

# McKinsey on **Finance**



## **Perspectives on Corporate Finance and Strategy**

Number 27,  
Spring 2008

### **Communicating with the right investors 1**

Executives spend too much time talking with investors who don't matter. Here's how to identify those who do.

### **Running a winning M&A shop 6**

Picking up the pace of M&A requires big changes in a company's processes and organization—even if the deals are smaller.

### **Starting up as CFO 12**

There are a few critical tasks that all finance chiefs must tackle in their first hundred days.

### **Preparing for a slump in earnings 18**

Historic trends suggest earnings may fall more than most executives expect. Companies should prepare for steeper declines and take steps to strengthen their positions when times improve.



## Communicating with **the right investors**

**Executives spend too much time talking with investors who don't matter. Here's how to identify those who do.**

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Many executives spend too much time communicating with investors they would be better off ignoring. CEOs and CFOs, in particular, devote an inordinate amount of time to one-on-one meetings with investors, investment conferences, and other shareholder communications,<sup>1</sup> often without having a clear picture of which investors really count.

The reason, in part, is that too many companies segment investors using traditional methods that yield only a shallow understanding of their motives and behavior; for example, we repeatedly run across investor relations groups that try to position investors as growth or value investors—mirroring the classic approach that investors use to segment companies. The expectation is that growth investors will pay more, so if a company can persuade them to buy its stock, its share price will rise. That expectation is false: many growth investors buy after an increase in share prices. More important, traditional segmentation approaches reveal little about the way investors decide to buy and sell shares. How long does an investor typically hold onto a position, for example? How concentrated is the investor's portfolio? Which financial

and operational data are most helpful for the investor? We believe that the answers to these and similar questions provide better insights for classifying investors.

Once a company segments investors along the right lines, it can quickly identify those who matter most. These important investors, whom we call “intrinsic” investors, base their decisions on a deep understanding of a company's strategy, its current performance, and its potential to create long-term value. They are also more likely than other investors to support management through short-term volatility. Executives who reach out to intrinsic investors, leaving others to the investor relations department,<sup>2</sup> will devote less time to investor relations and communicate a clearer, more focused message. The result

<sup>1</sup>Including a wide range of communications activities, such as annual shareholder meetings, conferences with sell-side analysts, quarterly earnings calls, and market updates.

<sup>2</sup>This article deals only with institutional investors, since management usually spends the most time with them. We also exclude activist investors, as they represent a different investor relations issue for management.

Exhibit 1

## Thorough due diligence

Intrinsic investors make a significant effort to understand the companies they invest in.

Activities of long-term intrinsic investors<sup>1</sup>

	Uncover investment idea	Conduct initial review	Due diligence	Monitor company
<b>Time</b>	<b>Ongoing</b> <ul style="list-style-type: none"> <li>Investment analyst identifies opportunity (through electronic scans, networking, conferences)</li> </ul>	<b>2 weeks</b> <ul style="list-style-type: none"> <li>Analyst develops preliminary view based on public information</li> <li>Analyst reviews with portfolio manager; portfolio manager makes go/no go decision</li> </ul>	<b>4–8 weeks</b> <ul style="list-style-type: none"> <li>Analyst conducts in-depth due diligence with focus on developing proprietary knowledge, information (review models, consultant work)</li> <li>Completes investment thesis with focus on long-term position of company, associated value</li> </ul>	<b>3–5 years</b> <ul style="list-style-type: none"> <li>Analyst monitors operating performance, share price</li> <li>Portfolio manager tweaks exposure, depending on changes in outlook and price</li> </ul>
<b>Relevant information on company</b>	<ul style="list-style-type: none"> <li>Past financials, consensus estimates, trading information, implied valuation</li> </ul>	<ul style="list-style-type: none"> <li>Web site, press releases, management press, sell-side analyst calls and reports, industry reports</li> </ul>	<ul style="list-style-type: none"> <li>Past operations and unit-level information, management's future strategy and forecasts, industry outlook, management's background</li> <li>Detailed follow-up information from company</li> </ul>	<ul style="list-style-type: none"> <li>Quarterly updates on performance, significant changes in outlook</li> </ul>
<b>Interaction with company</b>	<ul style="list-style-type: none"> <li>Limited; if any, probably through investment conferences</li> </ul>	<ul style="list-style-type: none"> <li>Limited, usually through telephone discussions with investor relations unit</li> </ul>	<ul style="list-style-type: none"> <li>Multiple in-depth meetings with executives at all senior leadership levels</li> <li>Follow-up conversations, if necessary, with investor relations unit</li> </ul>	<ul style="list-style-type: none"> <li>Occasional meetings, calls with investor relations unit</li> <li>Semiannual or annual senior-management meetings</li> </ul>

