

McKinsey on **Finance**



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Inside a hedge fund: An interview with the managing partner of **Maverick Capital**

What should a company do when a hedge fund shows up among its investors?

**Richard Dobbs and
Timothy Koller**

The hedge fund industry now comprises more than 8,500 funds around the world and continues to grow. Given the ability of many funds to buy and sell large amounts of stock rapidly, it would seem natural that CFOs and other executives would be highly attuned to the rising clout that hedge funds can have with the companies they hold stakes in. But many executives often don't understand how investing philosophies differ among funds or how to deal with them as investors.

A case in point: Maverick Capital, with \$10 billion in assets under management, has long been known as one of the largest and most consistently successful hedge funds. Yet Maverick, with offices in New York and Dallas, is not what most people might think of as a typical hedge fund. Rather than taking big bets on currencies, bonds, and commodities, Maverick relies on old-fashioned stock picking to generate its returns. Lee S. Ainslie III, Maverick's managing partner, likes to say that Maverick is more of a traditional *hedged* fund, investing only in equities and maintaining a balance of long and short positions. The 49 members of Maverick's investment team generate performance by understanding which stocks will be the best and worst performers in each sector and region, rather than by trying to time market movements.

Ainslie, a soft-spoken Virginian, was a protégé of the storied investor Julian Robertson at Tiger Management, one of the most successful hedge funds in history. In 1993 Ainslie left Tiger to launch Maverick, which had been set up with \$38 million in capital by the family of Texas entrepreneur Sam Wyly. On a recent afternoon, Ainslie talked in Maverick's offices overlooking New York's Central Park with McKinsey's Richard Dobbs and Tim Koller about the direction of the hedge fund industry, the way Maverick works with the companies it invests in to achieve long-term returns, and how executives should handle relations with hedge fund investors.

McKinsey on Finance: Let's cut right to the question so many executives have on their minds: when Maverick considers investing in a company, what makes you say, "Yes, we want to invest" or "No, we don't"?

Lee Ainslie: First and foremost, we're trying to understand the business. How sustainable is growth? How sustainable are returns on capital? How intelligently is it deploying that capital? Our goal is to know more about every one of the companies in which we invest than any noninsider does. On average, we hold fewer than five positions per investment professional—a ratio that is far lower than most hedge funds and even large mutual-fund complexes. And our sector heads, who on average have over 15 years of investment experience, have typically spent their entire careers focused on just one industry, allowing them to develop long-term relationships not only with the senior management of most of the significant companies but also with employees several levels below.

We spend an inordinate amount of time trying to understand the quality, ability, and motivation of a management team.

Sometimes we get very excited about a business with an attractive valuation only to discover that the company has a weak management team with a history of making poor strategic decisions or that is more concerned about building an empire than about delivering returns. We have made the mistake more than once of not investing in a company with a great management team because of valuation concerns—only to look back a year later and realize we missed an opportunity because the management team made intelligent, strategic decisions that had a significant impact.

MoF: How do you approach valuation, and what type of returns do you target?

Lee Ainslie: We use many different valuation methodologies, but the most common at Maverick is to compare sustainable free cash flow to enterprise value. But I believe it is a mistake to evaluate a technology company, a financial company, and a retailer all with the same valuation

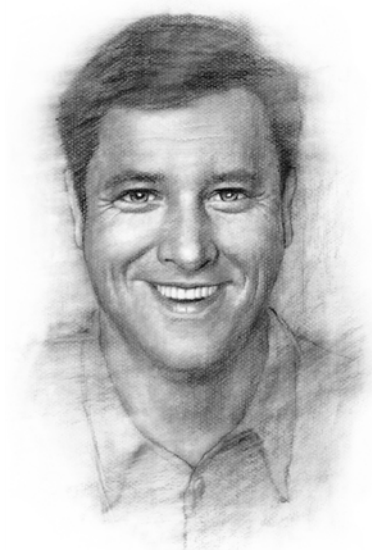
metric, for instance. You have to recognize that different sectors react to events in different ways and should be analyzed differently. Part of the art of investing is to be able to recognize which approach is the most appropriate for which situation over a certain period of time.

As for returns, we target stocks that we believe will under- or outperform the market by 20 percent on an annualized basis. This can be a daunting goal in this lower-volatility, lower-return world. Yet even in the past year, 35 percent of all the stocks in the S&P 500 either out- or underperformed the index by 20 percent. So it's our job to find the best and worst performers. In the end, our success is driven by making many good decisions rather than depending upon a few big home runs. In the long run, we believe this approach creates a more sustainable investment model.

MoF: What is the typical time frame that you are thinking about when you look at an investment opportunity?

