COMPLIANCE WEEK

# Changes in Market Trading, Investor Relations

By Louis M. Thompson, Jr., *Compliance Week Columnist* — August 21, 2007

If your investor relations department continues to practice in a traditional manner—especially in this rapidly changing investment environment—it will become increasingly irrelevant. Companies that recognize the forces of change and respond accordingly will have much greater success achieving strategic governance and shareholder communications goals.

Are these the words of an alarmist? Not when one looks at the new and evolving set of realities facing the shareholder communications world now and in the near future. And the changes are numerous. First, the role of the sell-side continues to decline, a phenomenon that I addressed in my October 2006 column and on which I will elaborate below. Second, the market structure is migrating toward electronic trading, which likely will overshadow traditional means. Third, there is a significant move away from traditional financial analysis toward the use of quantitative means for selecting stocks. And finally, portfolio management is shifting away from stock selection to "asset management," involving a set of players that may be unfamiliar to your IR department—or even your board of directors.

One might look at these factors as forming a "perfect storm" that corporations and their investor relations officers must navigate to be successful.

Let's examine these trends, and then explore strategies that companies—and their IROs—can employ to remain relevant in the investment process.

### The Impact of the Sell-Side Decline

As many Compliance Week readers have likely witnessed, the sell-side is going away. That's due to several factors, including Section 501 of Sarbanes-Oxley—which addressed conflict-of-interest issues between the research and investment-banking sides of the brokerage firms—and the $1.4 billion global research settlement that was orchestrated by former New York Attorney General Eliot Spitzer. The subsequent "wall" that was created between research and investment banking came just

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as money for research started to dry up—many institutional investors stopped consuming sell-side research with "soft dollars," which had been incorporated into trading fees. That meant investors would have to pay for the research with cold hard cash—something many were not willing to do, especially since they could conduct their own unbiased buy-side research.

There are other forces at play here as well—including, for example, the fact that many of the highly paid "rock star" analysts on the sell-side have begun migrating to the buy-side—but the upshot is that sell-side research has been replaced, to some extent, with buy-side research, or independent firms that sell their research to the buy-side.

However, many companies and their IROs continue to focus on expanding sell-side coverage as a primary goal. This is despite the fact that Prudential has closed its research operations entirely, and Goldman Sachs virtually has done the same, except for a few select clients. Others continue to cut back on their research coverage to the point that more than one-third of companies listed on the major exchanges have no sell-side coverage at all. The decline has caused an increasing number of "consensus estimates" on individual companies to become less reliable, since the sample size of coverage is statistically insignificant.

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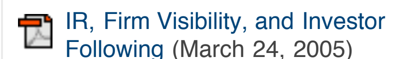
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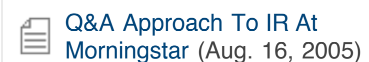
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Strangely, though, companies continue to focus on the sell-side, and many—unfortunately, in my opinion—continue to feed the dwindling sell-side's appetite with quarterly guidance and short-term performance measures.

### Electronic Trading and the "Quants"

The good news is that the buy-side is more focused on longer-term performance measures, both financial and nonfinancial.

However, the buy-side's world is also changing. Increasingly, analysts who formerly used spreadsheets to analyze companies are now feeding computer-driven models created by Ph.D. "quants," who are using quantitative methodologies and algorithms to create baskets of stocks that are traded on the electronic exchanges. The growth, for example, of Exchange Traded Funds traded on the NYSE during the past year has been nothing short of astounding. And for the investor—both institutional and individual—ETFs are cheaper and easier to trade than mutual funds.

An ETF is typically comprised of varying numbers of companies selected using quantitative methodologies. Those methodologies are sometimes referred to as "black box trading," as the investor (and the companies that comprise the ETF) often have no insight into the logic behind the ETF. You've also probably heard these related terms associated with ETFs and especially program trading: "algorithmic trading," "statistical arbitrage," "pattern matching,"

"genetic algorithms," and "neural networks."

