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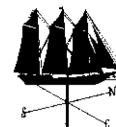

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Reading Between the Lines

*"Most businesses change in character and quality over the years,
sometimes for the better, perhaps more often for the worse.
The investor need not watch his companies' performance like a hawk;
but he should give it a good, hard look from time to time."*

Benjamin Graham, The Intelligent Investor

Early spring on Wall Street is known as "annual report season," when companies mail their reports to shareholders. Many investors become so overwhelmed by the numbers arriving each day that they start tossing them straight into the recycling bin. But as the financial crisis confirmed, investors, who are part-owners of their companies, are well-served by understanding what they own -- if only for the comfort of sleeping well at night.

The Securities and Exchange Commission first required companies to issue yearly statements on the condition of their businesses after the Stock Market Crash of 1929. Since then, reporting requirements have been steadily increased and refined, many times in the wake of another financial crisis or investment fraud. For example, the accounting scandals at Enron and Tyco in the late 1990s led to the Sarbanes-Oxley legislation which now requires top managers to personally certify the accuracy of their companies' financial statements.

Annual reports have also become easier to read and understand. More than a decade ago, the Securities and Exchange Commission began a "Plain English Initiative" in which both the private and public sectors were encouraged to write their disclosure documents and other communications in easily understandable, jargon-free language. The initiative has since become a requirement for many companies regulated by the SEC.

But even with these developments, many investors are often reluctant to read the materials they receive. One study by the SEC determined that many thought the reports were too complicated and hard to understand -- a finding not far off anyone's mark. As a firm, we have been reading annual reports for over thirty years and have developed a number of techniques for reading and analyzing them as efficiently as possible. In this Letter, we share our observations and thoughts on what investors should look for and how they can get the most out of their annual reports.

The information provided herein represents the opinions of David Wendell Associates and is not intended to be a forecast of future events, a guarantee of future results, nor investment advice.

First, some background information. Companies are required to report to their shareholders as well as to the SEC, but they do so by different means. Each year, they file a "Form 10-K"with the SEC -- a report in a standardized format that contains more information in greater detail than the annual report. Because the Form 10-K is written for government regulators, it is a dense document that usually requires careful reading.

In contrast, the annual report is addressed to the company's shareholders and is usually more readable than the Form 10-K. Some companies, however, attach a cover to their Form 10-K and send that out to their shareholders. On Wall Street, these types of annual reports are known as "10-K Wraps."

According to the SEC, the annual report should be a "state-of-the-company report, including an opening letter from the Chief Executive Officer, financial data, results of continuing operations, market segment information, new product plans, subsidiary activities, and research and development activities on future programs." Companies therefore have some leeway in how they present themselves as well as lots of opportunity for creativity.

Years ago, annual reports were usually prepared in-house, through a company's investor relations or public relations department. But with the growth of the advertising and marketing industries, as well as technological innovations in publishing, many companies have come to view their annual reports as more than just a statement on the condition of their business. Now, they are seen as marketing tools and are frequently outsourced to corporate communications firms. As one such firm explains:

> *"Smart companies, however, utilize the annual report as a marketing tool to attract potential shareholders, strategic partners and talent, as well as to influence opinion leaders . . . we help you move a targeted audience to action -- investors to buy or hold your stock, customers to purchase your products or services, employees to stay long-term or unite behind a common goal and communities to support your company or cause."*

A communications consultant advises:

> *"Whatever story a company has to tell for the year, from the reader's point of view, it's only as good as the way it's told. A near miss is still a miss. To get it right, each annual report demands a specific strategy: skillful planning, a strong creative direction, an authentic voice, fresh language and a story that's meaningful and motivating. Today's corporate "talking heads" should speak to the most burning issues in the minds of stakeholders. Design and content should be conceived in an integrated way, so the story comes across seamlessly and naturally."*

But the downside to targeting an audience with "meaningful and motivating stories," as well as with fresh language and splashy photographs, is that the document starts to look more like a marketing tool and less like a report that actually contains useful information. No wonder so many are treated as just another piece of advertising in the mail!

For this reason, we pay particular attention to the opening letter from the Chief Executive Officer or President. Many times, intentionally or not, the top executive's letter reveals more about a company, its management team and its prospects than other sections in the annual report. One of the first things we look for is some indication that the individual signing the letter actually wrote it.

