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TRANSCRIPTION OF INTERVIEW

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L. J. Rittenhouse, Author and Columnist

"Do Business With People You Can Trust: Balancing Profits and Principles"

Editor's Note: We have edited the interview in this transcription for clarity and readability.
The original real audio interview may be heard on our [Ask The Expert](#) page.

JIM PUPLAVA: Joining me on the program is L. J. Rittenhouse. She has written the first-ever guide for reading and understanding the shareholders letter that Fortune 500 CEOs publish in their annual reports. This guide is based on her annual survey of shareholder letters. Prior to founding andBEYOND Communications in 1991, Ms. Rittenhouse was an investment banker at Lehman Brothers. She has appeared on CNN and CBS MarketWatch and is the author of the series *Profiles in Change* and other articles appearing in magazines, journals and newspapers. Laura, I want to talk about your background. You began in the investment banking business and then moved from investment banking to investment relations advisors. What has that experience taught you?

LAURA RITTENHOUSE (LJ): Well, it was an interesting transition Jim. I made the transition because I began to see in my work with companies how important communication was in the execution of the company's strategy and in the kinds of financial results that the company ultimately achieved. As an investment banker, I would spend a good deal of time talking with my clients about how they could maximize their shareholder value and I began to see that, if the communication of whatever it is they were doing was not effective, it was hard to realize that value. So I began to focus on working with companies where I thought I could add the most value: in thinking through how to best communicate what they do. This, in turn, affects what they actually do.

JIM: Now, in your book, you focus on the words of CEOs. You look for trustworthy leadership. Why is the Chairman's Letter so important and what does it tell investors?

LJ: The Chairman's Letter is the only place in the annual report where the CEO signs his or her name to strategic commentary. These days it's pretty well known that the leadership of a company is one of the primary factors in determining the value of a stock. Leaders that are perceived as being dynamic, can deliver and have credibility because they produce the results they have promised. Investors can rely on the expectations that they set. They have the ability to motivate people to build trust among customers. All of these soft kinds of performance measures are really critical. Those are the kinds of things that you can look for in a well-written shareholder letter.

JIM: In your book you use as an example the letters written by Warren Buffett. What makes Buffett's Berkshire Hathaway's Chairman's Letter stand out in your mind?

LJ: Well, I could say the 10,000 or 11,000 words that he uses is one thing that makes it stand out. His letter is about five times longer than most letters that CEOs are writing. But one also has to remember that the Chairman's Letter is Warren's most important investor relations communication. He makes it very clear that he does not communicate with individual investors throughout the year, but instead, chooses to communicate with them completely and candidly once a year in that Chairman's Letter. As I note in the book, he's been very proud to publish these works, which have been collected in volumes of books that people can acquire or download from his website. They're noted for the straightforward way in which he talks about the results of the company and guides and educates investors in what is behind the success or the lack of success of Berkshire.

JIM: You know that's one thing I've always admired about Mr. Buffett. Even when he had a bad year, I think it was 2000, right up front in the letter he admits to his shareholders that if there's anything that went wrong in the company last year, I'm the one that's at fault. I think it's that straightforward trustworthiness that shareholders feel that when something goes wrong, he's going to tell you that too.

LJ: Yes and I think that the success of his company is very much tied to that relationship established with his investors. What's interesting, particularly today, is what we are hearing about this difference between companies that are adhering to the letter of the law and managements which now have to be also concerned about both the letter and the *spirit* of the law. This is rather ambiguous and not an easy-to-define concept or measure of performance. But again, those are the kinds of things that you can begin to get a sense of. Warren's letter is written not just to shareholders, but also to employees -- many of whom are also shareholders. The letter itself becomes a guide to set standards throughout the company, so that employees begin to understand what's expected of them in adhering to the corporate values.

JIM: Describe some of the behavior that destroys trust -- some of which Warren talked about in his annual 2000 report.

LJ: So what destroys trust? I guess the most important one, Jim, is something that I call "The Golden Rule of Financial Partnership." It is a management that sees shareholders as patsies not partners. That's one of the phrases that Warren has used. But this belief that the managers run the company for their own benefit and not for that of the shareholders -- that's certainly one of the most important trust-breaking behaviors and actions.

