In the News

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Instant disgruntlefication

EXCLUSIVE OUTLOOK

Paul Orfalea, Lance Helfert and Atticus Lowe

Most people know of the character Don Quixote, a madman who fancied himself a knight errant, fighting windmills he believed were giants. Readers of Cervantes' masterpiece learn what drove Don Quixote mad: bad books. Don Quixote not only read bad books; he developed an insatiable appetite for them, and "he went so far as to sell acres of arable land in order to buy books of chivalry to read."

We thought of poor Don Quixote when we read Ellen Simon's July 24, 2005, Associated Press article, "Some Say Earnings should be Reported More Often." She presented the theory that more frequent earnings announcements and other corporate reporting would reduce volatility on Wall Street.

We believe the opposite is more likely. Thanks to cell phones, the internet, cable television and other forms of 24/7 connectivity, people already choose to bombard themselves with vast quantities of information, usually far beyond their capacity for understanding. As Don Quixote's family and friends learned, too much of a bad thing is, well, worse.

PROS AND CONS

The reasoning behind the call for more frequent reporting goes something like this: Quarterly reports often include "surprises," which can cause dramatic swings in share prices. Simon cites, among others, the example of Molina Healthcare Inc. After the company "warned it would report a second-quarter loss and reduced its full-year earnings, traders lopped $20 off its stock price, which closed at $26 a share."

She goes on to say that many are calling for more frequent reporting, and cites the presumed benefits: "More information would make stocks less volatile and managers would have a harder time gaming their results."

Simon quotes former SEC commissioner Steven Wallman, who said, "It's one way to eliminate the shortsightedness that seems to be creeping into the market." According to the article, "the arguments against daily disclosure are that it would increase securities litigation liability and give competitors too many details about how a company operates."

Wallman then cavalierly dispenses with these contentions, claiming that a simple change to the law would reduce liability issues, and that big companies know all about their competitors anyway.

Well, one can always win an argument with oneself. We believe there are other, more compelling arguments against so-called "real-time" disclosure: 1) It could actually make market volatility worse, 2) it could distract companies from their primary objectives, and 3) it does not specifically address the quality of information, providing no benefits to investors who focus on more important measures of a company's ability to generate future profits.

WHAT CAUSES VOLATILITY?

"Fluctuation" describes the natural state of the stock market. Values rise and fall based on company performance, current events, interest rates and thousands of individual factors.

However, investor reaction, and especially investor overreaction, to these factors cause the market's so-called volatility, such as the dramatic punishment of Molina Healthcare. As we often point out, in the short run, the market runs on emotion. In the long run, the market responds to performance.

Some have called on public companies to make their daily sales figures available online. Others call for the markets to operate 24 hours a day, seven days a week. We suspect that access to such information would increase daily volatility rather than reduce quarterly volatility; the same people who overreact four times a year would have the opportunity to overreact seven days a week.

Shortsightedness results from a weak investment philosophy, not a lack of information. The desire for daily or monthly earnings reports springs from our society's increasing demand for instant gratification, but surely causes instant "disgruntlefication" more often.

Frankly, we are shocked by Wall Street's harsh reaction to quarterly reports when earnings miss company or analyst estimates by a few pennies. We are rarely swayed by such minor details, and are skeptical of companies that consistently meet their earnings' forecasts, such as GE. This usually illustrates a company's mastery of accounting trickery more than its management of the business. Imagine a company of General Electric's size and scope accurately forecasting earnings for its numerous divisions, months or even years in advance. When would they find time to make engines, or medical devices, or whatever it is they make?

Many excellent companies, including Gillette and Berkshire Hathaway, eschew earnings guidance altogether, but few people would accuse Warren Buffett of driving blind. Perhaps earnings estimates are not as important as Wall Street wants to believe.

