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Edited by Alexander V. Laskin

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The Handbook of Financial Communication and Investor Relations

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Alexander V. Laskin

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This edition first published 2018
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Registered Office
John Wiley & Sons, Inc., 111 River Street, Hoboken, NJ 07030, USA

Editorial Office
350 Main Street, Malden, MA 02148-5020, USA

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Library of Congress Cataloging-in-Publication data is available for this book.

ISBN 9781119240785 (hardback)

Cover Image: © HYWARDS/Gettyimages

Set in 9.5/11.5pt GalliardStd by Aptara Inc., New Delhi, India

10 9 8 7 6 5 4 3 2 1

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Part I

The Foundations of Financial Communication and Investor Relations

Theory and Industry

1

Investor Relations and Financial Communication

The Evolution of the Profession

Alexander V. Laskin

Sorkin (2016) calls publicly traded companies in the United States "a dying breed" (p. B6). Indeed, based on statistics from the National Bureau of Economic Research, between 1996 and 2012 the number of publicly traded companies decreased almost by half—from 8,025 to 4,101. The number of initial public offerings decreased from an average of 436 a year in 1990s to just 120 in 2015 (Colvin, 2016). The reason for the demise? According to the leaders of the financial sector—representing such companies as Berkshire Hathaway, BlackRock, JPMorgan Chase, T. Rowe Price, Vanguard, and others—there is "too little trust and connection between shareholders and management" (Sorkin, 2016, p. B6). In other words, there is too little of exactly what the investor relations professionals are responsible for!

Why do investor relations officers (IROs) fail at their jobs? Why do they fail at building trust and connection between their companies and their shareholders? The answer to this question is not simple; in fact, there may not be a one-size-fits-all answer at all. But one of the areas where we can start looking for answers to this question is public relations and strategic communication and, specifically, underutilization of public relations and strategic communication expertise in modern investor relations.

Trust is a key focus of public relations and strategic communication activities. Richard Edelman, the CEO and president of Edelman, the largest public relations agency in the world, underscores the importance of working on building and maintaining trust in all public relations programs: "Trust in institutions and their license to operate is no longer automatically granted on the basis of hierarchy or title; rather, in today's world, trust must be earned" (Edelman, 2016, p. 16). But do investor relations professionals see their jobs as aimed at building trust?

This handbook, focused on financial communication and investor relations, provides an in-depth overview and analysis of the profession from the communication standpoint. As a result, it describes and analyses financial communication and investor relations' history, main activities and key players, theoretical considerations, practical implications, future outlooks and concerns, and, perhaps most importantly, recommendations on how to move forward.

Definitions

Return on Expectations

The first step is, of course, agreeing on a definition. What do we mean when we say "investor relations and financial communication"? Many investor relations professionals, undeniably, will

The Handbook of Financial Communication and Investor Relations, First Edition. Edited by Alexander V. Laskin.
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point to a definition of investor relations adopted by the National Investor Relations Institute's (NIRI) Board of Directors in March 2003: "a strategic management responsibility that integrates finance, communication, marketing and securities law compliance to enable the most effective two-way communication between a company, the financial community, and other constituencies, which ultimately contributes to a company's securities achieving fair valuation" (cited in NIRI Board of Directors, n.d.).

Other practitioners of financial communication may suggest that investors are just one of many types of publics that corporations need to communicate with; these practitioners point to a wider definition: "a strategic communication process that builds mutually beneficial relationships between organizations and their publics" (Public Relations Society of America [PRSA], 2016). Here, of course, the word "publics" is used generically and can be replaced with a specific public depending on the function—for example, for investor relations, it would be investors, and the definition then would become: "a strategic communication process that builds mutually beneficial relationships between organizations and their investors"; for employee relations, it would be employees, and the definition then would become "a strategic communication process that builds mutually beneficial relationships between organizations and their employees"; for donor relations, it would be donors, and the definition would then become "a strategic communication process that builds mutually beneficial relationships between organizations and their donors"; and so on.