JIM: Berkshire is unique in the sense that they have what they call a Shareholder's or Owner's Manual. That's somewhat unique for most companies. Very few companies do that.

LJ: I don't know of any others, Jim. I don't know if you do?

JIM: No, I don't.

LJ: I have talked with many, many companies. In fact I've had conversations with Warren about this. I asked him why no other companies have this kind of manual. For example, if you buy an appliance or you buy some kind of equipment, you need a manual to help you understand how it operates. Similarly, when you read the entire annual report of Berkshire Hathaway, you get a sense at the end of it of how that company operates. I think it's crucial that recommendations proposed by the SEC to improve disclosure in annual reports have to get companies to write more clearly, more candidly, to get at the heart of what it is behind the business so that investors can begin to understand what to look for to make their own assessment about how likely the company is going to succeed. And again, that's why I think the principles are important; to show the investor how well you, the CEO, you, the leaders of the company, understand your own business. As you know from reading the book, Warren's comment in an interview we did was his concern that a lot of CEOs don't really understand how the business is run and that gets reflected in the shareholder letter.

JIM: How does an investor, when reading a report, tell that what they're getting is fact versus fluff. You talk about it in your book. If all you see are glossy photos and a bunch of more photos, and hype, how do you differentiate between fluff and fact?

LJ: The fluff is what I call the jargon that's in an annual report. And I think one of the most unfortunate things that's happened in our capitalist system is how many investors have been conditioned -- almost as a Pavlovian response -- not to read the letter because it's so filled with jargon. Jargon includes words that are just linked together without any apparent thought. They may use words that have a lot of sense inside a company. But, for someone outside of the company these words have no meaning whatsoever. So, you're reading a communication that's addressed to you, the shareholder, or the employee, or customer, you want to have to wade through paragraphs and paragraphs of meaningless information. When I talk about fluff, I'm referring specifically to the commentary where you read something and it absolutely makes no sense.

JIM: You give a good example in 1999 in Enron's report to their shareholders, they basically said, well, if you can't understand what we're doing, then you're not keeping up with us. Is this a perfect example where the management is trying to obfuscate the truth?

LJ: Well, that's a pretty blatant example. I think it's also wonderfully revealing of how arrogant they were becoming. This was the beginning of 1999 and that kind of attitude is something that is pretty easy to pick up in these communications. Now at the time, Enron was much admired for that kind of arrogance. I always was suspicious of it. If they think that they're going too fast, and that I am, therefore, not able to understand or keep up with them, then I'd like to know why that is. Business isn't that complicated. Not only that, but it should be their responsibility as management to be able to explain to me -- the investor who is providing them with the capital that they're using to run this business -- it ought to be their responsibility to explain it to me in a way that shows me they understand as well in allowing me to understand the business.

JIM: You've identified some important concepts that a good annual report would feature. You've been talking about some of the topics such as accountability and vision of the company, if there's a vision what is going to be the strategy to carry out that vision, who are the stakeholders and how candid is management in terms of how well things are going. Why don't you discuss a few of those?

LJ: The elements you just pointed out, Jim, are what I call the skeleton of the shareholder letter. I've presented those in the book because I've talked to so many well-educated, well-informed people -- lawyers, people who are very successful in their own businesses, etc. -- who tell me they throw up their hands and they can't understand these shareholder letters. So, I've tried break the code of these letters so people can begin to wade through the chaff and pick out what's really important that can help them understand the business better.

I consider accountability one of the very important things that you look for when reading the shareholder letter. For example, just about every company I know has goals. But how willing are they to disclose those goals to their stakeholders? What I found is less than half of the companies that I surveyed are willing to do so. Now often times these goals or statements are made so generically that they're virtually meaningless, but some companies will give very explicit goals that they expect to achieve and give you measures by which you can determine if they've achieved those goals. And, guess what? These companies perform better than companies that don't do this. So that's one example.

