

*A New Commentary on Emerging Investment Themes
by the Social Awareness Investment Team*

“GOOD”COMPANY, “GOOD” STOCK?

Over the recent past, each of us has witnessed stock prices of some “good” companies, as defined by their corporate citizenship/SRI attributes - companies that, on balance, are effectively responding to the socio-cultural factors that can potentially affect their competitiveness, business risk and future growth possibilities - “fall from grace,” if you will allow us to use such a term. Along these lines, we looked at the performance of ten companies that we felt were generally viewed as pacesetters on such matters over the past three years (May 28, 1999 through June 7, 2002). As a group, these companies lost 60% of their value over this time period, approximately 40 percentage points worse than the market, as defined by the S&P 500.¹ This, in turn, begs the question: don’t “good” companies make “good” stocks?

The answer is, quite simply, “it depends.” As we have noted in prior commentaries, there is a growing body of evidence suggesting that pacesetter companies — whether defined on workplace, environmental or some other sociocultural factor — do exhibit stronger relative financial performance.^{2, 3, 4, 5, 6} We believe that the reputational, operational, and financial benefits gained from pacesetting practices do, in many situations, improve a company’s risk-reward ratio on the margin.⁷

However, from an investment perspective, it is important to realize that the actual realization of a strong investment return also depends on various additional macro- and micro-level factors, including product cycles transitions, positive capital discipline, quality of strategic plan execution, innovation, earnings generation, and so forth. Furthermore, at times, the stocks of “good” companies have underperformed other stocks due to factors outside the control of the company, such as where we are in the economic/market cycle, a change in market sentiment toward capital intensity, or a geopolitical event of the magnitude of September 11th. These latter conditions generally prove transitory. On the other hand, actions — or a lack of action, as the case may be — by a company management also can erode the long-term

attractiveness of the stock of a “good” company. If you think back a few years, one corporate management’s serious misjudgment of the marketplace reaction to their innovation (e.g., genetically modified foods) made them much less attractive as an investment, despite their recognition as a “good” company on sustainability. Similarly, the stocks of other “good” companies have become unattractive due to poor execution of their business strategy, product safety concerns or — last but certainly not least — the use of aggressive accounting and revenue recognition policies.

So, what can we, as investors with a long-term view, take away from this? Well, a few things come to mind. First is the realization that the definition of “good” is not static, but takes on different nuances depending on economic, geopolitical and/or societal events. In the 1990s, from a social standpoint, companies that operated in apartheid South Africa were not considered to be “good.” Similarly, in the heyday of the dot-com, many considered anything technology to be a good investment, almost by definition. Today, however, attitudes toward both have changed considerably.

Investors must guard against a natural tendency to stick with the stock of a “good” company, because in the long-term its “goodness” will win-out. Good corporate citizenship is not a silver bullet that guarantees investment success. A widget company may “walk the walk” on workforce diversity, but if it continuously produces poor quality widgets it is unlikely to make a good long-term investment.

One must look beyond the numbers to understand what is driving a company’s stock price performance. The drop in price of a “good” company with good investment characteristics, coincident with a decline in the overall market, may present a great buying opportunity. On the other hand, if a stock price drops in response to concerns about eroding financial strength due to mounting liabilities from faulty products, then another course of action may be warranted.

Recognizing this, our stock selection process seeks to identify the “good company” and “good stock” attributes of an opportunity and to isolate which company and stock attributes are likely to influence the investment attractiveness of this opportunity on a near-term (tactical) and long-term (strategic) basis. This analytical approach has served us well in numerous

situations. In others, it has made us realize how very dynamic and complex these interdependencies are, particularly in an increasingly global economy. We continue to work on ways to enhance our fundamental and cultural analytical tools and thereby help us to deliver high quality investment services and competitive long-term returns to our clients.

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¹ Citigroup Asset Management, 2002.

² Watson Wyatt Worldwide, *Human Capital Practices*, 2001

³ Cap Gemini Ernst & Young Center for Business Innovation, *Measuring the Future: Some Thoughts on Value Creation in the New Economy*, 2000.

⁴ M. V. Russo and P. A. Fouts, A Resource-Based Perspective on Corporate Environmental Performance and Profitability, *Academy of Management Journal*, 40(3),1997, 534-559.

⁵ Smith Barney Asset Management, *Environmental Drivers and Shareholder Value*, 2001.

⁶ Smith Barney Asset Management, *Workplace Drivers and Shareholder Value*, 2001.

⁷ Smith Barney Asset Management, *The Bottom Line Implications of Social Investing*, 2001.