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A case for not talking to management

Factors such as an exuberant CEO or creative financial reporting can exert undue influence

INVESTMENT STRATEGIES

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An integral part of most institutional investors' analysis involves meeting with management to gain deeper insight into a company's strategy and prospects.

Unlike most investors, we steer clear of such meetings, for two essential reasons: to reduce the emotional aspects of investment decisions and to avoid the short-term outlook that often underscores earnings guidance.

Although most investors — experienced and novice — realize that fear, hope, hunches and solid information affect every buy, sell and hold decision, other factors may also exert undue influence.

A compelling narrative delivered by a charismatic chief executive may overshadow financial data that could serve as an early warning sign of shifting fortunes or trouble ahead. Favorable short-term results or earnings guidance delivered by an overly promotional management team may mask the unfavorable economic reality of the company's underlying business.

Our search for value focuses on identifying significant deviations between the price of a stock and the issuing company's intrinsic value.

For most value investors, the primary challenge of analysis is to fully understand the issues that have created the discount, whether those issues are temporary or chronic, and what circumstances or events are likely to close the gap between the company's stock price and its intrinsic value. Understanding the causes of the discount helps separate companies with serious structural, financial or secular problems from those that are simply not performing to their full potential.

In light of a significant gap between the company's stock price and our determination of its value, we assess the decision-making skills and leadership of a company's management team. We think that an accurate assessment of management's capabilities and role in the company's low stock price should rely less on what management says and focus instead on what the company's management has done and continues to do.

FORENSIC ANALYSIS

One of the fundamental tenets of our investment philosophy is that a forensic analysis of a company's financial statements, regulatory filings and accompanying footnotes reveals the quality of a company's earnings, the success of its strategy, the sustainability of its performance and the impact of management decisions on future free cash flow.

When assessing management, we pay particular attention to the economic reality of the company's financial statements and related footnotes, the conservatism of its balance sheet, and the quality and consistency of its disclosure practices. We also evaluate management by analyzing the consistency and integrity of its shareholder communications and presentations over many years.

Most companies use financial accounting and reporting practices to present themselves in the most favorable light, meaning that they engage in some type of earnings management or make assumptions that may prove to be unrealistic.

Our process "looks behind the numbers" through a careful and, at times, skeptical reading of company communications, press releases and shareholder letters.

Whether we are grading the performance of an existing holding or monitoring a potential investment, we read for "heat" — trigger words that, in our experience, might signal a noteworthy change likely to affect the company's future value. In particular, while examining shareholder letters, we look for a degree of consistency with prior communications, a realistic discussion of the objectives and expectations for company performance, and a discussion of shareholder-focused benchmarks that management uses to judge its performance.

ACTIVE INVESTOR

In situations where we have determined that there is an identifiable impediment to the recognition of intrinsic value, we opportunistically engage as an activist investor. Because such situations require interaction with management, we usually approach the company in a cooperative vein, offering strategic advice and recommendations.

From our experience, we have found that our nonconfrontational approach is often well-received by company management open to insights and a constructive engagement that focuses on improving free cash flow. We applaud a corporate leader who thoughtfully analyzes the situation, understands the company's strengths and weaknesses, and takes the time to pursue a strategy that addresses the company's most pressing problems.

Eric R. Heyman is portfolio manager of the Olstein Strategic Opportunities Fund.