

# Shareholder Letter Revelations: Can You Trust the Leadership?

Judging a firm's leaders is an important step in analyzing a stock for investment. But it's a murky area that offers no solid statistics to review. And most investors don't get the chance to actually meet a company's CEO and other officers in order to get a feel for how the firm is run.

The one window into a CEO's perspective and goals is the shareholder letter contained in the annual report. But upon reading one, you might find that you can't understand what the CEO is trying to say. Often, shareholder letters are riddled with jargon and glossy prose that convey no information. Six of the most popular CEO letter clichés:

- Talented people,
- Global presence,
- Market knowledge,
- Financial strength,
- Leverage competitive advantages, and
- Create significant value for our shareholders.

These are all important concepts. But so many generalities and so few specifics quickly become meaningless to any reader. Not only do such clichés fail to inspire trust, they should cause a prudent investor to wonder if the company has something to hide.

When an annual report arrives in the mail, go directly to the CEO letter, take out a red pencil and circle clichés like "to create shareholder value," and other words that don't make sense or add to your understanding of the business. When you have finished, look at the page. If you see more red than black, consider yourself warned.

## Reading Between the Lines

If a shareholder letter passes the circle test for fog, read it again. This time, read and underline what makes sense to you. Some shareholder letters are well-written and informative; they reveal a good deal about a company. Read in between the lines to determine how much effort the CEO is making to educate you about their business. Particularly look for insights about how the company balances its profits and principles.

A CEO signals his or her profit focus by reporting on the company's business opportunities and explaining how investors will benefit from them. Statements about strong credit ratings, focused

market intelligence, and a keen understanding of its competitive advantage will reveal how well a company can execute its strategy. You will have gained valuable insights into the company's goals and how well-equipped it is to meet them.

Principles are equally important. A CEO builds trust when he or she reports on successes and failures; and how the latter will be addressed. Detailed statements about the values of the business and how these are practiced build trust. Also, look for comments that reveal how the CEO articulates the needs of employees, customers and investors. Does the CEO show how the company is meeting the needs of these corporate stakeholders?

## Kicking the Tires

This leads to the third step in the analysis of shareholder letters. If you've developed a positive opinion about a company after sorting out the fluff and reading for profits and principles, then it's time to conduct due diligence. You should kick the 'company's tires' to see if there is tangible evidence to support the promises it has made. When a company provides exemplary disclosure in the shareholder letter and doesn't back up their talk with consistent actions, investors should proceed with caution.

## The Scorecard

To more thoroughly analyze shareholder letters, consider the following issues and assign each a letter grade:

1. **CEO Voice—Personal and Authentic:** When you finish reading the shareholder letter, do you feel like you had a meeting with the CEO? Do you feel as if the CEO is talking to you? Do you get a sense of the human face behind the CEO's public persona? Does the CEO suggest they are looking for a long- or a short-term relationship? A CEO's attitude toward shareholders can reveal how he or she runs the business—for long-term profits or short-term gain. You need to read between the lines of the letter to try to figure out what kind of "relationship" a CEO is looking for. This helps you decide if you want to be a long- or a short-term investor in the business.
2. **Practicing the Financial Golden Rule:** Is the CEO giving you information that he would expect to receive if he were the investor? Has the CEO addressed your general and specific questions and concerns about the company?
3. **Detailed and Jargon-Free Information:** Is the CEO explaining complex topics in simple terms without "dumbing" down this information? Is the letter free of clichés and technical

jargon? Are you getting relevant details that help you to make judgments about the profit and cash flow potential of the business and the company's intrinsic value? The best letters provide business details in simple, but never simple-minded, language. And they explain how these investment opportunities will produce profits. The CEO should also talk about profit drivers that reveal useful information about how a business opportunity will generate profits, how much profit to expect, and how the profits will be used.

4. **Consistent and Realistic Information:** Has the CEO provided historically consistent information, especially with regard to the company's earnings? Is the CEO explaining the company's goals and how the company intends to meet its goals? Does the CEO explain why the company's targets and other performance measures are realistic? A CEO who wants to show that he or she is trying to be accountable to investors and other stakeholders is going to tell you about their corporate goals. Financial goals reveal the financial targets that CEOs want their companies to achieve; operating goals reveal the CEO's aspirations to improve the way the work gets done. The highest score should be given to stated goals that: are not generic, but rather provide a specific performance measure; tell the reader the things a company must do to meet the goal; and candidly assess the chances of attaining the goal.
5. **A Proper Accounting of Earnings:** Does the CEO letter reveal an understanding of the difference between the company's cash and accounting earnings? Can you find statements of earnings in the shareholder letter and easily locate this same number on the firm's income statement in the annual report? When companies responsibly report their earnings in their shareholder letters, investors tend to gain greater confidence in the governance of the corporation. Even when CEOs do report company earnings, it's often hard to figure out what they mean. You can blame part of this problem on accounting. Earnings can be reported at different "layers." Many CEOs choose to report their earnings in shareholder letters several layers up, typically at a level that lets them show their company's earnings in the best possible light. This is not illegal. But when companies offer these customized pro forma earnings, you'll want to examine the underlying assumptions the company is using to calculate them. To judge management's accounting integrity in the shareholder letter, look for: clarity in reporting the nature of non-routine write-offs that affect company earnings; and consistency in the presentation of earnings over time.
6. **Balanced Strategic Sense:** Does the CEO include a balanced picture of the execution of the company's strategy and its results? Are you learning about the year's business failures as well as the successes? How is the CEO addressing the company's problems? The topic that is most frequently cited in a shareholder letter is "corporate strategy." This should be no surprise—when we learn about a company's plans to make money from tangible assets, like plants and equipment, and intangible assets, such as patents, brand recognition and new technology—we get to the heart and soul of financial analysis. Many companies describe the corporate strategy as a list of action steps they intend to take. But such a list only tells you what a CEO plans to do. They don't show how these steps are being acted out in real-life

situations. Give CEOs extra credit when they describe strategic stories, which allow you to get a feel for the CEO's "strategic sense."

7. **CEO Values:** Is the CEO describing his or her values and are these related to specific events in the company? Do you gain more understanding about how the CEO and his or her company practice these values in relation to their corporate stakeholders: employees, customers, investors, suppliers and others? Take the time to analyze the shareholder letter, and judge for yourself how much of your trust—and perhaps your investment dollars—you are willing to place with this CEO.