Morgan Stanley

Journal of Applied Corporate Finance

SUMMER 1993 VOLUME 6.2

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FINANCE THEORY AND THE NEW INVESTOR RELATIONS

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Investor relations programs represent a billion dollar per year effort to disseminate information with the objectives of increasing share price, lowering the cost of capital, and increasing market liquidity. Having evolved far beyond its early role of public relations applied to a company's shareholders, investor relations is increasingly seen as an asset management function—one that usually falls under the direction of the corporate chief financial officer. According to a survey by the National Investor Relations Institute, 42% of investor relations directors have a corporate finance background.

This grounding of the corporate IR function in the financial side of the firm supports the notion that investor relations is primarily a financial function, providing financial information to financial market participants. The ties to finance, however, go well beyond the kind of information being communicated. In doing their job, today's investor relations professionals draw on concepts from portfolio theory and models of bargaining under conditions of asymmetric information.

In this article we describe the *new* investor relations—how it works, the growing industry that supports it, and how firm value and market efficiency may be affected by it.

INVESTOR RELATIONS IS STILL A COMMUNICATIONS FUNCTION

All public corporations engage in investor relations activities. At a minimum, communications with investors must satisfy mandated disclosure requirements. The SEC has established rules that govern the structure and timing of filings such as the 10-K, 10-Q, and 8-K reports, and proxy statements. The annual report allows more flexibility, although it must include audited financial statements as well as a Management Discussion and Analysis (MDA) that meets SEC guidelines.

These mandated reports provide the backbone of financial disclosure, but they will rarely satisfy either the firm's required or desired level of communications with investors. Rule 10b-5 of the Securities Exchange Act of 1934 requires that companies make complete and timely announcements of material facts regarding a company's financial condition. Moreover, the listing agreements of the major stock exchanges and the National Association of Security Dealers contain language similar to that of rule 10b-5. Failing to disclose material information in a timely and accurate fashion can result in litigation and/or de-listing.[1]

While the required level of disclosure is supposed to be designed to provide sufficient information for investors to make informed investment decisions, companies can and do often choose to exceed that level of disclosure. Corporate managers are finding that well-developed voluntary disclosure strategies can increase analyst coverage of the firm, establish credibility with analysts, and help ensure that security prices accurately reflect the company's value.[2] Therefore, firms supplement required disclosures with a variety of voluntary communications. These range from the old standbys—press releases and CEO presentations to security analyst societies—to new approaches such as conference calls with analysts, faxing news releases, and one-on-one meetings with targeted institutional investors.

In developing corporate disclosure strategies, moreover, investor relations professionals draw on theory and evidence from financial economics. And, as the following discussion attempts to show, corporate IR officers and financial economists may have much to learn from each other.

Increasing Analyst Coverage

Finance theory suggests that stock prices are set "at the margin" by the most sophisticated investors. According to this view (see the Roundtable in this issue), attempts to increase the number of sellside analysts following a company may be futile.[3] Although this view is likely to be true for most Fortune 500 companies, it may not apply to smaller firms with limited institutional following and low trading activity. In such cases, increased analyst coverage may well lead to increased liquidity and share values.

Robert Merton, a prominent financial economist at Harvard, has developed a theoretical model that demonstrates that, in the case of smaller companies with limited investor following, increased investor awareness could result in lower costs of capital and higher share prices.[4] In fact, Merton links the "small firm effect" that has long puzzled economists—the tendency of smaller companies to earn abnormally high rates of return—to neglect by analysts and institutional investors.

Merton argues that investors and analysts incur start-up costs when adding a new company to the group of firms they follow. Providing information in a form that analysts can quickly use is one way to lower those start-up costs and thereby encourage analyst coverage. And, given the recent reduction in the number of brokerage analysts, voluntary disclosure policies that reduce the effort an analyst must expend may be especially important in gaining analyst coverage.

In an effort to test Merton's argument, we recently conducted a study of the stock market effects of CEO presentations to analyst society groups. Following such presentations, companies with a limited analyst following (no more than six analysts) experienced a significant decrease in their equity beta (a measure of market risk) and, hence,

1. See Wesley S. Walton and Charles P. Brissman, *Corporate Communications Handbook*, (Clark, Boardman Callaghan, 1991) for a thorough discussion of the duty to disclose.

2. For a further discussion of disclosure strategy, see Baruch Lev, "Information Disclosure Strategy," *California Management Review*, Vol. 34, No. 4 (Summer 1992) pages 9-32.

3. For several expressions of this view by corporate IR consultants and professionals, see the Roundtable on Relationship Investing and Shareholder Communication in this issue of the *Journal of Applied Corporate Finance* (Summer 1993).

