

Investors in Innovation: Survey of Global Financial community

Conducted at Waggener Edstrom Worldwide

By Lev Janashvili

April 20, 2009

Introduction

Hardly any business or political leader would dispute the importance of innovation in reinvigorating economic growth. But this consensus often splinters into clashing perspectives when questions arise about the precise locus, course and pace of innovation, or about the variables likely to impel or impede the flow of novel and commercially viable ideas.

Hence, in this second Investors in Innovation (III) survey, we decided to gauge the financial community's views on the countries and industries most likely to produce the next major wave of economically stimulative innovations. We also solicited respondents' views on the key economic and market trends likely to affect the course of innovation-driven companies in the foreseeable future. Launched on April 1, 2009 and completed on April 13, 2009, the survey focused on the following questions:

Innovation

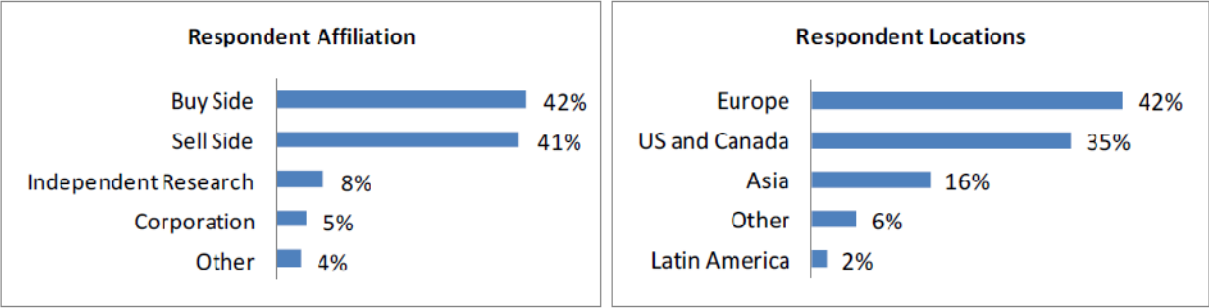
- The "innovation potential" of countries, including the U.S., Japan, the U.K., Germany, China, India and Russia
- The "innovation potential" of industries including financial services, technology, oil and gas, healthcare, consumer goods, and alternative energy
- The Obama administration's performance thus far, particularly in the areas of economic stimulus, stabilization of the banking system and the facilitation of economically stimulative innovations
- Innovation as a factor in investment decisions

General Market Issues

- Performance of key market indices worldwide for the remainder of 2009
- The current recession
- Key financial and nonfinancial variables affecting investment decisions
- New leadership of the SEC
- The uptick rule to curb short selling
- Mark-to-market accounting rules
- Oil and gas prices

A total of 130 people responded to the survey. Eleven of them also provided qualitative responses. Respondents to the survey constitute a geographically and functionally diverse sample of buy-side, sell-

side and other market participants from established and emerging financial centers around the world. The sell-side respondents mainly included equity analysts and directors of research. The buy-side respondents included portfolio managers, security analysts, chief investment officers and strategists.



Context-setting News and Trends

The following developments unfolded during the survey period, and may have influenced survey responses.

A respite from the bear market? We launched the survey on the heels of a significant rally in leading market indices over the preceding 30 days. Some indices have already eked out year-to-date gains. Much discussion in the financial media focused on whether this rally marked the end of the bear market or a mere pause.

