OnTarget Newsletter – May 2007

OTN gets a slight face lift this month for the start of its second full year in publication. We focus on hedge fund feeding frenzies, challenges in marketing European small- to mid-cap companies, and try to put ourselves in front of a few “Black Swans” while we’re at it.

OnTarget — Best Practices

The Black Swan Meets the IRO

Nassim Nicholas Taleb is one of the financial writers that provokes an immediate love-hate response from almost every reader. His *Fooled By Randomness* is one of the most-cited books in the financial industry (addressing as it does the potential for people to ascribe their own success to skill instead of luck, and to lock onto patterns that may be random in nature). Unfortunately, he has a writing style that is not exactly that of J.K. Rowling...

The title of his new book, *The Black Swan*, is based on the logical fault that "because I have never seen a black swan, and have only seen white swans, black swans do not exist." Used as a noun, Black Swans are unpredictable events that produce rapid change (think 9/11, Enron, Long-Term Capital Management, etc.) that, after the fact, we seem to believe *were* predictable.

In the book, Taleb introduces two concepts that are entirely relevant to the IR profession. Taleb calls the world in which nearly everything occurs according to the traditional predictable bell curve "Mediocristan." For example, measuring the height of a group of adults (which may range from 4 foot tall to 7 foot tall, with no outliers in the half-inch tall range or 12 foot tall range) or measuring the lifespan of a group of adults (in which no one will live to be 1000 years old) fall into this category. Contrast this with what he calls "Extremistan" – a world in which a few major events that occur outside the normal "bell curve" range dominate the results. Micro-cap stock returns fall into this category – it's tough to diversify yourself away from the possibility of losing 100% or gaining 10,000,000% on your individual investments. As an analyst, you're mentally biased to believe that you can predict everything that could go right or wrong (after all, you're sitting in an expensive chair and drive an expensive car, so your success can’t just be the result of chance, right?). For example, if you were at Amaranth Securities in July 2006, you might have believed an investment you were making fell into "Mediocristan," when in reality it sat solidly in the realm of "Extremistan."

The IRO walks into most investor meetings trying to place his company solidly within the realm of Taleb's "Mediocristan," where the company has predicted everything that could possibly happen in its upcoming guidance, and no surprises are in store in either direction. From the other side of the table, most financial analysts are thinking in terms of the company's performance in similar terms – the fact that they're even sitting at the table with you is proof that they've already discounted the possibility of a negative Black Swan in your company's near future. Your focus as an IRO will never be to cover the chance of a negative Black Swan (your company may have a business continuity plan in case of a major loss of equipment or employees – but if an analyst were concerned about this chance it's far less likely that you'd be speaking to them in the first place). In fact, spending too much of your presentation focusing on preparing for a negative Black Swan may be counterproductive.

Nevertheless, as Taleb says, leaving yourself open to the potential for positive "Black Swans" is one of the paths to business and financial success. While by definition, you'll never be able to predict the occurrence of a positive Black Swan, positioning yourself to take advantage of them if and when they occur can produce real value.

Unfortunately, investors in many sectors don't look with favor on the R&D line item you give in your financial statements. At its worst, it's money thrown down the drain, and since it's difficult to quantify the potential for a major breakthrough, analysts tend to discount it when reviewing a financial model. Biotech IROs know this better than anyone, as often the bottom of their product pipeline is completely ignored by investors looking only at their program that is closest to cash generation. Your R&D efforts, no matter what business you’re in, however, are usually the place where the positive Black Swan can happen, and it can take any number of forms – from a new method of inventory management using RFID, to a new chemical compound, to a new financial arbitrage tool, to name a few possibilities.

One of the themes of this publication is that challenges to investor communications are really just opportunities for an outstanding IR program to add value. Therefore, attacking investor perceptions of this type of line item can turn communications directly into value.

