

INFORMED

PROMOTING EXCELLENCE IN INVESTOR RELATIONS

ISSUE 104 AUTUMN 2019

IR FOR SMALL CAPS

a special feature on opportunities
and challenges – and a new
growth-focused IR programme



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excellence in investor relations*



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CHAIR'S LETTER

Every day is a school day!



I hope you all had an enjoyable summer and managed to get away for a break and to recharge the batteries. For me, part of recharging is learning new stuff, particularly when it comes to IR – every day is a school day.

The evolving strategic narrative

We all know that the way our industry operates is changing rapidly around us. We are evolving new ways of working, adjusting to the breakdown of old interactions and the emergence of new. Dark pools, automated trading and passive investment are becoming the dominant operational standard. But the rise of passive is spawning the rise of activism.

A young girl, by taking direct action, is creating a groundswell of change. Greta Thunberg is leading her generation into shaming ours to take action to stop damaging our environment. The industry association representing the masters of capitalism in the US, the Business Roundtable, has now said that a company must have a greater purpose than just profit.

A company's strategic narrative has to encompass an ever-expanding range of issues, from how a company operates, what its strategy is for a sustainable business (and everything that entails from people to assets to governance) and how it is fiscally responsible. This has to resonate across all stakeholders and therefore the strategic narrative is the heart of all communications from a company. As one of only a handful of roles in a company that can take the 30,000ft view as well as dig in the detail of a business, responsibility for this narrative sits front and centre with investor relations. This demonstrates further to me why investor relations is a key lieutenant for any CEO and deserves a seat on a company's executive committee.

Focus on small caps

The recent FCA review of MiFID II stated that it had found no evidence of material reduction in overall research coverage, including in listed small and medium sized enterprises. Probably not an unsurprising conclusion at this stage, given that the widely adopted model was a single payment for waterfront coverage. The review also states that buy-side firms are indeed paying less for research and anecdotal evidence suggests that this spend is becoming even more targeted. However, smaller companies typically need more research coverage and with the chess pieces still moving on the board the trends are directionally unhelpful.

For small-cap companies getting your narrative right and getting your story understood by the capital markets is therefore increasingly important. Not just in what they say, but in how and through what assets they do so. In this issue we explore how smaller companies can make the most of their listing and be winners in the competition for capital. At the Society we continue to develop products and services aimed specifically at smaller companies given their approach to, and interaction with, markets is very different from that of larger companies.

Continuous professional development

As our industry professionalises further and further, your Society is here to help and in this issue we discuss professional development. We are delivering a comprehensive overhaul of the Certificate in IR education programme to bring it up to date with the dynamics of our industry. We have another cohort of

Replacing the judges? Using AI to measure annual report quality

A number of linguistic differences can be found in award-winning reports. **Steven Young, Dr Jacqui Munro and Dr Paulo Alves** explain what these are, and why human judges are still important when it comes to reporting.

Corporate reporting quality is a slippery concept that's hard to measure objectively despite the array of recommendations and guidelines on how to write the ideal annual report. Companies are different and management teams have distinct stories to tell. An effective and informative report is like a good book: we know it when we read it but the 'formula' for success is not so clear, otherwise we'd all be bestselling authors. Beauty is often in the eye of the beholder and a reporting-by-numbers approach to investor communication is unlikely to deliver the wow factor. Or is it?

Ongoing research at Lancaster University Management School is seeking to identify the framework for annual report quality using artificial intelligence (AI) methods. Our question is simple: can we identify systematic patterns in the way high-quality annual reports are written and presented, and then combine these features in an algorithm to determine reporting quality?

Although our analysis is still at a preliminary stage, initial results are encouraging. We are able to pinpoint a suite of linguistic features linked to content and writing style that have significant predictive power. High quality reports appear to share common characteristics even though the look and feel of individual documents might seem very different on first inspection. Results suggest that a formula for good reporting may exist after all.

ABOUT THE AUTHORS

Steven Young is professor of accounting at Lancaster University Management School and director of the International Centre for Research in Accounting.

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‘ High-quality reports appear to share common characteristics even though the look and feel of individual documents might seem very different on first inspection ’

Our analysis is based on a sample of annual reports shortlisted for an award by one of the following six organisations: PwC, Investor Relations Society, ICSA Hermes, Communicate Magazine, Accountancy Age, and Report Watch. We match each shortlisted report with a non-shortlisted report issued in the same year by a company from the same sector with comparable financial and governance characteristics. We extract the text from each shortlisted and non-shortlisted report pair and then use machine learning algorithms to detect features of the text that discriminate between the two groups.

Winning reports

Our best model classifies 84% of our sample of shortlisted and non-shortlisted reports into their correct categories. Features that systematically distinguish award-winning reports from their non-winning matched counterparts include more discussion of strategy and more forward-looking content. We also find greater use of pronouns ('we', 'our')

AI JUDGES

- Certain linguistic features are more often found in award-winning reports.
- A greater use of pronouns and an accessible writing style is linked to higher-quality reports.
- Storytelling is an art as well as a science, so AI will not replace human judges any time soon!

among winners, consistent with management taking ownership of strategy and performance.

Winning reports also adopt a more accessible writing style; they include more cross-referencing to infographics and greater connectivity between sections, and fewer grammatical words such as articles ('a', 'the', 'it'), conjunctions ('and', 'but'), and negation. Language experts link these features to lower accessibility because they increase cognitive processing time and abstractness.

When we use these features to forecast winners in subsequent years we find that our model has significant predictive ability. Collectively, our analysis suggests that a set of basic principles underpin high-quality annual reporting. The lesson seems to be that while businesses, strategies and management teams vary dramatically, the foundations of effective (written) investor communication are uniform and clear.

Does this mean that our analysis marks the end of the road for expert human assessment of annual reporting quality? We think not. Effective corporate communication ultimately boils down to good story-telling, which involves 'art' as well as 'science'. While AI methods have the potential to measure the science of effective communication, the art of good story-telling is more a matter of personal taste. ■