A MANAGERIAL STRATEGY TO REDUCE INVESTOR UNCERTAINTY AND INCREASE SHARE PRICE

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INTRODUCTION

Maximizing the firm's share value is a common managerial objective. We accept that objective as the appropriate goal for management, because share price encompasses the many factors of primary concern to management: earnings per share, riskiness of various investment alternatives, timing of investment returns, dividend policy, and many others. The right decisions with respect to such an array of factors yield actions that increase share value. Knowledge and sensitivity to the guidance offered is important to all functional areas of management.

The purpose of this paper is to stress the importance of a simple decision rule regarding investor uncertainty. Actions consistent with the rule will enhance management's efforts to achieve the firm's goal, maximization of share price. With that in mind, we outline steps for implementation of the decision rule. The paper is organized as follows. Part one reviews some general concepts regarding firm valuation, which serve as a background for the decision rule. Part two sketches the role that uncertainty plays in the determination of share price and discusses the causes of investors' perceived uncertainty. This background leads in part three to the decision rule and the specific steps that managers can follow to increase share price. The paper closes with a summary.

I. BACKGROUND

It is important to recall that share valuation takes place in the market place — the world external to the firm. The market is the true test of the firm's decisions and actions regarding earnings, investments, financing, dividend policy, and other factors affecting share price. It is market participants who determine the market price of the firm's stock. Although management may believe the firm's stock is over or under valued, share price will change only if investors change their expectations.

Managements actions are only one of the many factors influencing market

participants' perceptions of the firm. To increase share price, managers must influence investors' expectations concerning the firm. Since investors are quite astute, creating positive expectations in their minds requires that management make the right decisions with respect to many dimensions of investor interest. Those decisions can be categorized in four basic areas. First, the investment decisions must have expected outcomes that are favorable relative to attractive opportunities available to investors elsewhere. Second, management should seek to finance the firm in the optional way in order to lower the cost of financial resources. The clue to the right way to finance comes from the external parties who provide the financial resources. Third, they must formulate and institute the appropriate dividend policy. Finally, they should consider the firm's role in relation to social responsibilities, ethics, and other such items. Correct decisions and diligent attention by managers to these four basic areas will have a positive impact on share price and variables such as earnings per share, return on investment, and other measures of firm performance.

But there is one more essential ingredient if management's efforts are to be rewarded with an increase in share price. Managers must provide information to the marketplace so their actions can be appropriately evaluated. Certainly management must strive to make and take correct decisions and actions to have favorable impact on firm performance. But it is **equally** important that investors have the **information** necessary to **form** the right perceptions. Management thus must not only **do** the right thing but also **communicate** with the marketplace so investors can value the actions.

Needless to say, it is difficult always to recognize and reach the optimal objectives. Yet the rule offered later in this paper will yield benefits even when outcomes are less than desirable. Regardless of the investment, financing, and dividend decisions that have been and will be made in the future, applying the rule will normally lead to an increase in share value even given poor decisions and actions. At worst, it will leave the value of the shares unchanged.

Share price is influenced — other things being equal — by the after tax package of benefits that investors expect to receive by holding the shares. Another determining factor, which will now be explored, is the perceived uncertainty associated with those benefits.

II. UNCERTAINTY

In forming expectations and assessing uncertainty, investors want **access** to all relevant information and the proper **interpretation** of that information. To a certain extent, management can control both access and interpretation.

Access

First, investors want to obtain the information they need to make sound investment decisions, and they want it at the same time it is available to

other market participants. This is true first because investors like to believe they are making informed decisions and, second, because the market has proven itself "efficient" in quickly reflecting available market price information. Consequently, those that receive information first can benefit from that information, regardless of whether it is "good" or "bad".

An individual investor certainly does not mind always being the first to receive information, but he does not like others to receive the information first — especially if it is bad news that negatively affects the value of the security he owns. In that case getting the information first might have made it possible to avoid a loss. The situation is different, however, if the investor does not own the security affected by the information. It is then only a matter of missing the opportunity to purchase on good news or sell short on bad news.

Certain realities suggest that information may not reach each investor at the same time. For example, some investors can spend all day in a brokerage firm office accessing the wire service and other news sources. Other investors might have accounts which are large enough that their brokers constantly monitor the information that affects the securities in which they are interested. Most investors, however, must rely on the evening news or the next day's paper for the same information. The literature is replete with studies which suggest that by the time information appears in the media available to the majority of investors, that information has already been captured in the price of the securities (e.g., 2, 3, 4). Any real world imperfections that keep investors from getting the same information at the same time add to the uncertainty perceived by investors. Similarly, if people **perceive** themselves to be at an informational disadvantage, their uncertainty increases even if they are not at an **actual** disadvantage. The increased uncertainty results in a lower price for the firm's shares, since other things equal, the more uncertain a benefit, the less the value.