Some companies outsource their Shareholders' Letter to communications firms, or to their own investor relations staff, or worse, to their legal department. Letters that are obviously outsourced tend to be filled with vague statements and trite generalities, or with legalistic "covering" language. They do not convey much about anything, and that in itself speaks volumes.

In contrast, a letter actually written by a top executive imparts a great deal of information through its tone and flavor. We look for candor and an honest discussion of the company's operations -- its achievements over the past year as well as its disappointments. We also try to develop a feel for management's attitude about the future of the company and its industry. We want to know what is on their mind and what they are going to do about it. Finally, we hope to see some spark of personality -- through a humorous reference, a strong stance or a heartfelt statement.

Some investors enjoy reading the Shareholders' Letters written by Warren Buffet of the diversified conglomerate Berkshire Hathaway. Since his first, written in 1977, many on Wall Street have come to consider Mr. Buffett's missives as "must reads" due to his frankness and clear language, and his insights and observations. Because his letters are widely read, they are fine examples of effectively communicating to investors.

In addition to reviewing Berkshire Hathaway's results each year, Mr. Buffett has also discussed such diverse topics as investment philosophy, portfolio management, corporate governance, diversification, selection of business managers, compensation policy, share repurchases, stock options, derivatives and mergers and acquisitions. His letters are not boring nor are they obvious marketing tools. Some wags have observed that a regular reading of Berkshire Hathaway's annual reports provides a better education for less money than an M.B.A. degree earned from a typical business school.

In his just-released 2012 Shareholders' Letter, Mr. Buffett immediately gets to the bad news. Berkshire's performance was "subpar" last year as its percentage increase in book value was less than the percentage gain in the Standard & Poor's 500 Index:

> *"Charlie and I believe the gain in Berkshire's intrinsic value will over time likely surpass the S&P returns by a small margin. We're confident of that because we have some outstanding businesses, a cadre of terrific operating managers and a shareholder-oriented culture. Our relative performance, however, is almost certain to be better when the market is down or flat. In years when the market is particularly strong, expect us to fall short."*

When reading a Letter to Shareholders, we also look for how well the top executive explains the company's business model. As some investors discovered during the financial crisis, many businesses in the banking, mortgage and financing industries were essentially operated as "black boxes." Competitors were beaten, revenues won, and earnings generated -- all in an opaque sort of way hardly communicated at all. When the crisis hit, many of these firms quickly collapsed.

A Chief Executive who can clearly describe how the company operates as well as how it gains market share and earns profits is usually a Chief Executive who is knowledgeable and capable, and has industry-specific experience. We are generally cautious around top managers who do not demonstrate in-depth knowledge about their company or their industry.

As a holding company conglomerate, Berkshire Hathaway is comprised of a number of different firms, many in the insurance industry and some in other industries. Berkshire does not pay a dividend but it does have its own investment portfolio, which holds many of the same high-quality companies we have recommended over the years. These include Coca-Cola, ConocoPhillips, IBM, Procter & Gamble and Wal-Mart, among others. As an aside, we recommend direct ownership of high-quality companies and thus direct participation in the growth of their earnings and dividends as opposed to owning them indirectly through a diversified holding company.

At any rate, the insurance industry can be complex and difficult to understand. Admirably, Mr. Buffet explains Berkshire's major insurance operations and its business model in very clear language, leaving no doubt he is knowledgeable about his business and industry:

> *"Property-casualty ("P/C") insurers receive premiums upfront and pay claims later. In extreme cases, such as those arising from certain workers' compensation accidents, payments can stretch over decades. This collect-now, pay-later model leaves us holding large sums -- money we call "float" -- that will eventually go to others. Meanwhile, we get to invest this float for Berkshire's benefit. Though individual policies and claims come and go, the amount of float we hold remains quite stable in relation to premium volume. Consequently, as our business grows, so does our float."*

While Berkshire Hathaway's annual reports technically qualify as "10-K Wraps," Mr. Buffett's in-depth and clearly written letters to his fellow owner-partners makes them superior to the average "Wrap." Berkshire's reports are famously devoid of colorful charts depicting rising metrics, nevertheless they effectively communicate the information that its owner-partners need to know.

Many of the companies we have recommended over the years also produce informative annual reports with well-written Letters to Shareholders. Benjamin Graham was Warren Buffett's mentor and we could not agree more with his advice: over the long haul, investors do themselves a great favor if, from time to time, they give their companies a good, hard look. We think the Letter to Shareholders is an excellent place to start.