The candidness of the communications, again, I think is very revealing. I look for reports that give me a balanced view of a company and its results. Most people think these letters are made just to spin results but in fact, you can find companies that tell you about the things that went wrong and tell you what they're doing to fix those things. We all know that life never goes perfectly, so in every single company, something has gone wrong. I want a CEO to tell me what it is, tell me what they've learned from it, and tell me how they're going to be better from it. That's something that Warren does in just about every

single letter. But people will say, "Well he can afford to do that. He's sitting on 35 billion dollars." I think what's interesting is to turn that around and say, "Well maybe he's become as successful as he is because he's able to look with such candor and objectivity about his business." So we look for things like that.

The vision elements are, I find, very interesting because this -- and again it's the only place where you can begin to get a sense of this is through the shareholder letter -- vision really relates to what we call the right brain way of thinking. It's the creativity, the intuition, and the imagination of leaders. There's no question that being a CEO today in the complex world that we live in -- with the necessity of making decisions based on imperfect information, with all kinds of events potentially impacting those -- it requires the ability to be decisive. It requires someone that can quickly synthesize information, understand it, and has a good grounding in their emotional understanding of situations. Those are the kinds of things that we look for in vision.

And, again, it requires a good balance. You want to find someone that can be both analytic and intuitive at the same time.

JIM: Now, one of the criticisms that have been leveled against many CEOs is that they are managing earnings for their investors. How does an investor determine, when looking at an annual report, that management is, in fact, managing the earnings instead of managing the business?

LJ: Well, there's a very interesting test. In fact, we just completed our analysis of the 2001 shareholder letters, and I wanted to make two statements about this, Jim, because I think it's so important. First let me respond to your question about how to get a sense of how straightforward a CEO is in communicating the earnings of a company. We do a simple test. First of all, I look to see if there's any discussion in the shareholder letter about the earnings. In our survey, almost half of the companies have no commentary in their shareholder letter about the earnings. I find this shocking because I think of earnings as the oxygen of the business. So here's a CEO that's having a meeting with you and they're not talking about one of the most important things that you need to know about in order to judge the company. Other companies will talk about and describe earnings. Some companies state what their earnings are, either the operating earnings or the net income or the earnings per share. They will report a number in the letter and we check to see if we can find that number in the GAPP-audited financial statements. In 25% of the companies that we looked at, you can't find it. So you'll find an earnings number in the shareholder letter. You go to the audited income statement and you can't find it there. So you spend 5 or 10 minutes searching through the footnotes to see what proforma number they've used in the shareholder letter and then circle around and figure out what went into the discrepancy between the earnings in the income statement and in the letter.

JIM: In your book you talk about the importance of goals. A lot of times investors overlook this, but to me they seem to be the compass heading of the company. Explain to our listeners why goals are important, number one. And number two, how do you hold management accountable to those goals?

LJ: Goals are the standards by which we can measure the performance of the company. But I think they're crucial because the goals and the commitment to publicly state the goals means that you put your credibility on the line. You're showing the world that you're going to step out and work towards meeting these goals. I think it's important for the employees in the company to see this kind of statement because it can act as a motivating force for them and actually help to realize the success in meeting those goals.

JIM: Now, in your chapter on goals, I thought one thing that you mentioned was very helpful and most investors don't think about this. You suggest that they keep, let's say, 5 years worth of annual reports, because what you're looking for is, let's say, the goal of the company's CEO 3 or 4 years ago is the same goal today or what changes. But it's a manner in which you can track consistency.

LJ: I think that's very important. I know a number of professional investors that track reports year after year. We've started doing this very rigorously and it's really fascinating. One of the things I've found over the years is how seldom companies actually go back to the previous year's letter to see what they wrote and then follow it up in the next year's letter to report to the reader how they did in meeting whatever it is that they had said they intended to achieve. I think it's a measure of how aware, even how awake, the management is.

JIM: Now if you've read the Chairman's Letter, we're looking at the financial results. You talk about "GAPP" and I use a word called "CRAP" or Cloudy Reporting Accounting Principles to refer to proforma numbers. I wonder if we might just take a moment and discuss this. The way we used proforma numbers in the past is like it this example. Let's say there was a new company that was merging or a company bought out another company, so now we're going to have a different company. You use these proforma numbers to give investors a look at what this new company might look like, or a company going public, but that's not the way they're used today.