Interpretation

A second source of information uncertainty involves the interpretation of available information. For various reasons investors may not properly evaluate and utilize information useful in forming/revising expectations. If, for example, the firm historically has issued erroneous "information", investors may hesitate to have confidence in that firm's current and future information offerings. Lack of credibility increases uncertainty and, correspondingly, decreases share price.

In addition, the **form** that available information is in can increase the chance of investor misinterpretation. And, any confusion that accompanies this misinterpretition can diverge investors' opinions. A lack of market consensus in itself can increase uncertainty as perceived by investors. It will also probably increase variability in the firm's stock price; when divergence of opinion is great, price **might** momentarily reflect over or under reaction by investors to the information.

In summary, although many factors undoubtedly affect investors' perceived uncertainty, we focus on how investors perceive information accessibility. Remember that **perceptions,** not necessarily reality, affect investor behavior. Second, we are interested in uncertainty caused by potential misinterpretation of information. Generally, managers can control firm-related information, and they can take measures to reduce uncertainty from this information.

III. DECISION RULE

Given the expected package of benefits associated with a firm's stock — dividends and appreciation in share value — reducing investors' perceived uncertainty will increase share value, assuming investors prefer less uncertainty to more uncertainty, other things being equal. Thus, even if management has already made decisions and taken actions that affect the package of expected benefits, any steps that reduce uncertainty will increase share value. This leads to the decision rule.

RULE: DO THOSE THINGS THAT DECREASE INFORMATION UNCERTAINTY AS PERCEIVED BY INVESTORS.

Management can take specific steps to promote equal access to information and to reduce investors' perceived uncertainty about information. These actions should increase share value. So as not to confuse the effects of other variables, assume management has made the investment and financing decision. The following actions should increase investors' confidence in information accessibility and interpretation.

Management should 1) develop a policy regarding the release of information about the firm, 2) consistently follow this policy and 3) make known to investors the information-release policy they have adopted. The policy should limit the opportunity for certain individuals to trade on released information, i.e., the information should be made available to all investors simultaneously. The firm should insure (and assure investors) that "bad" news will be as readily forthcoming as "good" news. Disclosure practices should aim to minimize the chances that investors may misinterpret the information. The policy should also contain certain provisions that reduce investors uncertainty about availability and accessibility of information. Specifically, the following guidelines are appropriate:

- Management should release all information after the market (on which their firm's stock trades) is closed. Thus, more investors can get the information before any trading opportunities.
- As soon as management knows information of potential interest to investors, they should release it. If one suspects the information has or will definitely "leak out", ignore the first guideline and dispatch the

information as widely and quickly as possible. State why you did not wait until after the market closed.

- Management should demonstrate a willingness to provide investors with favorable as well as unfavorable information.
- The information should be clearly presented; management must minimize the chance that investors will form misinterpretations.
- Management should welcome the questions of analysts and reporters but have a specific policy to follow in dealing with such queries. Answer telephone questions only after markets have closed. In case of personal visits, ensure that analysts will not release any information until after the markets close. The firm itself should release a summary of any information provided to analysts.
- The firm should establish a track record of providing as much information to investors as possible. Such openness by management instills confidence that all news will be shared with investors.
- Management should not hedge when presenting information. If management does not fully understand the implications of a certain development, they should clearly state and assess the possibilities and admit uncertainty concerning the outcome.
- Projections should be realistic. When management realizes the projections are not as reliable as originally thought, the projections should be revised. Investors must sense that management will keep them appraised of all developments.
- Management should develop an approach to handle rumors about the firm. Generally it is best to have a policy of either always or never responding to such rumors. The merits and shortcomings of the "always or never" approach need to be assessed prior to establishing the policy.

IV. SUMMARY

In addition to other factors, uncertainty perceived by investors affects how investors value a firm's shares. Aside from numerous actions which management may take (e.g., with respect to investments, financing, growth in earnings per share, and dividends) managers can reduce the uncertainty perceived by investors regarding two factors: (1) equal access to information and (2) misinterpretation of information. Reducing uncertainty from these sources will increase share value. Managers should implement the specific steps suggested to minimize uncertainty from these sources.

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