

g.a.kraut company inc.

Look Who's Watching! **New audiences should mean new scripts for IR**

**Remarks by Gary A. Kraut
to the
Citibank Investor Relations Leadership Seminar
London, England**

*Although this speech is somewhat dated,
the thoughts expressed are not.*

**275 Madison Avenue, New York, NY 10016
Tel (212) 696 5600 Fax (212) 685 2413**

www.gakraut.com

“Investor relations is the management of the perception of risk and reward.”

Investors' crisis of faith in corporate America has penetrated deeply into the always sensitive balance between ownership, stewardship and management. But CEOs, CFOs and IROs, overwhelmed with the impact of a poor economy and new regulations, may still not fully grasp just how – and in which direction -- this delicate balance is tilting.

In my view, for example, the very definition of an "investor" needs rethinking and broadening to include other stakeholders, monitors and NGO's, among others.

Burned by their expectations for limitless growth, investors have reversed themselves and are now sharply focused on risk: from the economy, the markets, and even corporate management itself'. This is leading to a melding of addressable issues for investor relations and risk management.

Investor relations, in fact, may be ready for a new definition: the management of the perception of risk and reward.

All this means that the way in which companies position themselves and deliver their messages is undergoing a transformation.

Let's begin with the "investor." The traditional narrow view of an investor as an institutional money manager or an individual stockholder is dated. Money managers and individuals are, of course, the investors in a legal sense. However, an unanticipated consequence of the regulatory and legislative attempts to restore confidence in the quality and accuracy of information provided by public companies is that there are constituencies which may not legally be shareholders but which nonetheless have investments in your companies that are emotional, professional, political or cultural.

You might think of this as the stakeholder concept and it is -- but with one vital difference. The Company's stakeholder groups are the same – employees, customers, suppliers, governments and communities – but they are now IR's audience as well. That's because they are clustering in increasing numbers around the IR stage for what they perceive as more solid information about the Company.

Increasingly, these "stakeholders" are beginning to marshal the powers of actual stockholders. Alone or in concert their activities can have the force of legal ownership. We should begin to think of these people as "investors," as well. Certainly their perceptions of your company feed into those of the stockholders. To be effective, IR must dramatically widen its focus to pay much more attention to such once-peripheral audiences.

Look Who's Listening!

For evidence of this, we only have to look at the simple investor conference call. A couple of years ago, the company hosting the call essentially spoke to active sell-side analysts who posed most of the questions, and to some institutional investors who for the most part listened passively. Today, the company has to be aware that on the other end of the line are not only shareholders, but reporters, customers anxious about its viability, employees concerned about jobs, suppliers worried about orders, specialists in shareholder class litigation, and a host of others. The reason they prefer the IR pipeline is painfully simple: they know that, thanks to changes in law and

regulation, there are especially painful consequences for misstatement, evasion and dissembling in communications with investors.

Already, the traditional IR audience itself not only wants more and better information from companies, but it also wants independent means of verifying what it gets. In addition IR must now weave into the investor message more than just the concerns of traditional investors.

Two examples of largely “non-owning constituencies” that have an emerging interest and influence in your business are “Independent Monitors” and “Non-Governmental Organizations,” or NGOs.

New Monitors

Independent monitors are organizations that watchdog corporate behavior. Traditional independent monitors include the press, and rating agencies such as Standard & Poor's and Moody's. But now there are corporate governance accountability screeners of one sort or another popping up all over. They are here to stay, and they are going to be part of your job. These monitors will have an increasing impact on shareholder value, so IR should not relinquish relationships with them to the General Counsel or Corporate Secretary.

What gives these monitors power is their clients. Monitors mainly offer their research to institutional investors worldwide. The hundred or so global institutions that control the lion's share of invested assets are the most likely buyers of their services. Such major investors as CalPERS, SWIB, and TIAA-CREF in the U.S.; Active Value Fund, Hermes, Morley, and USS in the U.K.; ABP in Holland; AFS-ASFFI in France; and Union Investment in Germany cannot afford *not* to use such services.

As an example of how rapidly this development is occurring, state pension plans in Connecticut, Florida, New York, North Carolina, and Wisconsin have already agreed to ban money managers who work for them from buying stocks unless they conduct corporate governance research. Eight more huge state pension funds are expected to join them.

So monitors not only want more information from you, but also information you are not used to providing. In the U.S., the Corporate Library, IRRG, and ISS are in the corporate governance rating game. They have been joined by S&P and Moody's along with GovernanceMetrics, a firm I co-founded.

To illustrate the scope of this scrutiny, GovernanceMetrics is rating companies around the world starting with the S&P 500 in November 2002 and moving on to 2000 top companies around the world by the end of 2003. It rates companies on more than 600 metrics in seven criteria: board accountability, financial disclosure and internal controls, shareholder rights, executive compensation, market for control, shareholder base and corporate behavior, and social responsibility issues.

There are also monitors looking at social, environmental or international security performance. Among them are SIRI and Vigeo in Europe and KLD and Conflict Securities in the U.S. The social responsibility people are gaining clout. A new report by SustainAbility in conjunction with the U.N.'s Environmental Program actually ranks the best 100 companies in the world on the quality of their social and environmental reporting. Many investors will be using such lists.

Much of this data, such as copies of your governance principles and your code of ethics may be available to IR departments, since many companies have them, but investors don't know they are there, and IROs do not usually push them. Monitors and investors also want the information they seek prepared differently. In the U.S., for example, investors are now actually reading proxy statements! These should become an IR opportunity, readable and interesting. They should no longer be monuments to dead and impenetrable legal discourse. We can do better.