Even if your company has a very small new product development effort, don't ignore it in your communications process. Giving a Reg FD briefing to the head of your research group can pay off in spades – just putting a name and a face on your innovation opportunities can remind analysts of the possibility that you (and they) may benefit from a positive Black Swan. Obviously, you'll draw the line at any processes that are truly proprietary, and you'll want to display awareness of intellectual property protection (make sure your investors know that you'll own all the benefits of any positive Black Swans). Even better, with investment shops where analysts have a specific industry background instead of just a financial background, you'll gain instant credibility by showing a level of knowledge that your analyst base isn't used to.

To Taleb, the sharpest investors are those that expose themselves to as many potential positive Black Swans as possible, while avoiding the potential of negative Black Swans. Make your company look as if it's ahead of a positive Black Swan, and whether or not it truly happens, you'll gain value from it.

By Brian C. Matt, CFA

Brian C. Matt, CFA, is a vice president and head of CapitalBridge's institutional targeting group. He has previously written on pension accounting and XBRL in the June 2006 and November 2006 issues of OTN. He can be reached at brian.matt@cap-bridge.com.

OnTarget — Analytics

Money Follows Headlines – European Smaller Companies Ownership Trends

European large cap stocks have it easy. For many, global brand names obviate the need for preliminary introductions. As well, their presence in widely followed indices such as the MSCI Europe naturally leads to being included in investor screens and as benchmarks, making the task of setting up meetings on road shows much easier. In contrast, smaller companies must surmount these obstacles to appear on investor radar screens. According to MSCI, about $3 trillion in assets worldwide is benchmarked to various MSCI International Equity Indices. Although MSCI doesn't report a breakdown by individual market cap, sector or country indices, just a cursory glance at a range of European small- to mid-cap funds shows that benchmarks such as the MSCI Europe Small-Cap Index don't nearly have the following that, say, the Russell 2000 does in the U.S. In other words, being part of a widely followed smaller-cap index does not guarantee as much following as being part of indices comprising the larger companies of Europe. And, if you're not part of one of the major small-cap indices, your work is probably the hardest.

The problem is particularly acute when it comes to seeking capital from UK and US investors. While the two regions have a plethora of money invested in Europe, the competition for space on the radar screen comes not only from large-cap European companies (in European-focused portfolios) but also smaller US and UK stocks (in market-cap-oriented portfolios) that are more likely than not to get preference because of the comfort level the investor has with local companies.

According to CapitalBridge research, small-cap European companies have, on average, about 41% of their institutional shareholder base in the US and the UK, while the same measure for large-cap companies is 54%. The number for mid-cap companies falls in between these two. There is a wide variance when it comes to smaller European companies' success in attracting ownership from the US and the UK, however, with some smaller companies' regional ownership distribution resembling that of their larger counterparts on the Continent. The gap is likely to be wider because the basis for these numbers is our client base, and any small-cap company that is already active on the investor relations front is likely to have higher-than-average ownership in the US and UK than other small cap companies. We will come back to this at the end of this article.

To understand this better we examined sectors in the smaller companies' universe that have done well in attracting ownership from the US and UK in the past two years and the factors that might be driving their success.

Top Sector Ownership	Total UK + US Investments ($M)		Top Sector Inflows	Total UK + US Net Inflow 2005-2007 ($M)
Financial (Real Estate Mgmt & Dev)	220,825		Financial (Real Estate Mgmt & Dev)	115,213
Financial (Regional Banks)	192,825		Financial (Regional Banks)	98,962
Financial (Diversified Banks)	160,333		Industrial Machinery	51,895
Utilities (Electric)	142,425		Utilities (Electric)	42,180
Industrial Machinery	133,707		Healthcare (Pharmaceuticals)	41,088
Construction & Engineering	111,378		Metals & Mining (Steel)	33,213
Telecom (Integrated Services)	92,846		Marine	26,369
Healthcare (Pharmaceuticals)	90,383		Healthcare (Biotechnology)	24,906
Financial (Other Diversified Services)	85,004		Metals & Mining (Diversified)	24,861
Metals & Mining (Steel)	83,095		Oil & Gas (Refining, Marketing, Transport)	24,603

