Down to the Letter

Few investors are as adept in deciphering corporate financial statements as Olstein Capital Management Bob Olstein. In 1971 he launched (with Ted O'Glove) the *Quality of Earnings Report*, an early forensic-accounting bible, and he has since made a career out of identifying opportunities and risks largely informed by a nuanced analysis of the numbers.

So it came as a surprise when he mentioned in our interview with him for this month's issue that he often finds much of interest in a more prosaic section of the annual report, the shareholder letter. He argues a careful reading of today's letters is particularly important given the tumult of recent years: "The adage, 'When the going gets tough, the tough get going,' has never been truer than during the past three years. What management is, and isn't, talking about in difficult times can provide a great deal of insight into its ability to create value in the future."

In his latest investor letter, Olstein lays out some of the key questions to which he's looking for answers today and why:

Does management adequately discuss the company's financial strength, debt levels, cash flow, working capital needs and cost controls? Does the discussion signal ongoing or growing problems with cash flow, cost controls, and ultimately, the company's financial strength?

How does management discuss challenges to operations posed by the recession? Has it reacted to the changing conditions? Has the company favored across-the-board cost cutting that may put it at a strategic disadvantage during the economic recovery? In the face of recession, has the company continued to invest in or pulled back from initiatives that will improve its competitive position or operations during the economic recovery?

Do measures undertaken during the past year reveal a significant break from the company's strategy from one, two, or three years ago?

The degree to which a company acknowledges the challenges posed by the recent recession and discusses its response to those challenges not only reveals a great deal about management's capabilities and credibility, it also highlights those management decisions or shifts in strategy that are likely to affect the company's future cash flow. These subtle shifts may generate investment ideas for further research, prompt a reassessment of our investment thesis for an existing holding, or signal a potential buying opportunity in a company our research team has been following and monitoring for some time.

Olstein uses Harman International (*see p. 7*) as an example for which a change in the tone and content of the company's letters helped reinforce that new CEO Dinesh Paliwal was transforming the company for the better. "The 2006 letter devoted two paragraphs to explaining an image of a surfer on the cover, and only two sentences on the failed four-month tenure of a replacement CEO," he says. "The 2007 letter [Paliwal's first] presented a blueprint for improving performance through cost control, risk management and simplifying business processes. The change was striking and merited further analysis and investigation."

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