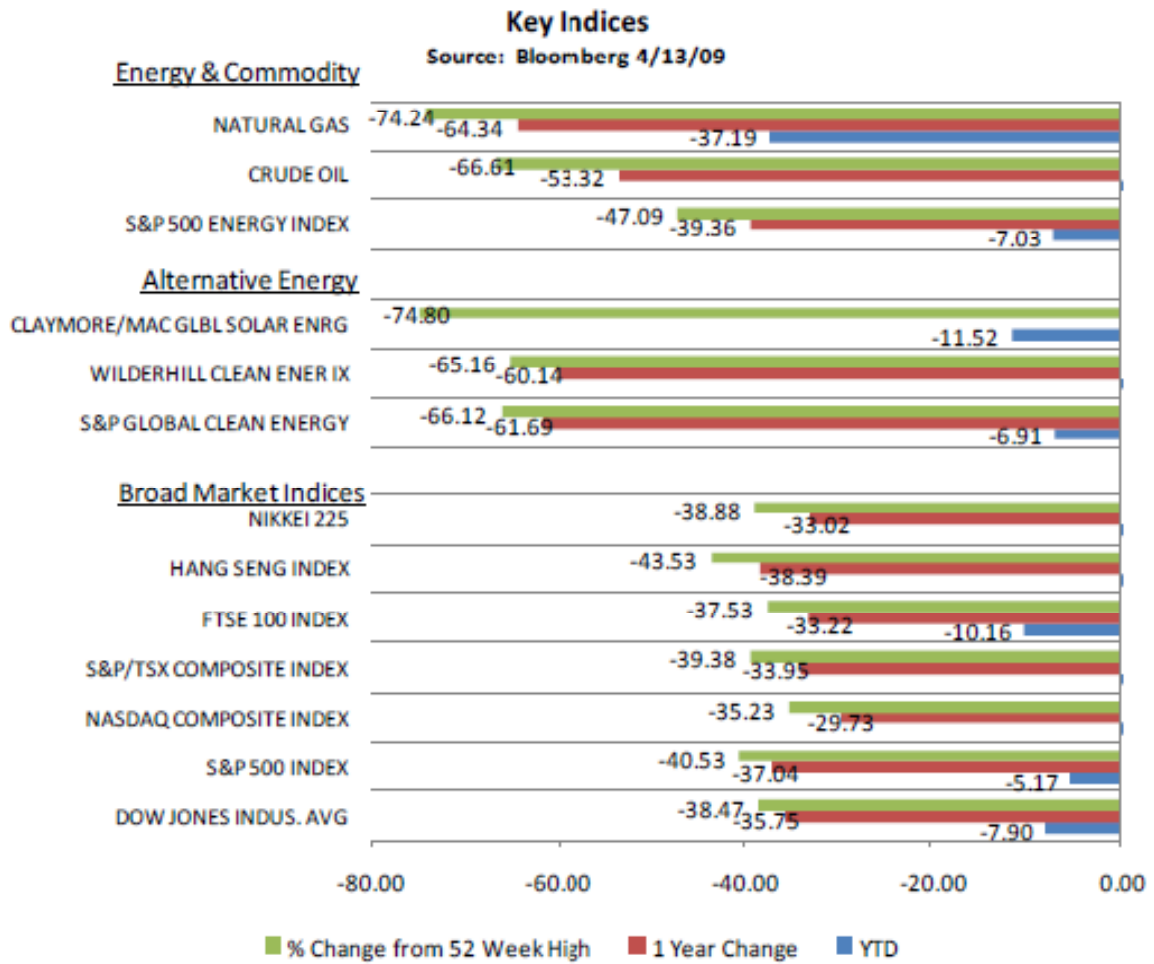
The price of oil rising. The price of oil increased by more than 26 percent year to date (and about 51 percent from its Jan. 21 low). The price of natural gas has continued to decline so far this year, down about 20 percent. The two commodities are trading at 66 percent and 74 percent, respectively, below their 52-week highs. These trends are important because oil and gas prices significantly affect the relative economic appeal of alternative energy solutions. In our first III survey, the majority of respondents agreed or strongly agreed with the statement that “Generally speaking, public interest and commercial investment in alternative energy will (continue to) diminish whenever oil and gas prices decline.”

The “uptick” rule returns. On April 8, the U.S. Securities and Exchange Commission (SEC) voted unanimously to seek public comments on five possible rules to limit short selling. The proposal comes on the heels of criticism from some lawmakers and executives that short selling exacerbated the current financial crisis. The proposed marketwide restrictions reflect the basic logic of the retired “uptick” rule, which required that every short sale transaction be entered at a price higher than the price of the previous trade. In this way, the uptick rule aimed to prevent short sellers from adding to the downward momentum in the price of an asset.

FASB eases mark-to-market (MTM) rules. On April 2, the Financial Accounting Standards Board (FASB) voted, under pressure from Congress, to ease mark-to-market accounting rules, which require companies to value their assets on the basis of prevailing market prices. Supporters contend that MTM methods generally reflect asset values more fully and fairly than mark-to-model approaches, which can be easily manipulated. Critics, on the other hand, argue that MTM rules should be eased to facilitate the valuation of hard-to-price assets. Hence, some observers criticized the FASB’s decision as a step away from honest accounting; others heralded the vote as a step closer to economic reality.

Mounting doubts about America’s leadership in innovation. A variety of recent reports and media commentary have called into question America’s credentials as a cradle of innovation. These reports generally acknowledge that America still contributes significantly to innovation, but they contend that the country is losing its innovation edge. They typically attribute this decline to a growing focus on incremental innovation rather than basic research, declining research spending and the global recession.

Concerns about the recession's impact on innovation-driven industries. A variety of reports have speculated that the global economic recession will dampen the growth potential of some of the most innovation-driven industries such as alternative energy, healthcare and technology.

