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Book Review Investor Response to Management Decisions: A Research Based Analysis of Actions and Effects. By Richard M. Altman

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Investor Response to Management Decisions: A Research Based Analysis of Actions and Effects.

BY RICHARD M. ALTMAN, Quorum Books, 1992.

Reviewed by August D. Smith*

In simple terms, when a person purchases the common stock of a publicly held company, that person becomes an owner or investor in the company. For decades, security analysts have struggled with the question of how the owner-investors of the company perceive value, in terms of the price of the company's stock.

Share prices can be explained in both fundamental, technical, and emotional terms. Fundamental analysts claim that share value can be ascertained from the information present in the balance sheet of a business. Correspondingly, if price-earnings ratios, book values, and so forth are compared between companies within the same or similar industrial sectors, such as capital goods manufacturers or semiconductors, their relative share values can be determined. Technical analysts, on the other hand, are chart-driven momentum calculators. Complete with their sets of comparison models, share values take shape over a series of cup and handle, head and shoulder patterns, or both. The emotional aspect of the capital market, manifested in the investor response to the kaleidoscope of corporate announcements, press releases and co-investor enthusiasm, has historically been viewed as a largely non-quantifiable concept. Born of a need to participate, it represents the random response to investor anticipation.

Investor Response to Management Decisions attempts to derive methods of quantifying investor anticipation. Although Mr. Altman adroitly weaves the fundamental and technical concepts of security valuation throughout his text, his central theme postulates that investor response is a measurable concept reflected in stock price volatility. Mr. Altman argues that investors do not generally make irrational decisions based on short sighted demand for profit in the near term, nor are their decisions the by-products associated with media coverage. Rather, investor response to management decisions should be viewed by management as an intelligent, well thought out signal which reflects, through the price of a particular stock, the totality of investor perceptions of the future cash generating implications of current company financing and operating data.

Investor anticipation of future cash flow bridges the gap between those who release information, that is, managers, and those who process it, that is, investors. It takes into account both the cost of capital or risk, alternative investments or growth, and the duration of time. While management may be motivated to act in its best interests by maximizing its control of resources and compensation, it is constrained by the restrictions of the information available to the market. The free flow of information will not allow management to minimize their exposure to outside judgement. As a result, investor response serves as a monitoring device and achieves a balance of power over such internal decisions as dividend policy, share repurchases, compensation programs, and the use of debt. To Mr. Altman, the correlation is clear. When management speaks, investors listen, evaluate, and respond.

Mr. Altman states that management, in turn, must respond efficiently respond to the actions of the investing public. He asserts that many managers make a critical mistake when they look at the price of their firm's stock, assume it is too low, and want only to know why

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it is not higher. In order to be effective, as well as efficient, Mr. Altman suggests that managers should instead assume that their company's stock is fairly valued and then analyze why. In this way they may be better able to influence stock value through their own decision making process.

Also central to Mr. Altman's thesis is his reliance on an "efficient market hypothesis," that is, that security prices reflect all publicly available information at all times. Mr. Altman contends that not only are the capital markets efficient, but that management must believe that they are. However, due to the well recognized practices, abuses, and other events of the 1980's, such as insider trading, merger mania, the crash of 1987, computer activated trading, junk bonds, and so forth, this concept may be highly debatable. Aside from the questions that may arise from relying on such an hypothesis regarding market efficiency, Mr. Altman does go to great lengths to substantiate his theories with full and well documented research.

Investor Response to Management Decisions is a thorough, detailed, and sophisticated analysis, and as such, its 375 pages may not qualify as easy reading. Each chapter contains data that span many years and numerous companies and that encompass hundreds of event studies. The result represents an enormous body of knowledge about capital markets, stock price behavior, and market efficiency that is normally buried in the annals of assorted financial journals.

While many books have been written addressing the fundamental and technical aspects of security valuation, few have attempted to quantify the elusive emotional element represented by investor response. Richard Altman has done so with both professional expertise and sophisticated financial theory. This book will be best suited to the interests of those actively involved in capital market analysis, investment analysis, mutual fund management, and high level management of publicly traded companies, among others. If readers are patient and follow Mr. Altman's reasoning from start to finish, they will be well rewarded.