4. Robert Merton has developed a theoretical model demonstrating the value of lowering such start-up costs, Merton, "A Simple Model of Capital Market Equilibrium with Incomplete Information, *Journal of Finance*, Vol 42, No. 3 (July 1987).

in their cost of capital. A similar result was found for the quartile of firms with the smallest market values. These results support Merton's argument that investor relations efforts should be particularly beneficial for lesser known companies.[5]

Credibility

The era of investor relations programs that exaggerate good news while hiding or downplaying bad news is past. Articles written by and for investor relations professionals stress the importance of telling both good and bad news with equal alacrity and openness. Credibility with analysts does not mean that the market will not react negatively to bad news. Rather, it means that when top managers describe the extent of the bad news, analysts will accept their assessment as an accurate or unbiased estimate. Moreover, a policy of providing full and timely disclosure helps analysts maintain their own reputation with investors. As one analyst puts it, "There is nothing an analyst hates worse than being surprised."

Having a reputation for credible disclosure means that analysts will consider qualitative information as well as measurable and audited quantitative data. Where qualitative information might be dismissed in many cases, analysts will listen to the qualitative appraisals of a firm that has a history of being truthful. Increasingly, analysts are looking beyond the purely financial in making their assessments of a company's worth. Strategy, focus, managerial quality, products under development, and the firm's responsiveness to customers and market changes are all important concerns of analysts. How analysts react to company statements about these topics depends on the level of credibility that the firm has established with the analyst community over an extended period of time.

Credibility or reputation effects have long been of interest to economists. In fact, bargaining models show that if two parties engage in repeated transactions, honest disclosure is almost always the best course.[6] Stated very simply, such models demonstrate that succumbing to the temptation to cheat raises costs, or otherwise reduces profits, in subsequent exchanges; and, for this reason, "full disclosure" turns out to be the most valuable strategy for a corporation with an infinite life. The investor relations profession has arrived at the same conclusion as the theorists regarding the value of reputation.

Liquidity Effects

Beyond gaining credibility with analysts, the voluntary disclosure of both good and bad news may increase market liquidity. Liquidity refers to the ease with which securities can be bought or sold quickly with a minimum change in price. The transactions costs of buying and selling a security—brokerage commissions and the bid-ask spread—affect liquidity. When the spread is large, investors will demand compensation in the form of higher returns, thereby increasing the firm's cost of capital.

A key determinant of the size of the spread is the degree of "information asymmetry" facing the market maker. Market makers maintain larger spreads when they believe that some traders have superior information. Providing public information about a firm's anticipated future performance reduces this threat, resulting in a eduction in the bid-ask spread.

Efficient Pricing of Securities. In its semi-strong version, the Efficient Markets Hypothesis states that security prices quickly reflect all publicly available information. Without sufficient information about the firm and its prospects, market prices will not accurately reflect the firm's value. Voluntary disclosures help move the financial markets toward efficient pricing of a firm's securities.

But, why would a corporate manager willingly release information if it meant a lower stock price? As discussed above, both legal and reputation effects require firms to reveal both good and bad news in a timely fashion. Therefore, investor relations programs that make timely and accurate disclosure of both good and bad news could improve the efficiency of the stock market.

RESPONDING TO OTHER TRENDS IN FINANCE

The focus of investor relations managers has evolved in response to changes in the investment and corporate finance fields. The greatest change in

5. See John Byrd, Marilyn Johnson, and Mark Johnson, "Investor Relations and the Cost of Capital," University of Michigan Working Paper, May, 1993.

6. A very readable introduction to the theoretical work on reputation appears in the text by Paul Milgrom and John Roberts, *Economics, Organization & Management*, Prentice-Hall, New York, 1992, pages 259-269.

Following CEO presentations to analyst society groups, companies with a limited analyst following experienced a significant decrease in their equity beta and, hence, in their cost of capital.

IR activities has been the increasing emphasis on direct communication with institutional investors.

Three trends have contributed to this change. First, institutions own a steadily increasing percentage of the outstanding equity of public U.S. corporations. Second, following the 1987 stock market crash and the deregulation of brokerage commissions, there was a decline in the number of brokerage analysts. As a result of this decline, less research is conducted by brokerage firms. Institutional investors must increasingly rely on direct contact with investor relations staffs to obtain information about the companies in their portfolios. Finally, many IR staffs have increased contact with institutional investors in response to narrowly averted takeover attempts or proxy fights. In the next section, we discuss how this effort to attract the "buy-side" is carried out in a very focused and scientific fashion.

