

Financial Reporting and the Bikini *RCB Summer Reading*

Even though we love the title, we will stick to tradition and start off with the more immediate thought of “what to do here and now” and then slowly digress into the meaty and juicy issues that, as usual, are surrounded by an unusually broad range of bad ideas and mindless posturing.

Somewhere in and around June 7th, 2002, “they” decided that there was one group of stocks that remained to be aggressively sold and these were the stocks owned by RCB (as well other value managers, not to be entirely self-critical.) There is no getting around how painful it has been the past month, and we feel it particularly strongly as we have not sold our souls to the false god of relative performance. Losing less money than the next guy is no way to go through life. Nonetheless, being within spitting distance (as of this writing) of flat at the half-way point in our large and all cap equity accounts and north of the line in small cap does have some attraction as an alternative to what may be a changing definition of a palatable investment strategy.

Looking forward, while we have absolutely no idea when the collective foot will be let off the fear accelerator, we think we are getting reasonably close to the proverbial price bottom, barring some disastrous turn for the worse on issues discussed below. While mathematically possible, “if it can’t go on forever, it won’t” is just as applicable to today’s downdraft as it was in the late 1990s bubble. We would again caution readers that a “price bottom” does not imply a return to the wondrous returns of the 1990s, but merely an improvement to an environment of malaise, from which it will be possible to experience the irregular climb up a mid to high single digit grade.

This cautiously ventured view is the product of a blend of left and right brain thinking. Most importantly, we are finding stocks to buy near valuation levels at which we can shed our shared fears of lurking accounting issues, fraud, domestic versions of homicidal bombers or buying the beginning of the end of the shares being dumped by some leviathan of a money manager who bought them 80 points

ago and has decided that the momentum has turned negative. In our large cap world, these include Time Warner, Disney, GM Hughes and AT&T. In brief, while AOL Time Warner is the official name, we refer to the company by its surname, as the market’s valuation of AOL is actually negative and the logic for a de-merger is overwhelming, no matter what line management is currently spouting. We have also purchased AT&T, where we are getting banged up by fear and loathing about an otherwise perfectly good cable business and not by our original worries about the consensus telephone implosion. (Thank you WorldCom!) GM Hughes is a situation where, once again, we are indifferent about the merger with Echostar going through and either way, we can lock in another few years of exceptional value growth. Lastly, we purchased Disney, where even the King Mouse cannot escape the corporate governance tidal wave. While all four of these companies have “issues”, as does nearly everything we buy at the start, they all possess prize franchise assets that are worth, according to our intensive research, at least twice their current prices. At a minimum, they represent levered plays on economic improvement, which will wave a magic wand over many “secular” corporate problems, much as 4% GDP growth made geniuses out of everyone with a title. On the small cap front, while we are loath to mention many individual names because we continue to take in money and liquidity is hard enough to come by, it is fair to say that the last six weeks have erased much of our apprehension about the sector getting too much attention and values becoming more difficult to find. Once again we are having no problem putting money to work.

On the right brain side, there are numerous signs of desperation, which usually signal reasonable windows in which to at least begin looking at stocks...or bonds for that matter, given the simultaneous meltdown in the corporate bond market. The following is by no means a complete list:

- The papers are full of “heart-broken” investors rediscovering a love of cash and real estate and bemoaning the fact that the market value of their account is down 75%.

- Friends and associates in the brokerage community report increasing frequency of clients demanding to be 100% out of the market.
- The “market” appears to be headed for a nearly unprecedented three down years in a row. June 30th marked the first negative three-year annualized rate of return since 1975.
- Long-term “buy and hold” investment strategies are currently being dismissed as “for chumps.”
- Wall Street is firing analysts left and right, which means that companies are losing analyst coverage and dropping off radar screens (insuring our next 5 years of small cap investment ideas.)
- Executives are finally being prosecuted for behavior that was conveniently ignored on the way up and politicians are trampling innocent bystanders to reach for open TV microphones.
- Investment professionals at RCB are beginning to feel truly queasy.