Lee Ainslie: Usually, one to three years. Having said that, we do evaluate each position every day to consider whether the current position size is the most effective use of capital. Certainly, there are times when we are very excited about an investment and take a significant position only to watch the rest of the world recognize the attractiveness of the investment and drive up the share price, which of course lowers the prospective return. Different firms handle this situation in different ways, but at Maverick, if we have developed that longer-term confidence in a business and a management team, we will typically maintain a position—though perhaps not of the same size.

MoF: How much of a factor is a company's growth prospects?



Lee S. Ainslie III

Vital statistics

- Born in 1964, in Alexandria, Virginia
- Lives in New York with his wife and 2 sons

Education

- Graduated in 1986 with a BS in systems engineering from the University of Virginia
- Graduated in 1990 with an MBA from the University of North Carolina at Chapel Hill

Career highlights

- Maverick Capital
 - Managing partner (1993 to present)
- Tiger Management Corporation
 - Managing director (1990–93)
- KPMG Peat Marwick
 - Consultant for national director of information technology (1986–88)

Fast facts

- Serves on the board of directors of the Robin Hood Foundation and the Robertson Scholars Program
- Serves on the board of trustees of the Episcopal High School
- Serves on the advisory board of the University of Virginia's alumni association
- Serves as a vice chairman of the Kennedy Center for Performing Arts

Lee Ainslie: We work hard to deconstruct growth to judge its sustainability and to understand the impact it will have on capital returns. Of course, we'd like to see organic growth, because its incremental return on capital is far superior to that of acquired growth. Occasionally we are able to find a business and a management team with a strong industry position that enjoys ample acquisition opportunities and where huge synergies are clearly going to be recognized. Unfortunately, in today's world these opportunities are quite rare. In our judgment, onetime acquisitions that enhance earnings by cutting expenses do not represent sustainable growth and are rarely as productive as either management or investors expect.

We also spend a lot of time trying to understand how executives value and analyze growth opportunities and what motivations drive their decisions. It's not uncommon to see companies pursue strategies that create growth but that are not very effective economically. This is particularly prevalent in today's environment of incredibly cheap financing. Indeed, with debt financing as it is today, companies can easily claim a deal is accretive—even if it makes relatively little strategic sense or diminishes long-term returns.

MoF: What about the high levels of cash that many companies have today?

Lee Ainslie: It's quite frustrating as a shareholder that companies are not using cash more productively for their shareholders, whether by buying back stock or by issuing dividends. To some degree, this probably represents a backlash to the dramatic overinvestment that was prevalent in many industries in the late '90s, but I'm amazed at how many CFOs don't truly understand the long-term sustainability and

value creation of stock buybacks. In some industries, especially in the technology sector, such a move is even viewed as an admission of defeat. It isn't, of course. Buybacks reflect executives investing in the company that they know better than any other potential investment or acquisition. And if they do not believe that such an investment is worthwhile, then why should I?

Today investors face the bizarre juxtaposition of record levels of corporate cash in the face of incredibly low interest rates—this past fall saw negative real interest rates in the United States for the first time in 25 years. US corporations have the lowest levels of net debt in history, even though the cost of debt has rarely been more attractive. Companies with inefficient balance sheets should recognize that if they do not address such situations, the private equity community and active hedge funds will take advantage of these opportunities.

MoF: How forthcoming should companies be about where they are creating value and where they aren't?

Lee Ainslie: Obviously, the more information we have to analyze, the greater our confidence in our ability to understand the business. As a result, we are far more likely to be in a position to increase our investment during tumultuous events. When we consider return versus risk, increased transparency greatly reduces the risk. Clearly, there are some companies in very narrow, competitive businesses where the disclosure of certain information could be damaging to the business itself. We understand that. But we often find that competitive issues are more an excuse than a reality. I believe that often the unwillingness to share detailed information is driven by the thought that this lack of disclosure gives them the ability to pull different levers behind the screen or

to hide reality for a quarter or two. But such realities come out eventually, and in this day and age the consequences of such games may be disastrous.

MoF: Boards and CFOs spend a lot of time worrying about whether or not to issue earnings guidance. As an investor, does it matter to you whether they do or not?

Lee Ainslie: That's a difficult question, and you have some very thoughtful people on both sides of the issue. Warren Buffet, for instance, has been a very strong proponent of not giving earnings guidance, and I understand his motivations. Personally, I believe there is some value in earnings guidance because it's a form of transparency and, if handled appropriately, should help investors develop confidence in a company's business. Investor confidence, in turn, can reduce the volatility of a stock price, which should lead to a higher valuation over the longer term. But even within Maverick, frankly, if you ask the 12 most senior people in the firm, you would probably get six opinions on each side.