As corporations look to overseas markets for customers and investors, their IR programs have also become more attuned to cross-border communications. Firms with an established presence in overseas product markets have used their brand-name recognition to tap foreign capital markets. For other firms, however—particularly first-time issuers—effective IR increases the success of security offerings in foreign markets.

Initially, overseas investor relations efforts rely on the contacts provided by brokerage houses, banks, and investor relations consultants with overseas offices. The objectives are to identify key investor groups—institutions, banks, individuals—determine the type of information they need, and then design IR activities to provide that information while conforming to local customs. For example, European investors have traditionally been long-term investors and have reportedly had a greater interest in the quality of management and the firm's long-range plans than their U.S. counterparts. Communications that help foreign investors interpret the impact of U.S. political and economic developments can also be very important.

Besides the increased importance of institutional investors and global markets, the 1980s saw an increase in the use of debt by U.S. corporations. With increased leverage, communication with lenders and rating agencies took on new importance. Investor relations professionals with finance backgrounds are better able to provide the information that lenders and rating agencies need. As debt of various types—bank credit lines, private placements, and publicly-traded bonds—comprises more of corporate capital structures, the impact of interest costs on companies' overall cost of capital has increased. A well-designed communications program aimed at lenders could conceivably lower a company's cost of capital; in periods of financial distress, it could also facilitate the renegotiation of loan agreements. As lenders, fixed-income analysts, and rating agencies demand more and better information, the role of communicating with these groups has shifted from solely a treasury function to part of the duties of the IR manager.

BEYOND THE COMMUNICATION FUNCTION: PROACTIVE INVESTOR RELATIONS

Today, the state of the art in investor relations extends far beyond providing information to and establishing credibility with brokerage analysts. Investor relations experts talk of managing share price, or managing the ownership mix of the firm. Taking a lesson from portfolio theory, many investor relations programs include diversifying their mix of shareholders among their primary objectives. Just as the variability of a stock portfolio is reduced through diversification, these IR managers believe that the volatility of their firms' stock can be reduced by diversifying the firms' ownership structure. Just as portfolio managers reduce the volatility of their portfolios by selecting securities that are not perfectly correlated with one another, IR managers are trying to reduce the volatility in their companies' stocks by diversifying the mix of shareholders across investors with different investment strategies. If shareholders pursue different investment strategies, all will not respond in the same way to a particular type of news announcement—and the resulting reduction in volatility could lower the firm's cost of capital and increase its liquidity.

The most significant change in investor relations has been an active effort to "target" particular institutional investors to achieve shareholder diversification. A recent study completed by Equity Communications, an investor relations consulting firm, found that 54% of the 200 largest U.S. corporations were actively targeting institutional investors. That study also documented that firms involved in targeting outperformed the S&P 500, industry, and size-adjusted indexes.

The effectiveness of targeting has also been documented by OLC Corp., an investor research and

communications firm. Targeted investors have purchased nearly $3 billion of the stock of OLC's approximately 100 client firms. Targeting has become such an important part of some IR programs that, according to Joe Shenton, President of OLC, IR personnel are compensated in part on the success of their targeting activities.

Strategic investor targeting, which has spawned a small industry of consultants, begins by identifying a set of companies with financial characteristics similar to those of the client firm. Knowledgeable consultants focus on the characteristics that institutional investors use to make their investment decisions—for example, earnings growth rates, discounted cash flow measures, or market-to-book ratios. Ideally, the peer group will also include companies that are not in the client firm's industry. Since investors typically desire diversification, an institution with major holdings in an industry may hesitate to increase its exposure in that industry.

Once the peer group has been identified, a list of 40 to 60 institutions with holdings in the peer group of firms is compiled. Data on the size of the holdings, length of time held, and general investment strategy of each of the institutions is also collected. In theory, these institutional investors should be interested in owning the client firm's stock, since the client firm has attributes that have generated "buy" decisions in the past.

Moreover, given the types of firms these institutions follow, they are more likely than other investors to understand the dynamics of the client firm and its industry. For example, "value investors"—those who choose investments based on discounted cash flow or price-to-book ratios—often have a good understanding of cyclical industries. In contrast, "earnings momentum" investors may be quite adept at understanding the workings of growth firms.

The final step is for the IR officer to arrange meetings with the managers of the identified investment funds. Focusing on the narrow list of high-probability investors allows the IR manager to tailor presentations to those investors. The targeting process is on-going. As the characteristics of client firms and the investment strategies of institutions change, the list of prospective investors also changes. Funds that did not invest when first approached may be more interested later, so contact continues. Alternatively, an initial investment might be nurtured into a larger stake over time.