Apart from a few exceptions, the reasons for investing in the sectors listed in the tables above strongly match one or more of the following macroeconomic themes that have dominated headlines in the past few years: (1) the seemingly insatiable appetite for raw materials by China; (2) mergers and acquisitions activity; (3) energy prices; and (4) the global construction boom. The mergers and acquisitions theme has played out across sectors in Europe, positively affected by the loosening of rules and attitudes to cross-border mergers within the European Union, resulting in $1.6 trillion worth of transactions in 2006. The indices representing these sectors have outperformed broader benchmarks. For example, Bloomberg's Europe Metals and Mining Index and Construction and Engineering Indices climbed 131% and 95%, respectively, between January 2005 and March 2007. During the same period, the MSCI Europe rose just 46%.

If you belong to a sector directly benefiting from these factors, you have probably outperformed relevant regional indices and attracted more attention from investors in the US and UK; you may be able to position your company as part of a favorable macro trend to attract investment. Positioning yourself within your sector will set you apart, however. If you don't belong to a sector benefiting from these factors you probably face an uphill battle attracting investor attention. The important fact to remember here is that a well-managed company in a neutral or attractive market environment will always be attractive. The challenge is to get on the radar screen amidst competition from stocks from the "hot" sectors. This requires, among other actions, aggressively targeting appropriate investors in the US and UK. The money is there for the taking, and it's not as likely to come to you – you'll have to seek it out.

By Sudarshan Setlur

Sudarshan Setlur is a vice president and head of product development in the international market intelligence group at CapitalBridge. He has previously written on targeting dividend growth investors and European ownership distribution in the August 2006 and December 2006 issues of OTN. He can be reached at Sudarshan.setlur@cap-bridge.com.

OnTarget — Trends

Anatomy of a Hedge Fund Feeding Frenzy

In this age of activism, most companies, particularly small and mid caps, have become keenly aware of the level of hedge fund ownership in their stock. The fact is, however, that even if you currently have little or no hedge fund ownership, the emergence of one hedge fund, particularly an activist, can alter your company's ownership profile in short order. CapitalBridge reviewed 13D filings in more than 200 U.S.-listed companies during calendar year 2006 in an effort to gauge the impact of an activist presence on a company's ownership. For the companies in our data set, we compiled the level of hedge fund ownership prior to the 13D filing and the level of hedge fund ownership for up to four quarters following the 13D filing. The results are pretty clear in establishing that hedge fund ownership will increase, and in some cases increase significantly, following the emergence of an activist. Not only does the bandwagon-jumping happen immediately, but it has staying power. As you move two, three, and four quarters away from the original 13D filing, hedge fund ownership typically will continue to increase.

Average Hedge Fund Ownership Increase	One Quarter	Two Quarters	Three Quarters	Four Quarters
% of Shares Outstanding	+5.1%	+8.6%	+8.2%	+9.1%
% of Hedge Fund Ownership	+134.5%	+471.9%	+763.6%	+478.8%

There are a few lessons that an IRO can take from the data in the table. First, hedge fund managers do have friends. Unfortunately, these friends tend to be other hedge funds that support their pals by buying shares of companies where they have started agitating for change. In the first three months following a 13D, average hedge fund ownership in the companies we tracked more than doubled and continued to increase in rather dramatic fashion as we moved out two and three quarters. The presence of more hedge funds provides the activist holder with leverage: more shares looking for a rapid return equal more votes in the activist's pocket. Ownership is a zero-sum game. The shares that hedge funds are buying are coming from other investors, most likely your traditional institutional shareholder base. While an increase in hedge fund ownership following a 13D is inevitable, the more convinced your traditional money managers are of your company's long-term strategy, the more likely they will hold onto their shares and reduce the impact of activist sympathizers. This conviction, however, needs to be in place prior to an activist showing up. Once that 13D hits the wire it may be too late.

By Chris Taylor

Chris Taylor is Managing Director of CapitalBridge. He has written previously on European proxy voting challenges in the January and March 2007 issues of OnTarget Newsletter. He can be reached at chris.taylor@cap-bridge.com.

OnTarget — Firms

Target Firm: Shapiro Capital Management Company, Inc.

