

## Thought Leaders

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### Be Like Buffett, Drive ROL (Return on Language): New Survey Reveals Top Ten Most Candid Companies, Best Practices for Superior Shareholder Letters

**Brian Pittman's exclusive interview this week: Laura Rittenhouse, President, Rittenhouse Rankings; Author, "Buffett's Bites"**



"Those who say most shareholder letters aren't worth the paper they're printed on make a great point – not about the quality or value of shareholder letters, but about the quality of the company's leadership," says **Laura Rittenhouse**, whose CEO strategic and investor relations company conducts an annual benchmark survey of CEO candor and stock price performance. Her research shows that candor—as expressed, in part, in shareholder letters—drives superior performance, and companies that consistently strive to promote candor in all investor relations

communications vehicles gain competitive advantage and superior valuation. Her metrics reveal which companies excel in candor and which do not.

"It's important to see the shareholder letter as a foundation for all communications," affirms Rittenhouse. "It's signed by the CEO, after all—that's a personal signature. What else is signed by the CEO? Sarbanes Oxley? Well, that's just checking the box. So, it's really up to the CEO to show that they respect the owners of the company. You do that by communicating in a way that is straightforward, gives relevant information, is highly efficient—and provides the most information with a minimal amount of words," says Rittenhouse, whose *Buffett's Bites* book analyzes the investment guru's own shareholder letters and their takeaway lessons for corporations, IROs and others. Buffett himself ranked the book A+.

In an interview in 2002, Rittenhouse actually asked Buffet why it's important for CEOs to write their own shareholder letters—like he does. The answer, Rittenhouse relates: "He said it's because they need to show their investors that they understand the business. What's disturbing is a lot of CEOs don't seem to understand their businesses, and that translates to the language used in vehicles like these letters. The less they understand and the less candid they are, the less credible the CEO's communication becomes."

In fact, the most recent research released just last week by Rittenhouse Rankings shows a substantial decline in credible CEO communication over the past five years—and also calls out ten companies—ranging from Edison International to Pfizer—whose shareholder letters actually buck the trend and do a stellar job of communicating candidly with all stakeholder groups.

So what were the results of the survey this year? Who made it onto Rittenhouse's "best of" list? What can IROs learn from the survey's winners and losers—and from Buffett himself? The answers:

## **When and why did you launch this survey—and what is the methodology behind your rankings?**

The CEO Candor Survey was started 15 years ago, and began because I wanted to show my CEO and investor relations clients how their communications compared to the communications of their peers and competitors. It was apparent that the letter to shareholders was the most public, personal and least regulated of all the CEO communications. I began reading the letters of my clients and comparing them with others, and it became clear that there were patterns repeated in all of these communications. Those patterns allowed me to develop a model that let me sort through all of these words and find comparisons so a CEO can see how their reporting of their strategy compares to that of another CEO—it was all very revealing, sometimes positive and sometimes negative.

We took the model to next level and assigned point scores to each of the topics we were looking for. That let us aggregate a score of content for each of the CEOs. Once we had those, we could order CEOs based on which ones were providing the most information and which weren't.

About nine years ago, we began looking at what we call "CEO F-O-G:" It's an acronym for: Factless, obfuscating, generalities. We developed a template model by which we can sort through any communication vehicle. We applied it to shareholder letters, quarterly earnings conferences, you name it. The important point about the model is that it truly is comprehensive: There are 150 different variables sorted into six categories.

Capital stewardness is the center of the model. Then we look for "Statements related to strategy and vision," "leadership and accountability" and "stakeholder relationships." So, a company that offers disclosure reporting on many of the topics in these categories will have a very high candor score.

## **How does that "candor score" tie to valuation?**

That's what we did next. We correlated those rankings with stock price performance. We have found for the past seven years since we starting doing the correlations, that the companies ranked consistently high in candor will outperform low candor companies—regardless of market conditions.

## **So what were the highlights of the most recent survey?**

The average stock price declined 10% for the top 25 ranked companies according to our candor score this time. It declined a full 58% for the bottom quartile. That's the largest differential we've seen—and is consistent with fact that this is the largest correction we've seen for many decades. As the stock market improves, that gap will narrow. It makes sense: If the company has candid, coherent, straightforward communications, it will be a more stable company and attract more long term investors.

It's important to note that the results of this latest survey reflect the communications in the 2008 annual reports that were published in 2009. We're working on the next letters that were out a month to two months ago now.