Public relations and communication scholars may suggest the classic definition of public relations by Cutlip, Center, and Broom (2000): "Public relations is a management function that establishes and maintains mutually beneficial relationships between an organization and the publics on whom its success or failure depends" (p. 5). Once again, the generic word "publics" here can be replaced with the specific publics of individual specializations, such as investors. What is unique about this definition is that instead of word "communication" we see the word "management." It could be argued that one cannot build and maintain relationships based on communications alone—actions are perhaps as important as words, or even more important. As a result, it is not enough to communicate; it is also important to act in a certain way, and for this investor relations professionals must have access to the top management of the organization and be able to influence the strategic direction of the company's development. This is why the word "management" replaced the word "communication" in this definition.

In the end, all of these definitions are correct in highlighting the importance of investor relations and financial communication for modern-day organizations. However, the NIRI's definition and the definitions of the PRSA and Cutlip et al. have very different final goals: the former talks about fair valuation of security and the latter talk about relationships. Laskin (2011) conducted a Delphi study of experts in the investor relations profession to find out what should be the final measure of investor relations' contribution to corporate value. Most of the experts rejected share price as a legitimate metric. In another study, "respondents strongly rebuked … the notion of using company share price as a valid measure of the success of investor relations" (Ragas, Laskin, & Brusch, 2014, p. 186). Instead of driving the share price, investor relations improves the availability and quality of information, helping investors and analysts to develop more reliable expectations about share prices, and this may be a better measure of investor relations' contribution.

Relationships, on the other hand, scored significantly higher among the experts. However, they were cautious about possibility of objectively measuring and evaluating the quality of relationships (Laskin, 2011). The same was also true in Ragas, Laskin, and Brush's study (2014). Experts highlighted that it may not be relationships per se that are significant but the expectations that they help to create, which make it easier to ignore temporarily blips in performance.

As a result, a definition of investor relations and financial communication may instead focus on expectations as the key outcome: Investor relations is a function of managing expectations. This managing of expectations is a two-way street—investor relations professionals manage the expectations of investors and financial analysts about the company's past and future performance, but they also manage the expectations of the organization's executive team about the financial

community's evaluation of the company and their reactions to the corporate news. The long-known equation of "return on equity," then, is being transformed into "return on expectations," and managing these expectations is becoming a key part of investor relations programs.

Efficient Market Hypothesis

The modern concept of investor relations is part of the efficient market hypothesis. The efficient market hypothesis is primarily associated with research by Fama (1970) and states: "A market in which prices always 'fully reflect' available information is called 'efficient'" (p. 383). Such a market is in equilibrium: all securities are fairly priced, according to their risks and returns. No investors can consistently outperform, or beat, the market, and thus there is no reason to constantly buy and sell shares of companies in an attempt to outperform the average market return.

The efficient market hypothesis, however, requires key assumptions to be met: All relevant information about the company and its performance must be publicly available, all market participants must have equal access to such information on a timely basis, and all investors must be rational and capable of evaluating the information available to them. Fama (1965, 1970) talked about three levels of market efficiency: weak, semistrong, and strong. In the weak form of market efficiency, not all information is available to all market participants and, as a result, some investors can outperform others, taking advantage of better or faster access to information. In the semistrong form of efficiency, all public information is equally available to everyone and, as a result, already reflected in the stock price; however, there may be other, nonpublic, information that is not reflected in the stock price and, as a result, somebody with access to such information through, for example, insider trading can beat the market. And, finally, in the strong form of market efficiency, all information is reflected in the stock price and all investors—internal and external—have the same access to information and the same knowledge and understanding of the company.

Once again, investor relations, a function charged with providing information about a company to shareholders, financial analysts, and other market participants, is at the very foundation of the efficient market hypothesis. In fact, investor relations has become a key activity not just for particular companies but also for the whole modern economy. The survival of modern capitalism depends on how well IROs perform their task of ensuring equal access to information for various financial market participants. IROs are tasked with ensuring that the key assumptions of the efficient market hypothesis are met through extensive and timely disclosure of all relevant information pertaining to the company and its stock.

However, disclosure in itself may not be enough for a successful investor relations program. The efficient market hypothesis requires not just access to information but also understanding of the information and the development of reasonable expectations based on such information. It is possible for somebody to have access to accurate information but still make incorrect conclusions based on it or have unreasonable expectations based on that information. So, Laskin (2016) proposes that good IROs must engage in educational efforts with the goal of educating investors, "essentially outsiders, to fully grasp the value" of the company and its business model (p. 378). As a result, for IROs to be successful in the context of the efficient market hypothesis, they must do significantly more than just put the information out there—they are also responsible for making sure their messages are received, understood, processed, and acted upon.

