

CHAIRMAN'S CORNER

by James A. Kaplan



Risky Investments Take Off - Will We Ever Learn?

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The Wall Street Journal published an article on June 5 titled "Wall Street's Clearance Sale Leaves Few Bargains."

The first sentence of the article caught my immediate attention: "It's the Great Garbage Market all over again."

The article went on to point out that ever since the market struck bottom on March 9, the "cruddiest" stocks have rebounded. "In fact, according to Strategic Research Partners, stocks in the S&P 500 with positive earnings have underperformed those with losses (or no profits) by a 24% margin." The fixed income markets have followed the same pattern, with junk bond prices rising much faster than investment-grade securities.

Of course, the market can always find an explanation (or, rather, rationalization) for these events. One can argue that risk premiums for "cruddy" stocks were far too high, particularly when viewed with the expectation that economic conditions may be improving.

At Audit Integrity, we do not characterize stocks according to whether they earn or do not earn profits. We look beyond the numbers, using them as a basis to measure corporate integrity and transparency. Low-quality management and lack of transparency define the "cruddy" (or "Very Aggressive") companies in our AGR risk ranking.

But it also turns out that during the last three months, the companies Audit Integrity has identified as "crud" have also underperformed the market as a whole. Again, rationalizations can be found (risk premium, economic conditions...) but these really beg the question.

How can we know when a stock is too risky?

"If only I'd known they were fraudulent, I would have avoided the stock." This statement, which encouraged the very founding of Audit Integrity, was made by the manager of one of the nation's largest pension plans after the collapse of Enron.

The problem of management malfeasance or fraud is not a cyclical issue to be ignored when returns are positive. The lack of integrity has an impact on stakeholders through good times and bad times, resulting in persistent lower returns, increased litigation, and bankruptcy.

Such adverse outcomes have been backtested across a period of many years, and have been continuously tested in real time since 2002 when Audit Integrity was founded. Unfortunately, many stakeholders will again learn the hard way. Ignoring these very real probabilities of negative events associated with poor governance and accounting, is far more expensive than the costs of incorporating them in financial decisions.

Most recently, on June 4 the SEC filed a civil securities fraud complaint against Angelo Mozilo, former CEO of Countrywide Financial Corp., alleging that he and his fellow executives misled investors by hiding the company's deteriorating financial condition. In evidence are "dire assessments" issued internally about "the most dangerous product in existence" (the subprime mortgages) and arrangements made by Mr. Mozilo to exercise stock options which he sold for over \$139 million.

During the period in question (beginning in the third quarter of 2006), Audit Integrity ranked Countrywide as "Very Aggressive," with AGR scores as low as 3 on our scale of 100.

In an uncertain world, absolute accuracy is unachievable. However, statistical models are highly predictive of malfeasance, and the cost of ignoring them is far too high. "If only I'd known" is no longer a valid excuse. Now the lament is, "If only I'd paid attention."

Below is a list of companies to be avoided. Their poor governance and opaque accounting represent a high level of risk for stakeholders, and the odds are they will hit the skids.

How high are the odds?

In 2008, Audit Integrity WatchList companies returned -48.2% compared with -28.8% for all companies with market cap greater than \$50 million.

In the first five months of 2009, Audit Integrity WatchList companies returned 1.2% versus 9.3% for the market.

If only we'd paid attention.

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