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Don't overlook shareholder letters

They offer unique insights into management's priorities, company's financial health

INVESTMENT STRATEGIES

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Investors usually pore over the pages of financial data provided by companies in their annual shareholder reports, but they often skim the “letter to shareholders” at the beginning.

Although investing requires a deep analysis of financial statements, an inferential reading of a company's present and past shareholder letters — especially those parts that can be verified by financial data contained later in the annual report — is one of the best ways to assess the quality of a company's earnings. It also can help identify subtle shifts that may indicate future changes in base earnings power.

Shareholder letters usually discuss a company's recent performance, its future prospects and the strategy that management thinks it should pursue.

A good shareholder letter not only describes how a company is adapting to changing economic or competitive conditions, it also provides insight into management's ability to create meaningful shareholder value over time. During the tumultuous economic environment of the past several years, a careful reading and comparison of shareholder letters has proven invaluable in understanding a company's priorities and assessing management's capabilities.

In recent years, we have focused on management's discussion of a company's financial health and whether recent management decisions materially could affect longer-term value creation. We have sought, often by reading between the lines, to answer several questions, including:

- Does management adequately discuss debt levels, cash flow and working capital needs? Are there any references to continuing 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 the company continued to invest in initiatives that will improve its competitive position as the economy recovers, or are cost-cutting initiatives likely to place the company at a disadvantage?
- Do the initiatives undertaken during the past year reveal a significant

break from the strategy discussed two or three years ago?

The extent to which a company acknowledges challenges posed by the recession and discusses its response to those challenges not only reveals a great deal about management's credibility and capabilities, it also highlights factors that may affect the company's future cash flow.

When evaluating companies, here are a few themes to look for:

Continuity. To understand what management emphasizes, minimizes or may have omitted in a shareholder letter, it is important to develop an appropriate context by reading a succession of letters from the previous three to five years, carefully evaluating the continuity of communications. We look for shifts in the discussion of the company's strategy — are there significant inconsistencies or changes in direction from previous years that can have a material impact on future revenue, costs and free cash flow? Shifts in continuity may generate investment ideas for further research, prompt reassessment of an existing holding or signal a buying opportunity in a company that we have been monitoring.

Realistic expectations. It is important to assess the overall tone of the letter and judge how candidly management discusses the company's problems. A careful reading should not only focus on what management chooses to emphasize, but also what issues or events management chooses to omit or minimize. Is there a frank discussion of issues or problems that the company needs to address? Absent such a discussion, we become concerned that management may have an unrealistic view of the company's operating capabilities or the overall business environment.

Appropriate benchmarks. We pay special attention to how management frames the discussion of financial results and the progress toward previously stated objectives. The discussion of financial results and yardsticks used to measure success allows us to determine whether management prioritizes overall financial strength, cash flow, working-capital controls and, ultimately, shareholder returns.

When read with vigilance and a healthy dose of skepticism, shareholder letters can provide valuable insight into a company's operations while providing a practical way to judge management's ability to create long-term shareholder value.

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