A History of Investor Relations and Financial Communication

Preprofessional Period

Investor relations is inextricably connected with the separation of ownership and management. In the past, when blacksmiths or other craftspeople ran their businesses, they did not need to communicate their financial information or build relationships with investors because they were

the ones who financed themselves. They were the investors, managers, and employees of their enterprises. As the industries progressed, they started hiring more employees, but the original investors were typically the managers themselves. There was still no separation between ownership and management.

At some point, instead of one manager, it became more common to see a family—fathers, sons, uncles, mothers, daughters, aunts, and so on—as investors and managers, and family businesses began to replace sole craftspeople. But still, family relations were used instead of investor relations in such family enterprises. Finally, the demands of these enterprises became larger than one person or even one family could satisfy. They required resources to be pulled together from many different individuals. Shareholding companies became necessary.

It is fitting that the first shareholding company is alleged to have been a mining company. Extracting resources from the earth is a massive undertaking that indeed requires the efforts and resources of many people to come together. The copper mine in the Swedish town of Falun is believed (based on archaeological studies in the area) to have been operational since the year 1000 (Rydberg, 1979). However, the first official documentation of the Stora Kopparberg Bergslags Aktiebolag, a corporation responsible for mining the Falun mine, dates back to June 16, 1288, when 12.5% of Stora Kopparberg's shares were sold ("The Oldest," 1963; see Figure 1.1). Thus, we can say that the history of shareholding companies dates back to the 13th century.

In 1347, as the largest copper supplier in Europe, the company was granted a charter by King Magnus Eriksson allowing it to "[set] up a corporation of master miners" ("The Oldest," 1963, p. 98). The company is still in operation today, with 2015 sales of over €10 billion and operational

Figure 1.1 The oldest share: Stora Kopparberg original shares, June 16, 1288.
Courtesy of the National Archives of Sweden.

earnings before interest and tax of €915 million. It is still a shareholding company, with shares traded on the Stockholm and Helsinki stock exchanges. It employs about 26,000 people in 35 countries and its focus has shifted from copper to "renewable solutions in packaging, biomaterials, wooden constructions and paper on global markets" (Stora Enso, n.d.).

Although Stora Enso is the first example of the separation of management and ownership, at its start it was not a publicly traded company. In other words, not anyone could purchase a share in Stora Kopparberg. In fact, the shares were reserved for professional miners and noble people of the area. The first publicly traded company, in which shares could be purchased by anybody who was willing to pay the price, is believed to have been the Dutch East India Company. The company, founded in 1602 for the primary purpose of trading between Asia and Europe, is claimed to be not just the first publicly traded company but also the first multinational company (Van Elderen, 2011). The first publicly traded company also required the first stock exchange: "The Amsterdam bourse was founded in September 1602 within six months of the [Dutch East India Company's] formation and was an integral component to its success" (Chambers, 2006, p. 1).

The revolutionizing idea of opening the company's ownership up to the people allowed the company to bring in more than 6 million guilders. The share price jumped about 15% in the initial period of trading, with a subsequent increase of 300% over the next 20 years. As a result, the Dutch East India Company was able to finance its growth to unprecedented heights: It had "50,000 civilian employees, with a private army of 40 warships, 20,000 sailors and 10,000 soldiers and a mind blowing dividend flow.... With a market for its stocks and bonds, the Dutch East India Company became probably the most powerful business in the history of the world" (Chambers, 2006, p. 1).

In the United States, investments in the securities of companies became popular at the beginning of the twentieth century. Macey and Miller (1991) explain this development by pointing to a variety of factors happening at the same time:

> The growth of large industries such as railroads and heavy manufacturing stimulated unprecedented demands for capital. At the same time, increases in wealth among the middle classes created a new source of capital that could be tapped effectively by means of public securities issuance. Developments in transportation and communication technology made widespread promotion and distribution of securities practicable. Realizing the potential purchasing power of the rising middle class, bond issuers began to offer securities in denominations of $100 instead of the traditional denominations of $1,000 or even $10,000. A surge of new investment followed. (pp. 352–353)

In addition to traditional blue chips, many speculative securities appeared that promised get-rich-quick opportunities: metal mines, oil companies, gold companies—usually something distant and at the very early stages of development. "The speculative securities in the early 1900s were typically equity securities issued by mining and petroleum companies, land development schemes (such as irrigation and tract housing projects), and patent development promotions" (Macey & Miller, 1991, p. 353). Many investors lost money in these schemes. The securities markets at the time had a severe informational problem—it was difficult, if not impossible, to verify the claims made about the securities, especially if the shares were part of a distant California gold mine, for example.