Moreover, volatility actually benefits engaged investors. Other people's overreaction creates buying opportunities for patient investors, and opportunities for companies to repurchase shares while they are cheap. As Buffett said, "Look at market fluctuations as your friend rather than your enemy; profit from folly rather than participate in it."

DOG AND PONY SHOW

Many companies already complain that compliance with the accounting/reporting reforms of the Sarbanes/Oxley Act distract them from their core competencies. We support any improvement in the quality of information supplied by companies, but agree that an arbitrary demand for more frequent information represents an unnecessary burden.

We like companies that focus on making money, not singing and dancing for the entertainment and edification of investors too complacent or unskilled to do their own research. Dealing with daily or monthly reporting requirements would be a major distraction for people who should be leading and managing their companies, not their dog and pony shows.

Our long-term sensibility drives us to companies like Wm. Wrigley Co., a solid performer over time. It makes chewing gum, and has a strong competitive advantage and great growth prospects overseas. Over time, we believe this company will continue to grow and increase its value considerably. Daily sales figures would not affect our position; only clear long-term trends can do that. We want to understand the company, not the company's financial situation on Tuesday at 2:41 p.m.

Too often, people focused on intricate details lose sight of the big picture; they cannot see the company, only the PowerPoint slides.

WHEN WARNINGS WON'T DO

No matter how many warning labels we attach to consumer products or investment prospectuses, there is no substitute for an alert, involved user. People who want to drive a car while talking on a cell phone, eating a hamburger, reading a map and watching a movie want to blame the automobile manufacturer if they happen to lose control of the vehicle. When such people wish to invest, we say, "You are going to crash, and it is your own fault."

Investing is much more like riding a motorcycle than driving a car. Not only must the operator maintain a much higher level of awareness and engagement, his safety also depends on complete commitment to firm operating principles. One of these, according to the Motorcycle Safety Foundation, is that a motorcycle goes where you look.

Buffett has said, "In the business world, the rearview mirror is always clearer than the windshield." True, but if you become obsessed with what is behind you, you will not see the hazards ahead.

Investing cannot be transformed into a risk-free endeavor. Rather than call for more frequent reporting, investors should take time and effort to understand the information available to them now.

Consider the comments of Jim Chanos of Kynikos Associates, as related in the book "The Smartest Guys in The Room: The Spectacular Rise and Scandalous Fall of Enron." Chanos studied Enron's financials and was one of the first to proclaim that the emperors of Enron wore no clothes. "As soon as anyone looked, they could see the stuff we saw."

The frequency of reporting was not an issue in the Enron scandal, only the quality of the reporting and the quality of the reading.

QUALITY VERSUS QUANTITY

Jim Chanos provided testimony about his Enron experience to the U.S. House of Representatives Full Committee on Energy and Commerce, and his testimony gets to the heart of the matter:

"First and foremost, no one should depend on Wall Street to identify and extricate investors from disastrous financial situations. There are too many conflicts of interest, all of them usually disclosed, but pervasive and important nevertheless. In addition, outside auditors are archaeologists, not detectives. I can't think of one major financial fraud in the United States in the last 10 years that was uncovered by a major brokerage house analyst or an outside accounting firm. Almost every such fraud ultimately was unmasked by short sellers and/or financial journalists.

"In addition, a company's adherence to GAAP (generally accepted accounting principles), does not mean that the company's earnings and financial position are not overstated. GAAP allows too much leeway in the use of estimates, forecasts and other inherently unknowable things to portray current results. In the hands of dishonest management (a rapidly growing subset, in my opinion), GAAP can mislead far more than they inform!"

In other words, more frequent reporting increases the availability of bad information — a situation that served Don Quixote poorly, and would serve investors even worse.

Paul Orfalea is the founder of Kinko's and co-founder of West Coast Asset Management. Lance Helfert is WCAM's president and Atticus Lowe is vice president. They can be reached at info@wcaminc.com. The principals of West Coast Asset Management, or its clients, may own shares in the companies written about in this column.