<sup>1</sup>For short-term intrinsic investors, review and due diligence could be a matter of days, and their hold period can be as short as 6 to 18 months.

should be a better alignment between a company's intrinsic value and its market value, one of the core goals of investor relations.<sup>3</sup>

### A better segmentation

No executive would talk to important customers without understanding how they make purchase decisions, yet many routinely talk to investors without understanding their investment criteria. Our analysis of typical holding periods, investment portfolio concentrations, the number of professionals involved in decisions, and average trading volumes—as well as the level of detail investors require when they undertake research on a company—suggests that investors can be distributed among three broad categories.

### Intrinsic investors

Intrinsic investors take a position in a company only after rigorous due diligence of its intrinsic ability to create long-term value (Exhibit 1). This scrutiny typically takes more than a month. We estimate that these investors hold 20 percent of US assets and contribute 10 percent of the trading volume in the US market.

In interviews with more than 20 intrinsic investors, we found that they have concentrated portfolios—each position, on average, makes up 2 to 3 percent of their portfolios and perhaps as much as 10 percent; the average position of other investors is less than 1 percent. Intrinsic investors also hold few positions per analyst (from four to ten companies) and hold

<sup>3</sup>If this goal sounds counterintuitive, consider the alternatives. Clearly, undervaluation isn't desirable. An overvaluation is going to be corrected sooner or later, and the correction will, among other things, distress board members and employees with worthless stock options issued when the shares were overvalued.

Exhibit 2

### Concentrated impact

When intrinsic investors trade, they trade more per day than other investors do.

Investor segment	Annual trading activity per segment, \$ trillion	Annual trading activity per investor in segment, \$ billion	Annual trading activity per investor in segment per investment, \$ million	Trading activity per investor in segment per investment per day, <sup>1</sup> \$ million
Intrinsic	3	6	72	79–109
Trading-oriented	11	88	277	1
Mechanical	6	6	17	2

<sup>1</sup>Includes only days when investor traded.

shares for several years. Once they have invested, these professionals support the current management and strategy through short-term volatility. In view of all the effort intrinsic investors expend, executives can expect to have their full attention while reaching out to them, for they take the time to listen, to analyze, and to ask insightful questions.

These investors also have a large impact on the way a company’s intrinsic value lines up with its market value—an effect that occurs mechanically because when they trade, they trade in high volumes (Exhibit 2). They also have a psychological effect on the market because their reputation for very well-timed trades magnifies their influence on other investors. One indication of their influence: there are entire Web sites (such as GuruFocus.com, Stockpickr.com, and Mffais.com) that follow the portfolios of well-known intrinsic investors.

#### Mechanical investors

Mechanical investors, including computer-run index funds and investors who use computer models to drive their trades, make decisions based on strict criteria or rules. We also include in this category the so-

called closet index funds. These are large institutional investors whose portfolios resemble those of an index fund because of their size, even though they don’t position themselves in that way.<sup>4</sup>

We estimate that around 32 percent of the total equity in the United States sits in purely mechanical investment funds of all kinds. Because their approach offers no real room for qualitative decision criteria, such as the strength of a management team or a strategy, investor relations can’t influence them to include a company’s shares in an index fund. Similarly, these investors’ quantitative criteria, such as buying stocks with low price-to-equity ratios or the shares of companies below a certain size, are based on mathematical models of greater or lesser sophistication, not on insights about fundamental strategy and value creation.