The Power of NGOs

The second emerging influence bloc, non-governmental organizations or NGOs, now sometimes known as civil society organizations, includes environmental lobbies and trade unions who have joined big business and institutional investors as part of the global power elite. They want similar information to the corporate governance and social responsibility/environmental rating agencies. In the U.S., unions like the AFL-CIO have policies that are making labor pension funds driving forces for good governance and employee affairs.

For example the Federation of Hospital and University Employees is a group of four unions pressuring Yale University to avoid investments that could injure the environment. The union says Yale's \$10 billion endowment is "shrouded in secrecy" and is advocating new stewardship. The University of Texas, with a \$14 billion endowment, has just agreed to make its portfolio transparent. Yale's union wants and may convince the university to follow University of Texas' example. Harvard's \$17 billion endowment could be next on the hit list.

In the U.S., CERES has a "sustainable governance" program and has argued for corporate involvement in climate changes. The International Finance Corporation, a part of the World Bank, is promoting social responsibility. And the NGOs are getting together in trade groups to coordinate their thinking and their efforts. University corporate governance programs have become commonplace, along with director training programs.

You not only need good corporate governance, you also have to tell investors how good it is. Now that corporate governance is getting the attention it deserves, it will not "blow over." As World Bank President James Wolfensohn says, "The proper governance of companies will become as crucial to the world economy as the proper governing of countries." It will get similar public attention.

IR Links to ERM

Another development -- and another evolving opportunity for IROs -- is ERM, or enterprise risk management. I define it as: "...the process of planning, organizing, leading, and controlling the activities of an organization in order to minimize the effects of risk on an organization's capital and earnings. Enterprise risk management expands the process to include not just risks associated with accidental losses, but also financial, strategic, operational, and other risks."

It also provides the basis for my new definition of investor relations: IR is the management of the perception of risk and reward. Not the *management* of risk and reward; it is the management of *the perception* of risk and reward.

Risk management is important because boards have gotten plenty of surprises. ERM is going to be a board-level priority, therefore one of the CEO's priorities, and consequently one of the IRO's priorities.

To me, corporate governance is a component of enterprise risk management. Unfortunately, many companies do not have enterprise risk management programs in place even though risk clearly impacts the likelihood of achieving corporate objectives.

IROs get internal flash figures. Perhaps companies should install flash risk assessments as well. The best risk monitoring technique I know is an enterprise risk management dashboard and the best one comes from Gupton Marris, a new U.S. company. IROs now have to know how information about risk is assembled and how it gets to the right people in the company.

In any case, how your company manages risk must now become a key component of your IR message. Investors of all kinds are starting to demand a clearer picture of your risk profile in an era where they are interested in reward but obsessed with risks. Presentations to investors are

going to change from the usual recitation of how you are going to reach your goals to include how you are going to overcome obstacles in your path.

Graham & Dodd traditional security analysis is not going away. The numbers matter – always have, always will -- but they are a somewhat smaller piece of the overall puzzle than they once were. Investors need to value lots of non-financial information about intangibles, including brands and intellectual property. But they also need more clarity and transparency on governance and risk.

A triangle of investor information requirements seems to be emerging: security analysis, analysis of intangibles, and risk management/corporate governance measurement. However, there are many potholes in the road and you have to tell regulators, legal stockholders, independent monitors, NGOs and many other audiences how you are navigating around them. . Thinking financially is no longer enough. IR has to think holistically if it is to manage the perception of risk and reward successfully.

Four Suggestions

In conclusion, there are four tasks I can suggest to help you build and protect faith and trust in your enterprise:

- Firstly, review carefully all your company's risks and opportunities, and then prioritize them under external, industry, and company-specific risks.

Here is an illustrative list of questions IROs are going to start to be peppered with, if this hasn't happened already. I credit some of this material to the recently beloved and departed Arthur Andersen & Co., who took little of their own advice.

1. What are the *external forces* that could put you out of business or reshape your value drivers? Do you have political risk in countries where you have major operations that could threaten you? What is the risk from new competition? Do you face regulatory risk or catastrophic loss?
2. What is your *process risk*? That is, are your processes aligned with business strategy? Can you produce what you need efficiently? Are you pleasing customers? Are your operations effective? Do you have the proper human resources? How effective is your R&D? Do you produce a safe product in a safe, healthy environment?
3. Do your people know when to adjust what they are doing? Is your internal communication good? Are your partnerships and JVs effective?
4. Is your IT working properly?
5. Is there anyone in the company who knows something that could sink your business? Can you manage your reputation if you lose revenues, customers, profits?
6. Are there pricing risks?
7. Is your budgeting and financial planning sound? How about financial reporting and organizational development?
8. What about IR risk — a decline in credibility or confidence among investors that paralyzes your ability to raise capital?

- Secondly, determine how your company will manage all priority risks (and opportunities).
- Thirdly, be completely transparent about all material risks and opportunities. Know what needs to be emphasized and why; skillfully position and communicate the relevance and relative scale of the risks to each investor group. Carefully balance risks and opportunities.
- Fourthly, continually monitor how investors perceive and act on their perceptions of these risks and opportunities. Share these findings across senior management and, in some cases, the board.

GARY A. KRAUT is president of G. A. Kraut Company, a New York City-based a global investor relations consultancy he founded in 1969. Clients include some of the world's largest companies as well as mid-caps, small-caps and IPOs. G.A. Kraut Company's website is: <http://www.gakraut.com>.