Targeting Profile
The firm is a niche player, with strong concentration in the small- to mid-cap value equity space; focusing on stable businesses generating free cash flow. While it's a bit out of the way to go to Atlanta for a top-tier non-deal road show, you may choose to package up a visit to the "Peach State" with other local players such as INVESCO, Trusco Capital, Atlanta Capital Management and Earnest Partners to fill up a good day of meetings in front of strong purchasing power. The firm has a focused portfolio, with a three-to-five year time horizon for holdings. Although the region is not typically associated with significant pools of capital, this investor frequently takes heavily weighted positions in a select group of companies.

How to Approach
The firm's management team is driven by three main principals, who remain entrenched in each aspect of the decision-making process. The screening process will look to dig deeply into its favorite sectors (currently Healthcare and Utilities) and uncover out-of-favor issues at attractive valuations. The firm has been rotating capital into Utility, Financial, and Industrial issues while reducing its exposure in Materials and Telecommunications companies. From a company perspective, management poured significant capital into Portland General Electric Co., Zale Corp., and Sierra Pacific Resources, Inc., while reducing its exposure to Mosaic Co.

Average equity holding period: 3 years

How Not to Approach
If you're heavily leveraged, you'll probably fall outside this investor's profile (only a 30% debt/capital average across the full portfolio); in this case, make sure to display your active balance sheet management outlook.

Largest Portfolios Managed
Primarily pension-related.

Investment Potential
Average holdings for the firm at each market cap range:
Giant-cap: ~$28mm
Large-cap: ~$18mm
Mid-cap: ~$58mm
Small-cap: ~$61mm

OnTarget — Funds

Target Fund: Janus Fund

Managing Firm:
Janus Capital Management – David Corkins (1-303-333-3863, david.corkins@janus.com)

Targeting Profile
If you are a larger well-established growth-oriented company headed to Denver, the Janus Fund is something you should consider. This traditional growth fund has been around for more than 35 years, and has exemplified Janus' research and stock-picking abilities. The fund's lower average PEG ratio shows the manager's focus on not overpaying for growth (as well as focusing on longer-established companies).

How to Approach
Corkins avoids loading up on individual stocks or sectors, and tries to seek a balance between risk and reward. Companies that have strong free cash flows and high returns on invested capital are characteristic of his stock-picking. Holdings in the information technology, financial, healthcare, consumer discretionary and industrials sectors made the largest contributions to performance during the quarter. Corkins has reduced the holdings in the portfolio from 120 to 90 to really know each holding well. He looks for strong management teams he feels comfortable with. In order to become a significant holding, you may need to invest a good amount of time in getting the fund acquainted with your strategy; but the hefty purchasing power makes it worth your while.

How Not to Approach
Value stocks in the utility and energy sector are generally out of favor. This fund relies a lot on the research analysts at Janus. Over 90% of the fund's stocks have a "buy" or "strong buy" current ratings within the Janus research group. Since restructuring of the fund in February 2006, David Corkins has set the fund up to be more dependent on growth companies and less reliant on industry bets. You won't need to "sell" your industry here once you get in the door.

Investment Potential
Average holdings for the firm at each market cap range:
Giant Cap: ~$167 mm
Large-Cap: ~$106 mm
Mid-Cap: ~$91 mm
Small-Cap: ~$48 mm

Average equity holding period: 2.6 years

OnTarget — Contacts

Recent notable contact moves:

Aled Smith (Global Head of Equities and Portfolio Manager) at M&G Investment Management Ltd. began managing the M&G Asian Fund in April 2007. He continues to manage the M&G Investment Funds OEIC – American Fund and M&G Investment Funds OEIC - Global Leaders Fund.

Robert Rowland (Portfolio Manager) at Fidelity Investments Japan Ltd. began managing the Fidelity Japan Fund in April 2007. He continues to manage the Fidelity Japan Blue Chip-, Fidelity 100 Mother-, and Fidelity Investment Funds - Japan Funds.

Nerea Heras-Mendaza (Portfolio Manager) joined SG Asset Management Ltd. in April 2007. She was formerly a portfolio manager and an equity analyst at AXA Investment Managers Paris.