In the case of closet index funds, each investment professional handles, on average, 100 to 150 positions, making it impossible to do in-depth research that could be influenced by meetings with an investment target’s management. In part, the high number of positions per professional reflects

<sup>4</sup>For more on closet index funds, see Martijn Cremers and Antti Petajist, “How active is your fund manager? A new measure that predicts performance,” AFA Chicago Meetings Paper, January 15, 2007.

the fact that most closet index funds are part of larger investment houses that separate the roles of fund manager and researcher. The managers of intrinsic investors, by contrast, know every company in their portfolios in depth.

#### Traders

The investment professionals in the trader group seek short-term financial gain by betting on news items, such as the possibility that a company's quarterly earnings per share (EPS) will be above or below the consensus view or, in the case of a drug maker, recent reports that a clinical trial has gone badly. Traders control about 35 percent of US equity holdings. Such investors don't really want to understand companies on a deep level—they just seek better information for making trades. Not that traders don't understand companies or industries; on the contrary, these investors follow the news about them closely and often approach companies directly, seeking nuances or insights that could matter greatly in the short term. The average investment professional in this segment has 20 or more positions to follow, however, and trades in and out of them quickly to capture small gains over short periods—as short as a few days or even hours. Executives therefore have no reason to spend time with traders.

#### **Focused communications**

Most investor relations departments could create the kind of segmentation we describe. They should also consider several additional layers of information, such as whether an investor does (or plans to) hold shares in a company or has already invested elsewhere in its sector. A thorough segmentation that identifies sophisticated intrinsic investors will allow companies to

manage their investor relations more successfully.

#### Don't oversimplify your message

Intrinsic investors have spent considerable effort to understand your business, so don't boil down a discussion of strategy and performance to a ten-second sound bite for the press or traders. Management should also be open about the relevant details of the company's current performance and how it relates to strategy. Says one portfolio manager, "I don't want inside information. But I do want management to look me in the eye when they talk about their performance. If they avoid a discussion or explanation, we will not invest, no matter how attractive the numbers look."

#### Interpret feedback in the right context

Most companies agree that it is useful to understand the views of investors while developing strategies and investor communications. Yet management often relies on simple summaries of interviews with investors and sell-side analysts about everything from strategy to quarterly earnings to share repurchases. This approach gives management no way of linking the views of investors to their importance for the company or to their investment strategies. A segmented approach, which clarifies each investor's goals and needs, lets executives interpret feedback in context and weigh messages accordingly.

#### Prioritize management's time

A CEO or CFO should devote time to communicating only with the most important and knowledgeable intrinsic investors that have professionals specializing in the company's sector. Moreover, a CEO should think twice before attending conferences if equity analysts have arranged the guest

lists, unless management regards those guests as intrinsic investors. When a company focuses its communications on them, it may well have more impact in a shorter amount of time.

In our experience, intrinsic investors think that executives should spend no more than about 10 percent of their time on investor-related activities, so management should be actively engaging with 15 to 20 investors at most. The investor relations department ought to identify the most important ones, review the list regularly, and protect management from the telephone calls of analysts and mechanical

investors, who are not a high priority. Executives should talk to equity analysts only if their reports are important channels for interpreting complicated news; otherwise, investor relations can give them any relevant data they require, if available.

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Marketing executives routinely segment customers by the decision processes those customers use and tailor the corporate image and ad campaigns to the most important ones. Companies could benefit from a similar kind of analytic rigor in their investor relations. **MoF**

*The authors wish to thank Jason Goldlist and Daniel Krizek for their contributions to this article and the underlying analysis.*

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