## **OK, so who topped your list this time?**

Here's the top ten from this year's survey:

1. Edison International (Ted Carver was 1<sup>ST</sup>. His first ever inaugural letter as CEO was the most credible.)
2. Novartis
3. Lowe's Home Improvement
4. General Mills

5. Sherwin-Williams (We named them a "Candor All Star," because they've been in the top decile of our surveys for six of the last seven years. They use little jargon, offer a lot of metrics to show how they're being accountable, etc.)
6. Costco
7. Ford Motor Co. (This is significant, since the company was in the bottom quartile last year and now is in the top. Their letter is significantly different, more specific and it reads as if Alan Mulally wrote the letter. This is consistent with their culture, it seems. But now that Ford is at the top, will they stay there? We need to see continuity.)
8. Burlington Northern
9. Conoco-Phillips
10. Pfizer (They moved up from bottom quartile; they are doing a good job.)

### **What are your tips that come out of this—best practices our readers should emulate?**

Number one: Minimize F-O-G. Clean it up. Our survey shows that implementation of Sarbox seems to have ushered in new era of excessive F-O-G in communications. It happens every time we substitute a legal standard for a moral standard. We had bad companies that did bad things, and now everyone has to sign a statement saying there are criminal penalties if disclosures are not proper. So now everyone is more cautious about what they say—and copy gets more obfuscated.

Number two: Be real. In this survey, we found a large number of companies who suffered significant earnings declines because of the market—and they never mentioned it in the letter. That really damages credibility. Don't ignore the facts and reality—and don't be afraid to talk about what went wrong.

Number three: Demonstrate accountability. How do you do that? Go back and look to see what was reported in the prior year, for example, and follow up. Say, last (year) we said we would do X, and this is what we did.

### **What are some worst practices?**

Number one: One of findings in this survey was that only 42% of companies in the survey provided the earnings per share dollars and cents number in the letter. In my view, that EPS number is the CEO report card. Why leave it out? That's like giving your mom a blank report card.

Number two: Relying on excessive platitudes, such as, "Employees are our greatest assets." Or, "The future will be brighter."

Number three: Narrowing the audience is a problem. There are often endless discussions at companies about who the key audience is. The idea that there is one vital audience will result in a very narrowly focused shareholder letter. In fact, what this ignores is that most employees are shareholders. If you don't address employees, you've missed an incredible opportunity.

### **Is writing by committee a problem?**

CEO failing to author the letter or take responsibility for it is a problem, yes. A lot of people, including CEOs, aren't gifted writers. It's best when a leader knows what their strengths or weaknesses are. But that doesn't mean a CEO should delegate the writing of the letter to people that don't have a good sense of the business, or who can't provide that fundamental business understanding and can't deliver that voice of the CEO.

### **So how do you deal with a CEO who can't write?**

A CEO who can't write—I'm not sure that's a CEO who can think. Writing is the evidence of the quality of our thinking. We're not looking at the "style" of the writing. We're looking at the authenticity of how the leadership is revealed. Is this a leader who inspires trust? You can be a plainspoken, yet fairly un-skilled writer—but if you know your stuff and the business and can articulate it clearly, that's what investors want to see. I've worked with companies where the CEO isn't gifted writer, but has staff who are and they know him and the company inside and out. Those letters reveal not only the leadership, but also the quality of the corporate culture.

That is vital because one of the fundamental flaws in investment analysis comes when investors say, "I don't bother reading the letter," or "I'll first look at the numbers." If you believe that, then you are forgetting where the numbers come from. They come from decisions made up and down the company ladder—people estimating them conservatively or realistically. The number is the net result of all judgments that are determined by the culture. Do you have an aggressive culture like Enron? If so, then you're going to get numbers that will have to be scrutinized more rigorously.

### **How would you quantify the ROL (return on language)?**

I developed a metric called "goodwill" compared to "total shareholder equity." It's a ratio. What is goodwill—it's an asset, but basically, it's the money spent over the book value of what you bought. Over time, you have to earn that back. Then you have total shareholder equity. What is the ratio of those two things? I had a theory that companies ranking high in candor would have relatively low ratios—and vice versa. It was absolutely correct. The bottom quartile have ratios that are three times greater than top ranked candor companies.

### **Any other advice for IROs?**

Have the courage of your convictions. I really enjoy working with IROs, because they are at the front line of accountability. They bring the outside into the organization and the inside organization to the external world. That's very important. There is so much value to be gained from mastering that relationship—and it all starts with communications. And candor is the competitive advantage!

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