Obviously, there are plenty of big, fat macro risks with which even the casual observer of CNBC is being bombarded. Having taken some decent body blows in some of the aforementioned stocks, we are certainly respectful of the very real possibility of being so early as to be very wrong. These risks include acceleration in the decline of the dollar; a continuation of inane economic policy like the imposition of steel quotas; the passage of a truly gluttonous, by ANY standard, farm bill; and more “temporary” tax bills. However, macro-risks are present every day when we go to work, and when values present themselves it has nearly always proven wise to relegate headlines to the back burner and stick to the specific fundamentals of securities.

Let’s put it another way. If the Tiffany jewelry chain announced a 40%-off sale tomorrow, wouldn’t you expect a line as long as you see at security outside any Southwest Air terminal? What is it about investments that cause people to freeze up completely and to become unable to utilize very basic cognitive functions? As painful as it may seem in practice, we want the market and many of its participants to occasionally experience bouts of panic and delusion. This enables a thoughtful and mostly rational investor to buy Tiffany-like businesses on sale.

While this letter risks falling into the same trap (sometimes we can’t help ourselves), what also makes us take notice is that very little commentary these days is remotely concerned with the value or potential value of securities. It seems the airwaves and papers are consumed with elegant yet useless diatribes relating to nearly everything but how to preserve and make money. This naturally brings us to the truly embarrassing spectacle of Congress thundering indignantly on about corporate malfeasance and financial mismanagement. Wasn’t that John “the Senator from

Arizona who was so deep into the Lincoln Savings scandal that he barely survived a Senate investigation” McCain pitching morality in a Wall Street editorial? Does the Federal government produce anything remotely like a passable GAAP financial statement; much less do its members have any idea what they are talking about in regard to accounting or how Wall Street works? Is there any place on earth that can match the accounting machinations and shenanigans employed since time immemorial by the self-styled white knights of purity when it comes to slapping together a multi-trillion dollar budget in the wee hours before a summer recess? Is this the same deliberative body that has successfully stood in the way of nearly every substantive accounting reform during the past decade, including the most obvious and important reform of forcing companies to treat stock option issuance as an income statement expense? A recent article in the Financial Times quoted one Sir David Tweedie, who heads the International Accounting Standards Board, to the effect that “American business spent \$70mm lobbying to stop Congress from implementing new rules on options accounting.” It unfortunately appears to be working.

While it is easy and preferable in the conduct of securities analysis to ignore the flurry of nonsense out of Washington on nearly every issue, there is something specifically unsettling about watching Congress, the SEC, the Bush Administration and of course the Fourth Branch of Government – the Attorneys General and their plaintiffs’ bar subsidiary – fight over who will take the lead in the one-upmanship of bashing the corporate fat-cats. We don’t think it is a stretch to say that these people are mostly ignorant of how markets and businesses work and that there is a real danger of anti-business populism injecting some seriously counter-productive regulation into an already fragile mix of environmental influences. There are a number of reasonable “actions” to be taken in this environment, such as expensing of stock options, encouraging restrictions on the holding periods of executive stock, and putting some teeth into the miserably ineffective self-policing of the accounting “industry.” On the whole, little really needs to be done that the market and existing criminal and civil statutes are not already doing to severely punish “wrong-doers.” Unfortunately, this is clearly a minority opinion as so eloquently expressed by “Billy” Tauzin, the believe-it-or-not Republican from the fine state of Louisiana: “This latest accounting scandal (WorldCom) only highlights the importance of Congress working together to pass tough new laws which will prevent future abuses and restore investor confidence.”

