SIGMA INVESTMENT COUNSELORS

Sigma Summaries

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Coke – The Real Thing?

On December 13, 2002, the Coca-Cola Company hosted a meeting for analysts and investors to provide an update on the progress of the operating fundamentals of the company. Buried near the end of a press release issued that day by Coca-Cola covering this meeting was a seemingly innocuous statement articulating a change in policy regarding the provision of "earnings guidance" to analysts.

Future Earnings Guidance
The Company has made a policy change with regard to providing future earnings guidance. In the future, the Company will no longer provide any quarterly or annual earnings per share guidance. Further, the Company will not update its outlook for full year earnings per share expectations for 2003 as the year progresses. In the future, the Company will continue to provide investors with perspective on its value drivers, its strategic initiatives and those factors critical to understanding its business and operating environment.

"Following a series of discussions with our Board of Directors over the past year, our management team has established a policy of not providing quarterly or annual earnings guidance," commented Mr. Daft. "We believe that establishing short-term guidance prevents a more meaningful focus on the strategic initiatives that a Company is taking to build its business and succeed over the long-run."

"We are quite comfortable measuring our progress as we achieve it, instead of focusing on the establishment and attainment of public forecasts. Our shareowners are best served by this because we should not run our business based on short-term 'expectations'. We are managing this business for the long-term."

Interestingly, this release took place on a Friday and there was scant mention of it in the press until the Wall Street Journal covered the issue at length the following Tuesday with an article titled, <u>A Guide to Going Without Guidance</u>. The catchy byline, "Will Coca-Cola's move to abandon earnings guidance leave investors thirsting for the real thing?" began a maelstrom of criticism amongst the investment community. The debate has raged ever since, as to whether companies have a responsibility to investors to tell them what they think the company will earn for the next quarter and subsequent near term quarters.

We think that the debate is baseless. The real question is whether the earnings guidance provided by companies in the past truly was helpful to investors in understanding the drivers of long-term value, those necessary prerequisites to a successful long term investment. We are not being cavalier, but are questioning how proficient one can expect the executives of a company to be at what essentially amounts to predicting the unpredictable.

Consider this, for example. Several months ago we met with the retired president of a division of a Fortune 500 company who was seeking investment counsel. Prior to getting around to discussing this former executive's career, we noted a substantial investment in a company whose price, we noted, had plummeted. As we traced the circumstances surrounding the acquisition of the shares, the executive let on that he had purchased the stock at the urging of the CEO of the parent company, who was certain that the shares were bound to rise, and rise substantially. Our client made a natural assumption – the CEO was in a better position than anyone to judge the relative value of the company and assert a direction for the share price. As history unfolded, that CEO proved no more adept at divining the future than anyone else willing to venture a guess.

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We do agree with the senior management of Coke, that when conducting an evaluation the analyst must focus on the company's *value drivers, its strategic initiatives and those factors critical to understanding its business and operating environment.* Investing is fraught with uncertainties, and any attempt to delude oneself into thinking otherwise, is folly. But this is what many companies were attempting to do. It would follow that if a company could decipher its near term earnings beforehand, and could ascertain the value of those future cash flows, why, certainly, they could predict the stock price. The frequent failure in this exercise is what leads to the frequent incidence that a stock price lost (fill in your number) percent of its value due to disappointing earnings.

The preoccupation with near term earnings, and earning guidance, has actually proven devastating for numerous companies and their shareholders these past few years. The most recent is HealthSouth, an Alabama firm facing insolvency because of fraud – manipulating earnings ostensibly to achieve what management was predicting. Worldcom suffered a similar fate. Ditto for Enron. Offering earnings guidance simply puts too many companies into a position where they *may* feel compelled to employ any measure, including fraud, to ensure that the company earned what management predicted. More important, perhaps, is that this preoccupation diverts the attention of management away from the task for which shareholders are paying them – the task of actually "running" the corporation, effecting decisions and executing to impact things that the company can control. We are encouraged that several other companies have taken the lead of Coca-Cola and are refocusing on the traditional primary task of management – managing and leaving near term earnings predictions to securities analysts!

To state the obvious, the last three years have been incredibly painful. As we review the portfolios of our clients that have been investing with us for a long time, we find a common trait amongst those holdings, which have proven to be true success stories: management has focused on operating the business with a decidedly profound lack of gimmickry. To highlight a few, they include Automatic Data Processing, General Electric, Sysco Foods, Amgen, Merck, American International Group and Microsoft.

Led by our Chief Investment Officer, Roger Steed, we securities analysts at Sigma Investment Counselors relish the challenge of employing our critical thinking skills and techniques in understanding interesting and unfolding common stock opportunities. Successfully discharged, we will be able to *approximately* forecast a company's potential earnings and cash flows and, ultimately, the intrinsic value of the entity. We prefer to see the management of the companies we follow focus their efforts on execution of their business plan, as opposed to providing earnings guidance. In this regard, Coke is it!

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.