Even when a company does provide earnings guidance, we don't evaluate the success of a quarter simply by looking at whether a company beat the market's expectations. Some investors who manage huge portfolios with hundreds of stocks will often judge a quarter simply by looking at reported earnings versus expected earnings. But there are also many investors, like Maverick, that are going to dissect and analyze the quarterly results every which way you can think of, compare our expectations to reality, and use these analyses to improve our understanding of fundamental business trends. When companies decide to stop providing guidance, that decision often induces volatility—often because companies do so during a moment of weakness. During

difficult times, the market usually interprets this change to mean that the company is not giving guidance either because it would be so bad that they would prefer not to talk about it or because they have no confidence in their own ability to predict the business. I would strongly advise that companies, if they are going to discontinue giving guidance, do so after a great quarter—do it from a point of strength, and it will be a much less destabilizing event.

MoF: With so many funds out there, how do traditional funds such as Maverick differentiate themselves from those that create value by being interventionists—by taking possession of a company and changing the management team?

Lee Ainslie: Perhaps we put a greater premium on the value of our relationships with management teams than many do. If we think we have invested in a management team that isn't acting appropriately or is not focused on creating shareholder value, we don't want to take our fight to the front page of the *Wall Street Journal*—because that would not only permanently destroy our relationship with that management team but also have a detrimental impact on our relationships with other management teams.

That doesn't mean that we're not going to have suggestions or that we won't communicate with the board. But when we do so, we work very hard to make sure the management team knows we're doing so in the name of partnership. Unlike private equity firms, if we are unhappy with management, we do not have the responsibility to change management. Ultimately, if we believe that the management of one of our investments is acting in an inappropriate manner and our attempts to convince the management and board of our

point of view are unsuccessful, we have the luxury of simply selling the stock.

MoF: How do you maintain a good relationship with executives when you have a short position in their company? Do they even know?

Lee Ainslie: Our short positions are not publicly disclosed, but if an individual management team asks what our position is, we will answer honestly. This policy can be difficult in the short term, don't get me wrong, but I think most management teams appreciate and respect this integrity, which over time leads to a stronger relationship.

I will point out that when we are short, by definition we're going to have to buy eventually. A short seller is really the only guaranteed buyer that a company has. Some companies disdain any interaction with short sellers. The more thoughtful, intelligent companies take a different tack and want to improve their understanding of the concerns of the investment community. Sometimes they'll listen and prove us wrong, and other times they will recognize that we have legitimate points. With the intensity of our research and analysis and our strong relationships with significant competitors, we may have insights or information that prove to be quite helpful to companies.

MoF: If I'm a CFO, how do I decide which institutional investors to develop a relationship with?

Lee Ainslie: For a CFO, whose time is a limited and valuable resource, this is a very important question. Unfortunately, there is no magic list of the funds that do thoughtful and in-depth analysis. It's not too hard to figure out that a CFO should develop a relationship with an institutional investor that owns millions of his company's shares.

The harder part is to recognize which investors are so thoughtful, intelligent, and plugged in that a CFO should find time to talk to them. At Maverick, for example, as part of our intensive research effort, we maintain constant dialogues with the competitors, suppliers, and customers of the companies in which we invest. As a result, many management teams find our insights to be quite helpful.

MoF: Who should lay that groundwork?

Lee Ainslie: A company's investor relations team can play a very valuable role in this regard. By constantly and proactively meeting with shareholders and potential investors and developing an understanding of their knowledge and abilities, the team can assess which investors a CEO or CFO should meet with. The better sell-side analysts can also be very helpful in this regard.


Management teams should seek out the more thoughtful investors who ask hard questions and have clearly done their homework. Over time such dialogues will hopefully develop into mutually beneficial relationships.

MoF: And finally, what's going on in the hedge fund industry today? Is there too much capital out there?

Lee Ainslie: If you look at the pricing of all assets—financial and real—one could argue that there is simply too much liquidity chasing too little return. To put the explosion of hedge fund assets into context, today the hedge fund industry manages roughly \$1 trillion in capital. This compares with an investment universe in stocks, bonds, currencies, real estate, commodities, and so forth well north of \$50 trillion. Some people have concluded that the dramatic growth of hedge funds will lead to shrinking

returns. However, I believe the impact of this capital will differ among different hedge fund strategies. For almost any arbitrage strategy, for example, the opportunity set is relatively limited, and virtually every dollar that is invested is deployed on the same side of each trade. So by definition the incremental capital will negatively impact the arbitrage spreads.

The opportunity set for long-short equity investing is quite different. At Maverick, we define our investment universe as all stocks that have an average daily volume greater than \$10 million—there are roughly 2,500 such stocks around the world. Since we may hold long or short positions in any of these stocks, we have about 5,000 different investment opportunities. Unlike arbitrage strategies, different long-short equity funds

may come to different conclusions about investment opportunities. In other words, one fund may be long a stock when another is short, and as a result incremental capital does not force spreads to close. Indeed, if you look at the spread between the best- and worst-performing quintiles of the S&P 500, for example, you can see that the annual spread has averaged around 70 percent over the past 15 years—which was almost exactly the spread in 2005. At Maverick, we are very excited about the potential to extract value from this spread to deliver returns to our investors. 

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