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Can company-fund manager meetings convey informational benefits? Exploring the rationalisation of equity investment decision making by UK fund managers

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A B S T R A C T

Conventional economic theory, applied to information released by listed companies, equates 'useful' with 'price-sensitive'. Stock exchange rules accordingly prohibit the selective, private communication of price-sensitive information. Yet, even in the absence of such communication, UK equity fund managers routinely meet privately with the senior executives of the companies in which they invest. Moreover, they consider these brief, formal and formulaic meetings to be their most important sources of investment information. In this paper we ask how that can be. Drawing on interview and observation data with fund managers and CFOs, we find evidence for three, non-mutually exclusive explanations: that the characterisation of information in conventional economic theory is too restricted, that fund managers fail to act with the rationality that conventional economic theory assumes, and/or that the primary value of the meetings for fund managers is not related to their investment decision making but to the claims of superior knowledge made to clients in marketing their active fund management expertise. Our findings suggest a disconnect between economic theory and economic policy based on that theory, as well as a corresponding limitation in research studies that test information-usefulness by assuming it to be synonymous with price-sensitivity. We draw implications for further research into the role of tacit knowledge in equity investment decision-making, and also into the effects of the principal–agent relationship between fund managers and their clients.

Introduction

Fund managers are the primary investment decision makers in the stock market and so play a central role in the allocation of economic resources. In making their investment decisions they rely heavily on published information, aspects of which may be clarified by a company's investor relations team. In the UK (and in somewhat different forms in other markets) they also meet regularly, in private, with senior executives of the companies in which they invest (Reuters, 2011). Market regulation prohibits the disclosure of price-sensitive information in these private meetings (FSA, 1996). Yet conventional economic theory suggests that information is not useful to investors if it is not price-sensitive (Fama, 1970; Kothari, 2001). Accordingly, at least when viewed through the lens of conventional economic theory, it is difficult to understand what information such meetings provide which might help fund managers in their investment decisions. Yet, in the prior research that we review below (and that our own research supports), these meetings are perceived by fund managers not only as important but as the *primary source* of information to inform their

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investment decisions (Barker, 1998; Holland, 1998; Lok, 2010; Reuters, 2011). What is happening here?

This apparent paradox is economically important. Conventional economic theory appears to suggest that the considerable investment of time by senior company managers and fund managers in meeting one another does not yield any return. More fundamentally, the importance ascribed to such meetings invites us to refine our understanding of the rationality and effectiveness of capital resource allocation decisions on stock markets.

In what follows, drawing upon interviews with fund managers and CFOs, supported by direct observations of the meetings between them, we explore three possible, and non-mutually-exclusive, (theoretical) explanations for the apparent paradox.

The first possibility is that, by constraining 'useful' to mean 'price-sensitive', conventional (neoclassical) economic theory is too narrow with respect to useful information. Our research points to two reasons to conceptualise useful information more broadly. The first concerns the tacit nature of much knowledge, and the associated need for rich face to face interaction through which information can be effectively communicated and interpreted. The second concerns the narrow practical scope of the concept of price-sensitive information, which fails to take account of uncertainty and the related value of subjective evaluations of management capability. The implication here is that the actual investment decision making process of fund managers differs from that assumed by neoclassical theory. Our qualitative research suggests that both fund managers and CFOs distinguish between short-term corporate performance horizons of about 2 years, where quantitative forecasts are relatively firm, information is tightly controlled, and the scope for anticipating market movements is very limited, and longer term horizons, where performance will depend on management decisions that have yet to be taken, in response to situations as yet unknown, in respect of which information is not formally price-sensitive. For fund managers, privileged access to corporate management allows them to judge whether company performance over this longer period is likely to differ from current market expectations.

The second possibility is that the apparent paradox arises because fund managers place an excessive confidence and importance in the information gleaned from company meetings; the paradox arises here from a failure of fund managers to act with the rationality that economic theory assumes. Notwithstanding the arguments above for the usefulness of non-price-sensitive information, and thereby the possible credibility of fund managers' claims to derive informational value, an obvious question is whether the short, infrequent, formal and (typically) formulaic meetings we observed can in fact provide a rational basis for such (necessarily subjective) judgements of management capability. It was clear from our interviews that fund managers think, or at least hope, they can. Yet we suggest several reasons to question whether the fund managers actually are able to adopt the trading strategies they describe, and whether the access to senior managers provided by the meetings can in fact give them the competitive advantage they claim.

Finally, the third possible explanation is that the primary value of the meetings for fund managers is not related directly to their investment decision making but rather to the claims of superior knowledge that they can make to clients in marketing their active fund management expertise. We argue that while it is difficult in practice to distinguish between subconscious, irrational bias, and conscious, rational misrepresentation, prima facie there is an agency problem in the fund manager–client relationship. Active fund managers' claims to be able to beat the index on the basis of their superior knowledge allow them to charge clients, such as the trustees of pension and endowment funds, a premium over passive index-based fund management.

The paper contributes to the literature in the following ways. First, we challenge the assumption, held in conventional economic theory and common in market-based accounting research, that 'useful' and 'price-sensitive' are synonymous. Our findings suggest that 'useful' is a broader concept, the understanding of which requires a greater focus on the role of tacit knowledge in investment decision making, especially with respect to relatively uncertain information relating to periods beyond the short term. Second, our evidence concerns not just the actual and perceived usefulness of information from company meetings, but also the claims made by fund managers to their clients with respect to this usefulness. We therefore also identify a potentially important principal–agent problem. Overall, these contributions to the literature can be summarised as follows. Conventional economic theory does not support the existence of the meetings that are the focus of this paper. The importance of the meetings therefore suggests, in a classical hypothetico-deductive sense, that the theory must be rejected in this context. In its place, we offer three alternative theories. We find evidence in support of each, and none is rejected. We therefore propose further research to test the validity and implications of these theories.

Our paper also has a potentially important policy implication, relating to the selective disclosure of information that is useful but not price-sensitive. This concerns a possible trade-off that would result from a greater restriction on the selective disclosure of information, for example in the form of a prohibition of private meetings between companies and fund managers. This trade-off would be between, on the one hand, greater equity from the restriction of privileged access to information and, on the other hand, lower efficiency from constraining the flow of information and, as a result, compromising the stock market's allocation of economic resource. Further insight into this policy implication would result from more evidence relating to each of the three theoretical possibilities identified and explored in our paper: specifically, the questions of whether the informational benefits of company meetings are genuine, falsely perceived, or misleadingly claimed. The market efficiency argument rests upon evidence in support of the first of these three possibilities, and it would lose force in the face of evidence supporting the second or third.

The paper is structured as follows. The next section comprises an exposition of the theoretical foundations of the paper. This is followed by a review of prior research