Surprisingly, when targeting institutions, investor relations officers do not target only those buy-and-hold investors who make no waves. Rather, they prefer investors that conduct careful research, stay well informed, and do not overreact to rumors.[7] The least desirable investors are those that base buy-and-sell decisions solely on quantitative analysis—the indexers, asset allocators, and quantitative screeners. Much preferred are active fund management styles. Active management provides firms an opportunity to tell their story, explain their unique qualities, and establish relationships with fund managers.

Targeting concentrates on institutional investors, but some companies also make efforts to attract individual investors, who are often seen as value-oriented, long-term investors. Two corporate approaches to encouraging individual ownership of stock are participation in investment club conventions and investor fairs and establishment of low-cost investment programs. The regional and national investor fairs sponsored by the National Association of Investors Corporation (NAIC) give companies an opportunity to meet individuals actively involved in investing. To support share ownership by individuals, the NAIC has developed the Low Cost Investment Plan. This program allows individuals to invest small amounts in a set of participating corporations. Once an account has been established—usually by buying one share of stock and enrolling in the participating firm's dividend reinvestment plan—investments of as little as $10 or $20 can be made in additional shares at prescribed times, typically monthly, without brokerage or administrative fees.

Pro-active IR, then, has had a marked impact on the IR profession. In many corporations IR is now seen as an important finance function. But, as we discuss in the next section, more change may yet be in store for IR professionals.

THE FUTURE OF INVESTOR RELATIONS

As the managers of the largest pension funds in the U.S.—funds such as CREF, CalPERS, SWIB, and

7. For more information, see the survey results in Mary Lowengard, Corporate America's Favorite Shareholders, *Institutional Investor*, December 1990, pages 63-67.

A recent study found that 54% of the 200 largest U.S. corporations were actively targeting institutional investors. That study also documented that firms involved in targeting outperformed the S&P 500, industry, and size-adjusted indexes.

others—adopt long-term investment strategies, they are advocating a new form of corporate governance known as "relationship investing" that calls for a larger IR role. These fund managers want more information about companies' long-range plans and strategies, new products under development, and the quality of management. The IR office, as the direct contact with the investment community, is the natural link through which this interchange will take place.

In part, relationship investing also involves information flowing from institutions to management. Pamela Jameson, a strategic IR consultant with Johnnie D. Johnson & Co., argues that IR offices have traditionally been under-utilized as information suppliers to management. To ignore the natural "early warning system" provided by IR contact with investors, she argues, is to waste a potentially valuable resource. Changing IR into a two-way conduit of information is one of the changes Jameson and other IR professionals see occurring in the 1990s. For example, Jameson has successfully used a compilation of analysts and investor questions to provide managers with some insight into how the firm was perceived on the Street; in a few cases, it served to alert managers to potential problems.

Lou Thompson, President of the National Investor Relations Institute (NIRI), notes another relatively new development—one in which IR people provide more *non-financial* information to analysts. As a company changes its strategic direction and exploits opportunities abroad, it becomes increasingly important to explain its strategy, its new markets, and the competitive advantages it brings to those markets. The more complex the firm and its environment, the more important are these non-financial variables in enabling analysts to understand the firm and then present its full value to their investor following. Presenting non-financial information places new demands on IR professionals and requires a much different set of skills than were called for in the past.

CONCLUSION

With the increased importance of institutional investors, there has been a growing recognition among managers that the corporate investor relations function must adapt to the changes in information gathering and analysis now occurring in the marketplace. As OLC's Joe Shenton puts it, "We have seen a 180 degree shift away from public relations-based IR to a finance-based IR at almost all sophisticated companies."

This new emphasis on a financially-based IR is having a marked impact on IR professionals. First, they are expected to communicate directly with targeted groups of institutional investors, debtholders, and international investors, providing kinds of information previously available through brokerage house analysts. Second, communication with institutional investors is increasingly comprised of "soft" information about the firm's future plans and strategies. Third, within the corporation the importance of the investor relations function is growing, as its potential impact on share price is recognized. Thus, the IR profession is shifting away from its old image of "promotion" and public relations, and preparing to play a more significant role in the corporation and its quest for value.

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Journal of Applied Corporate Finance (ISSN 1078-1196 [print], ISSN 1745-6622 [online]) is published quarterly on behalf of Morgan Stanley by Blackwell Publishing, with offices at 350 Main Street, Malden, MA 02148, USA, and PO Box 1354, 9600 Garsington Road, Oxford OX4 2XG, UK. Call US: (800) 835-6770, UK: +44 1865 778315; fax US: (781) 388-8232, UK: +44 1865 471775, or e-mail: subscrip@bos.blackwellpublishing.com.

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