In other words, the basket of stocks was created using a methodology you can't ascertain. This basket of stocks is then offered as a security. ETFs can have characteristics of sector stocks, regional stocks, or an index of stocks—they are traded on the various exchanges under names like VIPERs, Spiders, Diamonds, and iShares.

The impact of this development is profound and will soon be the subject of a white paper published by the PR Newswire Disclosure Advisory Board, of which I am a member. In short, the traditional methods that institutional investors use to analyze a particular company are being replaced with models designed to detect nonintuitive relationships from a mass of data that investors (and even companies) cannot readily evaluate. The advantages of this approach to stock selection are numerous: The electronic models can make decisions faster than humans, the trades are more economical, the decisions are dispassionate, and the models can evaluate factors that your average brilliant investor cannot.

The downside, of course, is that while investors using traditional analysis still need to understand your corporate strategy and assess senior management, the institutional investor who uses quantitative analysis has no reason to sit down with your CFO and no need to communicate with your IRO.

Also complicating this development for companies is the fact that there is little transparency in these trading mechanisms, thus making stock surveillance very difficult. Efforts to get the Securities and Exchange Commission to speed up the 13-F filing process so that companies have a more current way of assessing their principal owners are becoming virtually irrelevant, since changes in ownership can occur intraday.

And how prevalent is the use of quantitative means for stock selection and electronic trading? It's more common than you'd think: The Boston-based consulting group, Aite Group LLC, says that in 2006, one-third of all U.S. stock trades were driven by automatic programs or algorithms. The firm projects that by 2010, those trades will reach 50 percent.

**Asset Management and Action Plans**

The fourth major change is in the realm of portfolio management. That process is shifting from true portfolio managers—who used a thoughtful, probing process of financial analysis—to asset managers and financial planners, who are managing portfolios for high-net-worth individuals. These asset managers, which include hedge funds, are relying increasingly on trading baskets of stocks using the various electronic means.

The result—in fact, the result of all the realities mentioned above—is that the shareholder and buy-side communities have radically altered the way they make investment decisions, leaving many companies with archaic analysis and communications processes.

Given these changes, what can the companies and their investor relations executives do to remain relevant in the investment process?

1. **Get Educated, and Educate:** Investor relations executives need to learn all they can

about the quantitative stock selection and electronic trading processes, so they can explain to management and the board of directors why the company's stock is behaving differently from the way it has before. ETFs and baskets of stock are traded on a real-time basis throughout the day, and that can move the share price significantly without the means to see what is driving it.

2. **Communicate Effectively:** There are still institutional investors who want to hear your strategy for long-term value creation. I recently spoke with the IRO of a small-cap biotech company who had reached out to an investor to communicate at a strategic level about what drives long-term value in her company. The investor subsequently bought one million shares, which may have been the factor that resulted in the company's stock being picked up in several electronically traded baskets of stock.

   The key here is effectively communicating—at a high level—the company's strategy for creating long-term value, and not dwelling on short-term factors such as earnings, cash flow, and short-term revenue growth. Those metrics, as outlined above, are becoming increasingly irrelevant to institutional investors and asset managers. To wit: A recent Rivel Research Group study of 243 buy-side investment professionals (from some of the nation's leading mutual funds, pension funds, and insurance firms) found that management credibility and business strategy outweighed short-term factors such as EPS, cash flow, and a strong balance sheet in making investment decisions.

3. **Stress the Right Factors:** Keep in mind that even the quants' firms consider nonfinancial factors such as good corporate governance practices and corporate social responsibility, since some go to great lengths to analyze and document how they vote their clients' proxies. Therefore, these factors need to be stressed through the various means the company uses to communicate with the investment community.

For years, the sell-side has been the primary means for communicating a company's story to the investment community. But regulatory and litigation developments, market changes, electronic trading, and the rise of the "quants" have fundamentally changed that dynamic. Companies and the investment community must recognize that the changes are dramatic and consequential. And the professional associations representing financial executives, IROs, analysts, and investment professionals must play a key role in helping their members adjust to these changes.

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