Christopher Darling (Portfolio Manager) at Lloyd George Investment Management Ltd. began managing the Eaton Vance South Asia Fund in March 2007.

Teresa McRoberts (Portfolio Manager) joined Carlyle Blue Wave Partners in April 2007, covering the healthcare sector. She was formerly a senior portfolio manager at Tribeca Global Management.

Cara Goldenberg Castaldo (Portfolio Manager) joined Carlyle Blue Wave Partners in April 2007. She was formerly a senior analyst with Brahman Capital Corporation.

Adam Brenner (Senior Analyst) joined Glenhill Advisors, LLC in April 2007. He was formerly a senior analyst at Intrepid Capital Management, Inc.

Jean-Marie Eveillard (Vice President and Portfolio Manager) at Arnhold and S. Bleichroeder Advisers, LLC re-joined the firm in March 2007.

Jeremy Green (Founder and Portfolio Manager) founded Redmile Group LLC in April 2007. He was formerly a managing director and portfolio manager at Steeple Capital, LP.

Matt Robertson (Portfolio Manager), Ken Wren (Portfolio Manager) and Craig Harper (Portfolio Manager) joined SG Asset Management Ltd. in April 2007. Both Mr. Wren and Mr. Harper were formerly portfolio managers at Daiwa SB Investments Ltd.

To keep an eye on other major contact moves, subscribe to CapitalBridge's IRxtras monthly newsletter containing research updates on movements from contacts, firms, and funds. There is no charge for this newsletter. To subscribe, simply email IRxHelp@cap-bridge.com.

May is a busy month as conferences really picked up steam.

Conferences – May 2007

Mon	Tues	Wed	Thurs	Fri
	1 Lehman Brothers Retail Seminar – NYC Merrill Lynch Tech Gathering – NYC	**2** Jefferies & Co. 3rd Global Clean Technology Conference – NYC Goldman Sachs Alternative Energy Conference – NYC Deutsche Bank 32nd Annual Health Care Conference – Washington, DC Morgan Stanley Global Healthcare Unplugged Conference – Key Biscayne	**3**	**4**
7	**8** Bear Stearns Global Transportation Conference – NYC Goldman Sachs Consumer Products Symposium – NYC UBS Global Pharmaceuticals Conference – NYC Merrill Lynch Global Metals & Mining Conference – Dublin	**9** A.G. Edwards Leisure & Lodging Symposium – NYC Piper Jaffray Semiconductor & Communications Conference – NYC Merrill Lynch Global Industries Conference - London	**10** Goldman Sachs Power & Utilities Conference – NYC CSFB European Technology Conference – London	**11** Deutsche Bank Hospitality & Gaming Conference – NYC
14 Rodman & Renshaw Global Healthcare Conference – Monte Carlo, Monaco UBS Alternative Energy Conference – NYC UBS Global Financial Services Conference – NYC	**15** CSFB SC3: Semiconductor & Supply Chain Summit – NYC Morgan Stanley Communications Conference – Washington, DC Goldman Sachs Basic Materials Conference – MYC Deutsche Bank Technology Conference – San Francisco	**16** Bank of America Smid Cap Conference – Boston Wedbush Morgan 5th Annual Institutional Investor Conference – NYC	**17** Susquehanna International Group Global Opportunities Conference - NYC	**18**
21 JPMorgan 35th Annual Technology Conference – Boston UBS Global Oil & Gas Conference – Austin	**22** Morgan Keegan Homeland Security Conference – NYC Citigroup Healthcare Conference – NYC	**23** Goldman Sachs Internet Conference – Las Vegas	**24**	**25**
28	**29**	**30** Deutsche Bank Global Energy & Utilities Conference – Miami Bank of America Healthcare Conference – Las Vegas Cowen & Company 35th Annual Technology Conference – NYC Lehman Brothers Worldwide Wireless & Wireline Conference - NYC	**31**	

This calendar shows a sampling of investment community events held around the world during the month. Source: FactSet CallStreet, LLC

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