others in the investment community. The stakes are high, the potential rewards from the wise use of technology are substantial and the penalties for failure can be significant, for both producers and users of strategic and financial information.

# *IR Bookshelf*

## On the Road to Recruitment

Timothy McKenna


**Be Hunted!**
12 Secrets to Getting on the Headhunter's Radar Screen

Smooch S. Reynolds

John Wiley & Sons, Inc., New York
ISBN: 0471410748 2001

Smooch Reynolds, a West Coast-based recruiter with an active practice in investor relations and communications, has written a guide to the search process that ought to serve as a useful handbook for beginning to midlevel professionals who for the first time are seeking or getting attention from search firms.

The heart and value of Reynolds' book, *Be Hunted!*, is a detailed discussion of what job seekers should expect when working with a retained search firm. Reynolds devotes a chapter to each step of the process: how search firms organize and research an assignment, the typical interview schedule, negotiating compensation, providing references and so on. The chapters are organized into sections with subheads such as "Questions you should ask … How do you calculate your marketplace value? … Controlling the interview." That makes it easy for readers to scan the book for topics of greatest interest.

Reynolds offers copious advice, some of it basic, such as erring on the side of formality in dress and manner in an interview situation despite the growing informality of the workplace. Some advice is not so basic. For example, her discussion of what is likely to be negotiable, when to back down on negotiating and when to push for more would be a useful summary for anyone who has not bargained compensation for a higher-level post.

Though the book's subtitle mentions 12 secrets to getting on the headhunter's radar, one may outweigh all others. Reynolds argues that recruiters

are most likely to be attracted to candidates who develop personal marketing plans and promote themselves, subtly and carefully, throughout their careers. These professionals will understand their strengths, know their interests and be ready to communicate them effectively when a recruiter calls. And they likely will have begun establishing an identity with recruiters long before they become involved in active job searches.

"Remember that when you interact with a recruiter, your mindset is critical to the relationship that you will develop," Reynolds says. Better, she advises, to begin building that relationship when you are relaxed and in command of your situation than when you are eager to move.

Like many business books that are written by working executives, *Be Hunted!* is heavy on common sense. For someone who has been through the process, much of this is familiar ground. On the other hand, for the midlevel manager, being contacted for the first time by a search firm, it can be useful to have this common sense organized in one convenient place.

A more serious quibble: Reynolds spends the first 50 pages warming up on tangential issues such as the role of an in-house recruiter or the differences between retained search and contingency firms. She even catalogs a week in her own life as a headhunter. By the time professionals begin to get calls from recruiters, they're usually familiar with these basics.

The book also is a bit too chatty. For example, I'm not sure we need an anecdote to illustrate every point she makes on the etiquette of interviewing. It ought to be sufficient to say that a job search is no place for pursuing a personal relationship, rather than telling us about the candidate who tried to date the receptionist. As you might expect, the hiring firm didn't appreciate his advances.

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