LJ: Right. Well it gets back to your question about managing earnings. I remember when I started at Lehman Brothers about 20 years ago, there was actually a "Chinese wall" between the research department and then the corporate finance department where I worked. It was a very different environment than the one in which we're working today. The velocity with which information is produced is intensifying. Also, the expectations of investors who will buy a stock based on what they understand are the earnings growth promises of a company have ramped up. These promises have become the most important factor in the stock selection process. As a result, the game investor's play is to make sure that you achieve quarterly earnings promises. And the proforma numbers really become the mechanism by which managements try to make good on these promises. But a company like Berkshire Hathaway, has become successful because Warren can rely on the patient capital of investors who – because he's built up this trusting relationship, trusting partnership – are more likely to keep their investment in Berkshire and not sell on the sign of bad news in a quarter. Again, it goes back to that ability to create the relationship with the investor. CEOs can create this kind of patient capital. It is necessary for management to give them more latitude in their operations and their ability to manage their company rather than manage the earnings. I think if we did a really rigorous analysis, we'd find the companies that are less likely to provide the CRAP, as you describe it, are companies that probably enjoy a more patient kind of investor base.

JIM: Let's talk about a way to double check management's earnings numbers. You talk about the importance of cash flow. Say you have a company, as we saw certainly in the latter part of the 90's, that is reporting 20% per year earnings growth but you see something different when you look at the cash flow. I wonder if you might relate to our listeners how cash flow might act as a check on those earnings numbers.

LJ: If earnings are the oxygen, then cash flow is the blood of a company. What I found in the Shareholder Letters is how cash-blind a lot of CEOs appear to be because very few of them actually talk about the cash of their business. Without the cash, ultimately, you're not going to have the earnings. Earnings then become something that would be more akin to paper profits rather than real profits. So, it's really important for investors to first find CEOs that are very focused on cash. Shareholders can see evidence in the way CEOs talk about it or in other parts of the annual report, they will see how explicit the company is in describing the cash flow of the business and how focused they are on paying attention to that cash.

JIM: You know the one thing that I found rather amazing that kind of relates to this, if you would have read K-Mart's annual report back in the year 2000, management was talking about implementing a sort of global strategy to reformulate the business. They were going to spend billions of dollars here and there to do it and then they were going to spend billions of dollars buying stock. But if you look at their cash flow statement they were going into debt. And so the cash flow statement did not agree with the goals and objectives of management.

LJ: Right. Well I think the kind of cash flow that's described is also important. A lot of companies still report on their EBITDA, which stands for earnings before interest, taxes, depreciation, and amortization. Warren Buffett asks how can a company think about cash in that way, particularly if it's a capital-intensive business where you're going to need to be investing cash with a lot of depreciation. You need to be investing in the future of the company through your new investments. So you've got to put your cash to keep the growth of the business. So when he hears reports about EBITDA, he wants to ask management, "Do they think the tooth fairy brings the cash?"

JIM: In your book you talk about four types of CEO stories inside the Shareholders Letter. I wonder if you might give a few examples of what they look like.

LJ: That is one of the most interesting and certainly one of the more fun results from reading all of these letters. I look for stories as an indication of two things. One is the visionary ability of a CEO. A CEO that can describe and think about their business in terms of stories has a more imaginative approach. They're showing what I call "strategic sense." A lot of companies, when you ask them what their strategy is, will make almost like a laundry list. They'll say, our strategy is to grow earnings such and such, and to increase our marketing expenditures, to build our brand and so on and so forth. In contrast to that are CEOs who will describe stories that will give you an example of how they're actually increasing earnings and in a way that you really can't forget. It leaves an impression, and you can remember something about the company and it gives you a context and understanding in which to think about that company going forward into the future. Warren Buffett is the master of telling stories in his Shareholder Letter. For example, he'll tell stories about how he came to acquire different businesses, how he got to meet the management of the businesses. He'll use stories from his family to talk about why people should want to do business with some of the companies that he owns. I remember he talked about his Aunt Alice one time when asked if or when people decide if they should sign up for Execujet. He reminds them of when his Aunt asked him if she should buy a mink coat. Well, he replied, either you or your heirs will buy it. He offers a way to think about decisions that can affect how a customer chooses to work with his businesses.

