Additional Information Can Lead to Better Judgment

Research by Conference Call

by Nancy Isaacs

Using the NAIC methodology, we learn to identify companies of high quality when they are available at reasonable prices. Our tool is the Stock Selection Guide (SSG), through which we make a series of judgments to determine the potential risk versus reward for a given investment. The more information we have about a company, the better our judgments will be and the more trustworthy our results.

In this column, I would like to highlight a phenomenal resource for exploring a company's culture, its management, its current condition and its future prospects. That resource is the quarterly earnings conference call.

Most of the companies that would attract NAIC-type investors hold conference calls soon after releasing their quarterly earnings reports. A conference call is actually a telephone conversation between the company's officers — usually the chief executive officer (CEO) and chief financial officer (CFO), and often the director of investor relations as well — and the analysts and institutional investors who follow the company. Until fairly recently these calls were privileged and unavailable to individual investors. Fortunately, that has changed. Though in most cases individual investors cannot participate in these calls, we can listen to them either by telephone or on the Internet.

There are several reasons for the change. For one, companies are recognizing the importance of attracting and retaining individual investors as shareholders. They realize that increasingly, individual investors are conducting their own research and making their own investment decisions.

Perhaps even more pertinent is the implementation by the Securities and Exchange Commission in October 2000 of Rule FD — Full Disclosure — which mandates that all publicly traded companies disclose material, market-moving information to all investors at the same time. By opening conference calls to the public, the SEC has taken a major step toward leveling the playing field. Whereas we were limited to receiving significant and timely investment information secondhand through analysts' research reports, based on their interpretation of the information, we can now go directly to the source and make our own judgments.

We can dial in and listen by telephone or we can access it on the Internet. For those with computer capability, the Internet is probably the better choice. RealPlayer and Windows Media Player are two widely used programs for accessing the Webcast on the Internet. If you do not already have one or both of these programs on your system, you can usually download them at no cost from the site of the Webcast.

The software allows us to pause, rewind, fast forward or select a particular segment. What's more, we can listen at our convenience, usually for about six weeks after the date of the presentation.

The typical conference call begins with an introduction by a facilitator who gives instructions to listeners and introduces the company's CEO. The CEO then welcomes the participants, cautions that forward-looking statements may differ materially from actual results, and offers a few prepared opening remarks. He or she turns the call over to the CFO, who presents a financial overview.

Preferring to limit my number crunching to the SSG, I'll often play FreeCell during this part, tuning out the breakdown of gross, operating and net margins as well as such investor buzzwords as "capex" (capital expenditures), "COGS" (costs of good sold) and "EBITDA" (earnings before interest, taxes, depreciation and amortization). I know from experience that anything of great significance in the financial overview will be raised in the forthcoming question-and-answer session.

The CEO usually follows with the business overview. This is when I start paying attention. I like to hear how the economy is affecting the business. I am writing this at a time when the events of Sept. 11 come up a lot. We may learn how the company and its customers were affected. It has been fascinating to hear the lengths to which technology companies have gone to get their customers up and running after the tragedy.

As part of the business overview, we are informed about new products, pending acquisitions, divestitures of non-strategic businesses, plans for international expansion, new marketing initiatives and technological advances. Perhaps the company has a new information system or is increasing its use of the Internet for sales and services. It may be facing increased competition or gaining market share.

Balance sheet issues will be raised. Is the company using cash flow to pay off debt, to buy back shares or to acquire other companies? We get a sense of the company's culture as management discusses such subjects as customer service and employee retention. The company may be providing a new childcare facility, a health fitness center or an expanded training program. There is usually a review of economic or industry-related issues that can be most interesting and informative.

The picture is not always rosy. If earnings were disappointing, we will find out whether management has a decisive plan to remedy the situation. Plans for expense reduction or a new strategy will be outlined. Some companies display what I refer to as the "it's always something" syndrome. Each quarter there is a different excuse for declining fundamentals — adverse weather conditions, raw material or fuel price increases, a faulty information system, supply shortages and so forth. A CEO might cover up disappointing results by emphasizing what I might consider pie-in-the-sky plans for the future accompanied by nothing concrete. On a few occasions I have decided to sell my shares of such companies.

I'm not sure what intrigues me more — the message or the messenger. One CEO will appear to exaggerate, while another may seem down-to-earth and more truthful. One will gloss over problems, while another will face them headon in a clear, understandable manner. One will appear to be fascinated with the business and excited about future prospects, while another read a script in a monotone. Just the tone of his voice will speak volumes when a CEO presents his outlook for the company's future, near- and long-term.

No annual report or news release can provide the insight that comes from listening to the information directly from those who manage the company. Of course, we need to be aware that some company officials are simply good talkers. Then again, the ability to impress us during a conference call can suggest a similar propensity to inspire confidence in customers and employees. Mainly we get a sense as to whether the speaker is upbeat or downbeat, optimistic or pessimistic.

In many ways, the best part of the call is the question-and-answer session (Q&A). Invariably an analyst will raise a question that addresses an inconsistency, or he will ask for clarification of a subject that I found confusing as well. We will hear analysts congratulating management for impressive results in a challenging quarter or dwelling on a specific concern such as a change in accounting procedures. They will ask repeated questions on a subject until management provides a lucid explanation, or until it's clear there is no acceptable explanation. I enjoy listening to a company official who has all of the facts readily available and can address questions honestly and efficiently.