Unfortunately for the World’s Greatest Deliberative Body, rushing to set up new government entities with unlimited subpoena capabilities and vague and duplicative missions is hardly going to soothe investors’ nerves. Enron, WorldCom, Adelphia et al are indicative of nothing more than the

perpetual ability of well-educated thieves and weasels to temporarily evade detection of massive fraud. If anything, “woe is me” investors should be thankful for the opportunity provided by these frauds in that it allowed additional time for those even remotely paying attention to what their hard-earned savings were invested in to get out with merely a solid licking as compared to complete decimation. At the market top in December 1999, a Gallup Poll found that 46% of investors surveyed thought the market was overvalued and 5% thought it was undervalued. Yet several questions later, 75% of investors reported that “now is a good time to invest in the financial markets.” There is something seriously wrong with our “society” when we think we need new rules to prevent people from committing fraud or making egregiously poor decisions about how to invest their own money. The de-facto godfather of all value investors, Ben Graham, noted as much in a series of lectures at Columbia University back in the 1940s regarding the progress of the profession of securities analysts. “In one important respect we have made practically no progress at all, and that is in human nature. Regardless of all the apparatus and all the improvements in techniques, people still want to make money very fast. They still want to be on the right side of the market. And what is most important and most dangerous, we all want to get more out of Wall Street than we deserve for the work we put in.”

However, we digress. What is most interesting and important to us as securities analysts is the debate about what constitutes accuracy in the preparation of financial statements. In no way do we condone the miserable and self-serving state of the general accountancy profession which, like many before, has fallen prey to obvious temptation in the pursuit of fee income. While there are all sorts of high and mighty conceptual definitions of the accountant’s role in the socio-economic hierarchy, as NYU professors Alvarez and Fridson noted in their recent book, “the purpose of financial reporting is to obtain cheap capital,” a summation which should not surprise anyone with the slightest business experience.

That said, let’s move to a hypothesis: while Generally Accepted Accounting Principles might be fraught with problems, they provide a perfectly acceptable basis on which to build a methodical process of securities analysis whose purpose is to assess a reasonable approximation of value. This, of course, assumes that assets and revenues are not being grossly overstated and costs and liabilities understated or simply not reported at all, and it certainly assumes that an investor will actually bother to thoroughly read financial statements and the accompanying footnotes and exhibits, none which evidently appears to be a “money-good” proposition.

The basic flaw that has developed in the widespread

application of this hypothesis in the investment management world is that there have been numerous iterations of gross simplification, whose net conclusion is the acceptance of Earnings Per Share and measures built upon it as the sole basis for valuing companies. The adoption of THE NUMBER as the single foundation of analysis has a myriad of flaws, the biggest of which is the obvious series of guesstimates in its compilation, the interpretation of which has as many shades of color as anything in a modern art museum. There is no magic number or bullet in financial analysis, despite its handiness in one-liners on TV or to clients. At RCB, we build a mosaic encompassing a number of different ways to analyze and value companies, most of which centers around balance sheet examination and trends, return on capital analysis, and the present value of our forecasts of future cash flow. There is no one valuation “point” for any company nor is there one measure that is the Holy Grail to determine whether to buy or sell, and any attempt to cram this process into EPS or P/E is fruitless and usually painful. It is always better to be somewhat right rather than precisely wrong.

Much of this began with the wholesale application of what is known as Modern Portfolio Theory, which has shifted emphasis away from individual securities analysis to the analysis of the portfolio as whole. When you believe that the market is completely efficient, what’s the point in wasting time in the analysis of all those pesky little stocks when what is really important is the beta, tracking error and style box of your output? Thus the investment management industry has grown to focus mostly on the creation of “products” that are highly marketable in a variety of distribution channels as opposed to studying financial statements and boning up on accounting issues. There should be little wonder why and how WorldCom and Tyco can pull off such deception in front of such a well-dressed and educated public eye.