JIM: Now, towards the end of your book, you talk about twelve important topics that should be included in a Shareholders Letter. You've come up with a sort of a point system to evaluate how well management is doing. I wonder if you might talk about its importance and also how an investor can actually apply this when they're looking at evaluating a company.

LJ: The book describes twelve principal categories that you can look for when you're reading the Shareholder Letter that gives you some insights about the management of the company and the potential success of the business. But, we're all time-starved and we don't have a lot of time to do the kind of research that I spend on these letters. So I wanted to simplify the whole methodology and come up with a score card which an investor can read as they're reading through the letter. It helps them, guides them, through the reading of the letter to arrive at some conclusions. So, for example, one of the measures that I recommend is after reading the Shareholder Letter: Do you have a sense that you've actually met with the CEO? Another measure is: Do you get a sense, in reading the letter, that the CEO is looking out for your interests as a shareholder and that they're giving you the information that you would want if your roles were reversed? I recommend that they grade the letter in terms of how clear the information is – how jargon free is the writing? Are you getting earnings in the letter that you can find in the income statement? So there's a consistency: Are you getting goals and some evidence that the company actually met the goals. We've talked about the link between GAPP and cash. We want to look for a company and a CEO that's focused on cash and is willing to talk to you about their GAPP accounting versus proforma numbers. We want to find a CEO that gives you a balanced strategic sense. And one thing we haven't talked about, that I think is increasingly important these days, is an understanding of the values of a company. One of the things that I think is really important is not just to find a statement of value platitudes, but actually some examples, or stories as to how these values are being acted out in the life of the company.

JIM: You talk about this point system. What kind of score would you want to see before investing in a company on a scale of 100?

LJ: On a scale of 100, we would be looking for companies probably in the top quartile – in the 75 to 100 points range.

JIM: And of those point systems, in your estimation, what is the most important to you?

LJ: In terms of the topics that we look for, Jim, is that what you mean?

JIM: Is there any one that stands out?

LJ: It's *Balancing Profits & Principles*. That's so important it's in the title. After spending the last 10 years looking at how language seems to affect performance and the differences in the way the companies communicate, that the companies that have both a well-grounded understanding and attention to profits as well as a grounding and appreciation for principles, how employees are treated, respect for customers, respect for investors. That's the thing that seems to make the company stand out.

JIM: And finally, if there was one thing that you would want the readers of your book to learn, what would that be?

LJ: I would hope that they learn how important language is, not just in understanding the business, but in the way that it provides a foundation for the business to succeed. A subtitle for the book might be "George Orwell meets Warren Buffett." George Orwell wrote a well-known essay back in the late '40's about the degradation of the English language and the consequences of this in our political life. He said we had to see language as a natural growth and not as an instrument that we shape for our own purposes. So I hope that the readers of my book really appreciate and begin to focus on the language of these CEOs. It's a measure of how clear their thinking is and the clearer their thinking is, the more likely they will succeed as a business.

JIM: Well, I don't know if you've realized it or not, I'm sure you probably do, Laura, but you in many ways have written a Shareholders Manual. When we think about it, any kind of stock that we're looking at -- whether it's Berkshire Hathaway or any other company -- when we look at that annual report, your book in my mind, serves as a guideline to help investors to know what it is that they're reading, what they should be looking for, and more importantly cues to the integrity and truthfulness of what it is that they're looking at. I want to compliment you on writing this.

LJ: Well, thank you very much Jim.

JIM: The name of the book is *Do Business With People You Can Trust: Balancing Profits and Principles* by Laura Rittenhouse. Laura, I want to thank you for joining us on the program. I highly recommend your book. Especially for individuals that are thinking about investing in an individual stock. You owe it to yourself to pick up or order a copy of the annual report and at least know what it is that you're looking at. Thank you once again for joining us on the program.

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