As I mentioned earlier, anything significant in the CFO's report will be brought up in the Q&A, often in a way that will be more understandable than in the original number-laden presentation. If there are concerns with regard to receivables or inventory management, about shortfalls in cash flow or about unusually high debt ratios, you can be sure they will be raised.

There is usually a fair amount of time devoted to margins. Are they narrowing or widening, and why? This information can be most helpful as we attempt to project future earnings growth in our SSGs.

During the Q&A, the analysts will usually ask for future earnings guidance. Sometimes the response will be quite specific. At other times management will advise that visibility is low, and that it's just too soon to make projections, especially in times of economic uncertainty.

Perhaps the industry is currently in disarray. Questions will elicit information as to where the company stands during the crisis and why management believes it can be expected to survive. The responses to questions about a particular competitor can be enlightening. Analysts take advantage of the Q&A to delve into such issues as market share, proposals for restructuring, unutilized capacity, plans for downsizing, recruitment initiatives or the outlook regarding demand for the company's products and services.

Of course, the questions vary from industry to industry. A retail concern will field questions about same-store sales comparisons; a trucking company will be asked about fuel prices and their effect on the business. Company-specific concerns will come up as well. During a recent EMC (NYSE:EMC) conference call, an analyst mentioned the company's sales force, specifically its reputation for arrogance.

If a CEO is heading for retirement, management will be given the opportunity to discuss succession plans. Analysts tend to maintain certain mathematical models for each industry, raising relevant questions that are well beyond my comprehension or even my interest. That's when I go back to FreeCell. For the most part, however, the Q&A session is quite comprehensible and tremendously informative.

It's especially interesting to listen to a company's conference calls from quarter to quarter. You become familiar with the personalities of its executives and learn to read subtle changes in their mood and tone. What's more, you find out whether plans proposed in one quarterly call actually come to pass in the next. I follow a small company called Mity Enterprises (NNM:MITY). Following its conference calls quarter by quarter has been like reading an exciting novel. The company manufactures and markets lightweight, durable folding tables and stacking chairs for multipurpose rooms. The business was doing just great year after year, quarter after quarter, until it failed to maintain control of a newly acquired company, CenterCore, a marketer and manufacturer of office and call-center panel systems.

Brad Nielson, the company's CFO, actually moved his family, bag and baggage, from Utah to Arkansas in an attempt to rectify the situation. I was impressed by his dedication to the company. Unfortunately, it turned out that things were more out of control than he had anticipated. He and his team accomplished a lot — collecting receivables, reducing inventory and attempting to reconnect with dissatisfied customers. In the interim, however, the misguided acquisition wreaked havoc on the company's financials.

At some point, management decided to hire an investment banking firm to evaluate strategic alternatives for the business. Listeners were privy to the process every step of the way. Greg Wilson, the CEO, and Nielson pulled no punches, presenting the ongoing situation with candor and unmitigated honesty. Alternatives included taking the company private, selling the whole company, liquidating non-strategic divisions or selling the rejuvenated subsidiaries and returning to the core business. I was hoping for the last option, which turned out to be the company's choice as well.

CenterCore recently returned to profitability. Management is in the process of negotiating the sale of that company and intends to refocus on its core business. This was a very difficult period for Mity Enterprises, but the problems clearly represented a learning experience. I believe it will emerge an even stronger company. I certainly learned a lot about business by following this saga quarter by quarter. Had I simply viewed the PERT-A in the Investor's Toolkit, I would have sold the stock long ago.

NAIC aficionados say, "trust the numbers." This is an example where knowing what's actually going on behind the numbers can be productive. Instead of selling, I have been adding to my position along the way and hope to be well-rewarded. Time will tell, but I can't imagine a better way to gain insight into a company's culture than by following its executive decision-making process from one conference call to the next.

If I have succeeded in convincing you that the hour or so spent listening to these calls can be well worth the time, I should spend a moment telling you how to find them. There are several sites on the Internet devoted to keeping us informed about conference calls, such as www.earnings.com, www.bestcalls.com and www.vcalls.com. Additionally, http://finance.yahoo.com, http://moneycentral.com and similar sites allow us to set up personal portfolios and provide news releases for our companies, including information about links to conference calls as they occur. They can also be accessed at the company's Web site in the investor relations area. Those without computer capability can phone the company's investor relations department for the date and telephone number of an upcoming call.

For most of us, time is a precious commodity. It's impossible to monitor every call for all of our stocks, so it's important to be selective. Investment clubs could institute a process whereby each member listens to the calls for the stock he or she follows and presents a summary to the club. Members of the NAIC Forum on Compuserve and the I-Club-List (ICL) occasionally post such summaries. NAIC is about volunteering and sharing. Here is a great opportunity to share information.

This has been a difficult time for investors. Earnings comparisons have been erratic, and investment advice from the media has been inconsistent and confusing. The more we can learn about the companies we follow, the more successful we'll be at forming our own opinions.
Conference calls can provide that insight. They are also a great source of general investment education. What we learn about one company or one industry tends to apply to others. I think you will find that listening to conference calls on a regular basis will support your endeavor to become a more sophisticated and informed investor. BI

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