These speculative securities were also distributed outside normal distribution channels—often by door-to-door salesmen and in other face-to-face solicitations. The securities salesmen were also among the first to use mailing lists—which traditional brokers referred to as "sucker lists"—where securities were hyped beyond any measure: "one-third of which [letter] is devoted to an extravagant flattery of the intelligence of the recipient, and the remaining two-thirds to the extolling of the excellent merits of the Gold Hammer Mines and Tunnel Company, from the investment standpoint; after which this most valuable stock is offered at the amazingly low price of seven and one-half cents a share" (as cited in Macey & Miller, 1991, p. 354).

As a result, thousands and millions of dollars were lost to "pure fake" and "near fake" enterprises (Macey & Miller, 1991, p. 367). Other enterprises may only have been too risky and too speculative, but the end result for investors was the same—loss of money. Investors could not rely on the truthfulness of statements made in connection with securities transactions, and that put the whole securities market in jeopardy. A banking journal at the start of the 20th century wrote: "So many people have lost their money on 'fake' investments that they seem to be incapable of distinguishing the false from the genuine, and hence are distrustful of all" (as cited in Macey & Miller, 1991, p. 394).

These developments required Kansas in 1911 to enact legislation to protect its citizens from these con artists. As Kansas Banking Commissioner J. N. Dolley complained, these fakers were duping unwitting investors by selling worthless interests in fly-by-night companies and gold mines along the back roads of Kansas. Yet, no actual assets backed up these securities, nothing but the blue skies of Kansas (Gelber, 2013). The first actual use of the term "blue sky" dates back to June 5, 1895, when an article in the Colorado newspaper *Castle Rock Journal* stated: "When a promoter by artful persuasion succeeds in getting money for something which has no value except in the mind of the credulous purchaser he is said to have been selling 'blue sky'" (as cited in Gelber, 2013). As a result, these types of securities were called "blue sky" and "hot air" securities (Wooldridge, 1906), and later just "blue sky securities."

Soon after Kansas, other states followed with their own regulations and, as a result, a network of comprehensive securities legislation developed at the state level. These state laws are commonly referred to as "blue sky laws":

> The name that is given to the law indicates the evil at which it is aimed, that is, to use the language of a cited case, "speculative schemes which have no more basis than so many feet of 'blue sky'"; or, as stated by counsel in another case, "to stop the sale of stock in fly-by-night concerns, visionary oil wells, distant gold mines and other like fraudulent exploitations" (*Hall v. Geiger-Jones Co.*, 1917, p. 539).

These laws created the first requirements for disclosure and securities registration. The issuers were required to file periodic reports on the financial conditions of the company; before selling its securities in a state, the company was required to provide a business plan and a copy of the securities offered for sale. The state had the right to ban the company from doing business in the state if it did not "promise a fair return on the stocks, bonds or other securities" (as cited in Macey & Miller, 1991, p. 361).

So, as a result, the first type of securities regulation that could have started the development of investor relations and financial communication in the United States, blue sky laws, were created as

> a means to thwart the schemes of a class of people who were denigrated repeatedly as fly-by-night operators, fraudulent promoters, robbers, cancers, vultures, swindlers, grafters, crooks, gold-brick men, fakirs, parasites, confidence men, bunco artists, get-rich-quick Wallingfords, and so on. Against this class of bad operators was counterpoised a class of victims, usually portrayed as innocent, weak minded, vacillating, foolish, or guileless, and usually cast in the roles of widows, orphans, farmers, little idiots or working people. (Macey & Miller, 1991, p. 389)

The legislation was needed not just for their protection, however. In fact, "if consumers could not discover accurate information about the quality of securities offered for sale, a loss of confidence in securities markets generally might result" (Macey & Miller, 1991, p. 394). The legislation was needed for the protection of the whole of society. "The functioning of capital markets in facilitating capital formation would be severely impaired, to the detriment of issuers, buyers, and the economy at large" (p. 390).