EQUITY IN A NUTSHELL

UNDERSTANDING FINANCIAL COMMUNICATION

"*There could not be bondless communication. If it was so, it would be the truth*"
P. Ricoeur, French Philosopher.

Equities are bearing specific risks. In order to be able to react to news, one has to monitor news flows. A growing body of research is focusing on the content of companies' financial statements. Harvard has developed a specific dictionary (The Harvard Psychosociological Dictionary) helping in identifying whether a text is rather positive or negative. The regulatory environment stresses that comments have to be written in "plain-English" (Sarbanes-Oxley Act of 2002) so that investors understand statements without prior accounting or financial knowledge. Investors can then get a grasp of the activity but it leaves room for management to focus on good results and mitigate potential threats for the company. It has been proven that unexpected returns are higher as press releases adopt a positive tone. It has been shown that the longer a press release, the weaker the impact of unexpected results on the share price. In reading announces in media (Newspapers, the Internet…) one has to be extremely cautious and should manage to identify the following three main criteria:

Reliability

Generalist blogs are bourgeoning but are not reliable. Specialized blog with known specialists are more valuable sources of information but are not bullet proof; comments are based on personal interpretation. Traditional media should benefit from a greater credibility; however, journalists need to write and create a "buzz" by being the first one to publish; they might forgo their due diligence. Agencies such as the SEC and the AMF are the most reliable but are not known for their accessibility.
Another aspect of reliability is the ability of the sender, in this case the company, to abide by the promises made. A good practice is to identify past earnings guidance communicated by the company and actual results. Another clue is to look at guidance revisions (up or down) so that we can assess whether the communication is transparent or if the company has its own agenda.

Content

The aim is to identify news that could impact on the stock price. There are certain words that one should look for. A good exercise is to read the letter from the CEO at the beginning of Annual Reports. It was proven (Karapandza, 2011) that "investment strategies based on buying stocks of companies making few promises in their annual reports generate significant positive abnormal returns". An extensive amount of research is focusing on the impact of the content of these reports; various finance theories (Diamond (1985); Easley and O'Hara (2004)) anticipate that if we were to compare two otherwise identical equities, the one with scarce public information would be deemed riskier and would generate a larger excess return. The opposite view would push the idea that, by providing extensive public information, companies would be able to fool enough investors so that it would lead to an overpricing of its shares.

Frequency

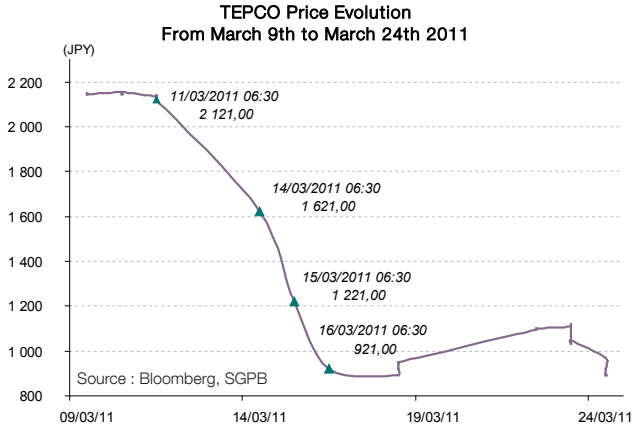
The less frequent a message, the most important it is. Almost all companies publish quarterly results and it is well known and anticipated by market participants. The earnings estimates tend to narrow the range in which earnings should fall long before the actual publication. This is obtained by aggregating news along the quarter thus making non-recurrent news crucial.

The all too well known ENRON scandal happened in 2001. In the 2000 Annual Report, K. Lay (Chairman) and J. Skelling (CEO) started-off a four-page Letter to Shareholders by this sentence: "Enron has built unique and strong businesses that have tremendous opportunities for growth". In the following four pages of self gloating, we come across words that should be taken as warnings. "The Astonishing Success(…)" could mean that even the management was surprised and admitted it or that they want to emphasize on something that the investor will be less intrigued. At one point, the statement says that "the performances and capabilities of the company cannot be compared to a traditional energy peer group"; very often companies compare themselves to peers so that investors can have a better grasp on the model in place and the competitive advantages. To tag oneself as being unmatched is a doubled-hedged sword.

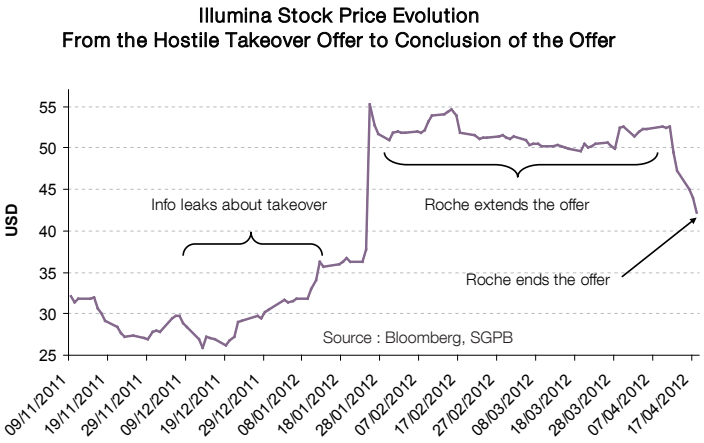
Market Efficiency Theory

- **Strong Efficiency**: All information, whether private or public, is already priced in by market participants. Not even insiders can benefit from their knowledge.
- **Semi-Strong Efficiency**: All public information is accounted for by market actors. Technical and fundamental analyses are irrelevant. Only insiders could achieve superior results if it is allowed in the country the investment is made.
- **Weak Efficiency**: All past prices are reflected in current prices thus making technical analysis irrelevant leaving the investor with fundamental analysis and expectations of positive news flows.

Tracking information pertaining to a stock is time-consuming. One should not only focus on news impacting the stock (operational hazards, change in executives…) but should also follow industry related news (Merger of two competitors, change in regulatory framework…), macro-economic data such as commodities (higher cost of raw material for some, increase of margins for others), and even natural hazards (earthquake in Japan).
In the TEPCO Price Evolution chart, it is interesting to see how the news concerning Fukushima impacted the share price. The news came on March 11th at 2:30pm Japanese Time. Over a 4-day period, the stock lost over 56% of its value. In the mean time, the Nikkei 225 lost over 18% of its value thus showing an impact on all equities listed in Japan even though they were not related to the nuclear meltdown or were distant from the Tsunami.



Another interesting event was the offer made by Roche on Illumina. The hostile takeover was launched on January 25, 2012 at a price of $44.5 per share. What we notice in the chart is that rumours were probably leaked as the share price rose with no specific reason from Dec. 19th to Jan. 23rd. It seems that rumours were setting the offer at around $36 per share. Roche was then hinting a possible action at $54 which explains the sudden spike in Illumina's price (+52%). As long as Roche was extending the offer's deadline, the share price was moving around $51. We notice that as soon as Roche decided to end its offer the stock value dropped 20% in 4 days.



IN A NUTSHELL

Following news that could impact a portfolio is a never ending story and requires dealing with wide news feed and favours those with the comprehension of how information ripples through markets. Moreover, comments made should be considered biased thus hurting investors relying on the good faith of managers. One way to avoid such trickery is to implement Warren Buffet's rule not to invest in a company whose disclosures or footnotes he can not understand as he believes this would imply intentional concealment.

Coming soon : «How to Mesure Performance»
If you want to read the previous issues, please refer to your usual contact.

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Finished drafting on 13/06/2012