



The Best Shareholder Letters Convey Important Insights

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The best shareholder letters should provide you, the investor, with good insight into the corporate culture of the company. Shareholder letters are optional and unregulated, which allows CEOs to personalize their letters. Unfortunately, the vast majority of shareholder letters do not give you any insight into the company or management's thinking. But the best letters share many similar characteristics, which I have highlighted below.

The best shareholder letters provide insight into a range of topics that are important to investors. Warren Buffett, the CEO of Berkshire Hathaway, often comes to mind when talking about excellent shareholder letters. But Buffett is just one of many CEOs who can paint a picture of corporate culture that gives great insight to investors.

Trust

The best shareholder letters instil confidence. They make you feel good about management accountability. The combination of share ownership, aligned compensation structures with long-term shareholder interests, focus on culture, clear business and leadership principles, all serve the purpose of building trust. The best CEOs talk openly about under performing investments and failing product successes. They seem almost proud to describe failures. The best letters are not written by the investor relations department, but by the CEO. They are personal. They do not try to cover up and hide challenges. They are honest and convey a message based on trust.

"One of the analysts who covers Constellation recently changed his perennial "sell" recommendation to a "buy". We lost one of our few critics. Analysts who worry about the quality of earnings and reversion to the mean and the impossibility of trees growing to the sky are valuable"

(CEO Mark Leonard, Constellation Software, Shareholder Letter 2017)

Culture

The best letters are able to provide deep insight into the culture of a company over many years. Over time, employees self-select themselves into or out of a culture. It's the same with investors. Companies get the kind of shareholders they deserve. A company that takes a long-term view and does not focus on quarterly numbers will attract investors who value those aspects. If the company spends a lot of time talking about short-term results and quarterly numbers, it will attract speculators. Long-term communication attracts long-term investors, which is a great competitive advantage.

Conservatism and frugality

The best shareholder letters convey a story of conservatism, but also of rationality and boldness. The best shareholder letters convey a frugal culture. The message sends a strong signal to the company about how it should best spend its hard-earned money. CEOs themselves lead by example and do not spend money on expensive hotels or plane tickets in front of the curtain. Employees adapt to the frugal mentality.

Ownership and compensation

The best shareholder letters are written by CEOs who act like owners. They treat the company as if it were their own. These companies often have a dual share structure where the original founders or CEO control the voting shares of the company. These companies are big fans of internal stock ownership among all employees and often supplement employee 401(k) plans with company stock. In cases where the company grants stock to employees, the vesting period lasts many years.

Long termism

The best shareholder letters provide a long-term vision. The CEOs who write these letters do not provide earnings forecasts and use the shareholder letter as the primary medium to convey information about the company. They usually do not have a large investor relations department - if any. Many of these CEOs aim for low turnover in the stock, which is a sign that many long-term shareholders are onboard. They use the letter to explain the strategy, and often take the time to explain the history of the company and how it got to where it is today. The best letters address the importance of long-term shareholders.



"Our approach to ownership is perpetual"
(CEO Per Waldemarson, Lifco annual report 2020)

Principles

The best shareholder letters contain ideas that relate to the business and management principles upon which the company is built. These principles serve both to build the company's culture and to manage investor expectations. Leadership principles are often about how people in the company treat each other, and they focus on processes rather than goals. These CEOs know what they are influencing. By making the culture process-oriented, they increase the chances of achieving their goals.

Succession planning

The best shareholder letters clearly set out the company's succession plan. Therefore, there are no surprises for employees or shareholders when the CEO decides to leave the company. Often, internal candidates are promoted to CEO, which greatly reduces the risk of changes in culture and strategy.

Capital allocation

The best shareholder letters emphasise the important aspect of capital allocation. The letters explain how the company will allocate its capital and what its priorities will be in terms of dividends, share buybacks, investments, acquisitions, and leverage. Some of the CEOs have very clear ideas about dividends and share buybacks. Most CEOs who write good shareholder letters are aware of the need to reinvest in the company with high returns on capital to create shareholder value.

Performance measurement

The best shareholder letters describe how shareholders should evaluate the company's performance. The best letters, contain different types of performance metrics, but the common thread is some type of economic value creation (EVA). The performance metrics that the CEO presents do not alter from year to year. The CEO does not cherry-pick the metrics based on what looks good in the current year. The best letters often explain and argue why the metric is used.

Accounting

The best shareholder letters frequently discuss accounting and the limitations of accounting in measuring true economic profit. They explain to investors the subjective nature of accounting and its drawbacks. These letters take time to explain to investors what they should look for in financial statements. They try to guide investors. For example, Larry Page and Sergey Brin wrote in their first letter on Google's IPO, *"We won't 'smooth' quarterly or annual results: If earnings figures are lumpy when they reach headquarters, they will be lumpy when they reach you."*

Sum up

The best shareholder letters stand out from others. These letters are based on trust and go to great lengths to attract the right shareholders. They have a long-term focus and often cover the same topics such as ownership, principles, capital allocation, and how best to value the company. When you invest in companies that are able to clearly articulate the fundamentals of their corporate culture, you increase your chances of excellent long-term returns. At REQ Capital, we call it Investing With Insight.