The irony is that we are beginning to see ridiculous amounts of disclosure in stupefyingly long SEC filings, a good chunk of which we find immaterial, but companies and their auditors are so paranoid that if the CEO has a dog, we must know its name, what it eats and which accounting treatment was chosen for the construction of its doghouse. If many investors got themselves into the complete mess they are in now because they never bothered to read financial statements in the past, then we can assure you they certainly aren’t going to be reading them now! We would consider the paranoid disclosure regurgitation an actual tax on serious investors, because while you can be sure 50% of the disclosure is boilerplate and gratuitous, you are not sure which 50% that is until you read the entire document. We have spoken with several companies with April and May fiscal years who are reporting that their auditors are spending three and four times the man-hours on the current audit than they have on any previous one. All we ask for as

shareholders is pertinent and timely disclosure of all material facts and liabilities as can best be determined at the time so that we can do our own valuation work. As the NYU Professor Emeritus and the conscience of the accounting industry, Abe Briloff, has said: "Corporate financial statements are like bikinis...what they show is very interesting; what they hide is vital." (We've always said it pays to read the footnotes.)

The SEC has its issues and is developing more of them every day, but as recently noted by former SEC Commissioner Laura Unger, there are more than 12,000 public companies and the SEC has 100 lawyers and 90 accountants. If we instantly adopt Congressional calls to nearly double the SEC budget and the bodies available to audit the auditors, so what? The SEC's role can only be compared to screening our borders for terrorists; you can't possible check everyone, but you hope to do enough to provide material deterrence to those who may be tempted. Clearly, huge increases in staff and a more focused mission for the SEC will bring benefits for investors over the long run, but it will not "stop" corporate malfeasance, which will remain a Sisyphean task as long as the two-legged species is running the planet.

The whole issue of audited financial statements will ALWAYS be contentious and fraught with conflicts. No matter how you cut it, companies pay accounting firms to audit them and therefore accounting firms and their employees are under obvious pressure to maintain client fee streams and not to blow whistles. Like democracy, it may be a lousy system, but it is a thousand times better than the alternative, which is some sort of government-funded auditing function as has been suggested lately. On this basis, we don't see that separating consulting from auditing is the panacea, but it seems unlikely that it is a step in the wrong direction.

If one intelligently concludes that auditing and the preparation of financial statements will always be at best a series of guesstimates submitted with integrity, what would be interesting is if the auditing process assigned companies letter grades like A-B-C-D-F instead of the current pass/fail. A market-based system where investors would judge over time which auditing firms give the tough grades and which are pushovers would then likely evolve. Raise a few million dollars, hire twenty senior auditors, advertise yourself as the toughest auditing team in the West and you will have one heck of a business idea for the next decade. A "when-issued" market is already developing on this basis as firms that are perceived to be conservatively stating financials are receiving higher multiples and those with a tainted reputation are being whacked, although we are making the case that this has gone a bit too far in certain instances.

While we have left out all sorts of fun stuff in regard to corporate governance and the stock options nonsense (to even call it a debate is embarrassing), we will call it a day on public policy.

We will close with some thoughts shamelessly repeated from our last Strategy Letter, but since a disgraceful amount of time has elapsed since its publication, we don't feel that badly. Even a mild analysis of history is incomplete without countless examples of epochs in which the swing of the pendulum to greed seemingly compels otherwise intelligent individuals to carelessly ignore common sense and to throw money at dubious ventures. We refer you to Where Are the Customer's Yachts?, written in 1940 by Fred Schwed, Jr. in which he noted: "The information contained herein, while not guaranteed by us, has been obtained from sources which have not proved particularly reliable in the past."

Value-oriented investing, with a focus on maintaining a margin of safety, is a time-tested process and a strategy for all seasons and cycles because it accepts the potential that the worst outcome is conceptually possible and severely discounts our ability to guess the future. We at RCB frankly accept our own limitations and do not aspire to the greatness and universal accolades of finding the next Microsofts and Wal-Marts. We will be content to avoid the next batch of WorldComs.

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Summer Reading List

- The Rediscovered Writings of Benjamin Graham: Janet Lowe
- Beyond Fear and Greed: Hersh Shefrin
- Wealth and Democracy: Kevin Phillips
- A Conspiracy of Paper: David Liss

The opinions expressed herein are those of Reed, Conner & Birdwell Investment Management and are subject to change without notice. Securities mentioned herein are not to be construed as a recommendation to buy or sell and are not guaranteed to be in portfolios.

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