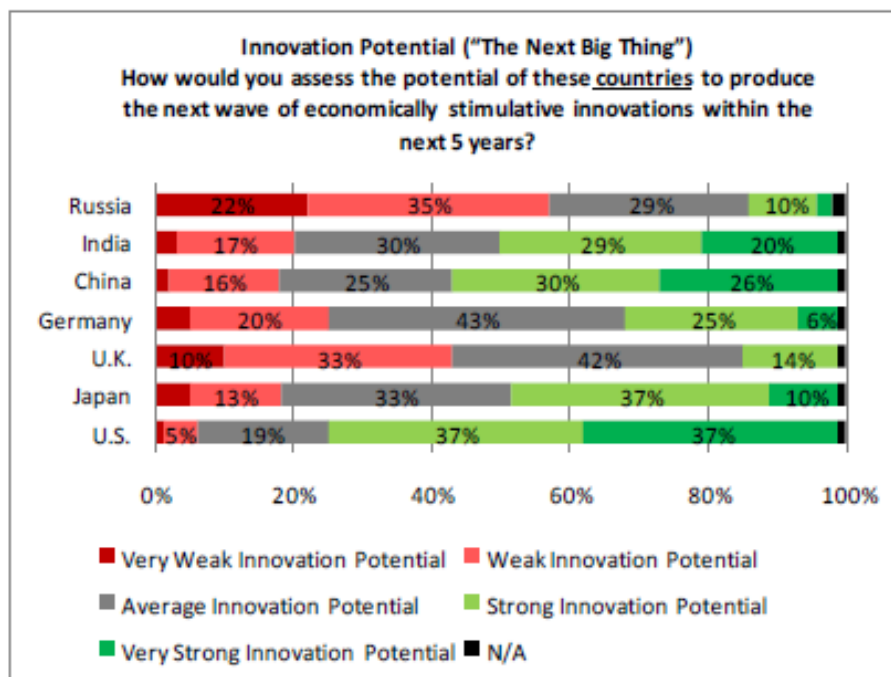


Key Findings

America emerges as the innovation leader. Respondents clearly see the U.S. as the most likely country (of the seven countries listed) to produce the next wave of economically stimulative innovations. America’s “innovation potential” received the highest positive ratings and, importantly, the lowest negative ratings. Interestingly, these response patterns do not appear to reflect a bias among U.S. respondents. In fact, the Asian respondent segment assigned the highest ratings to America’s innovation potential; 85 percent of Asian respondents rated America’s innovation potential as strong or very strong, compared with 83 percent for U.S. respondents and 75 percent for European respondents.

Note that these responses do not necessarily contradict the claim that America’s innovation prowess is declining. The respondents are simply saying that America’s innovation potential is currently strongest among the countries listed here.

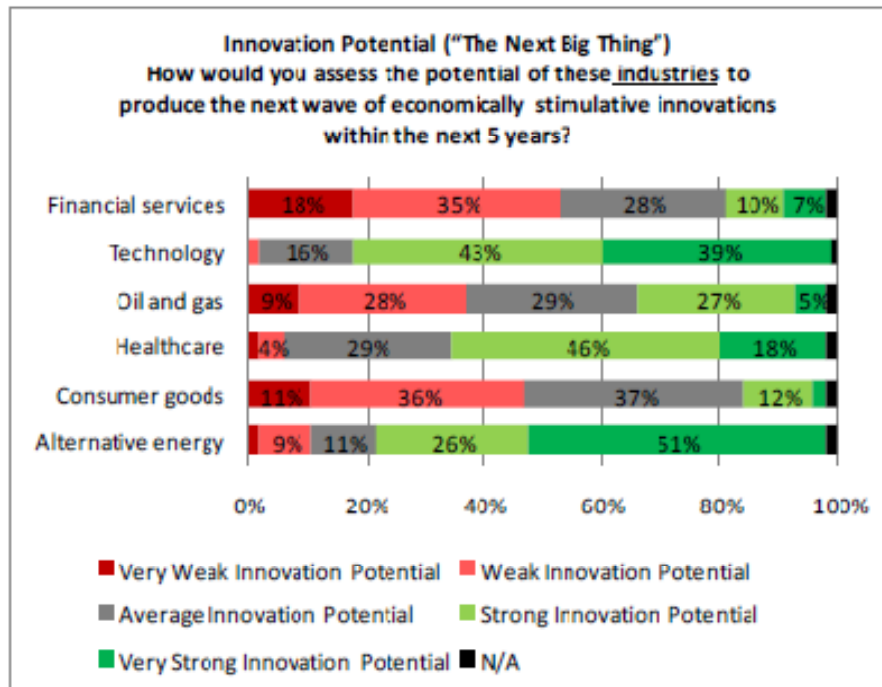
Still perceived by many as a commodity-driven economy, Russia emerged as the weakest innovator in the survey, with lowest positive ratings and highest negative ratings. The U.K. did not rank high either, with 85 percent neutral-to-negative ratings.



Alternative energy and technology expected to drive innovation. Despite the fears of a recession-driven investment drought, the investment community’s highest hopes for economically stimulative innovations still hinge largely on alternative energy and technology. Asian respondents were somewhat less optimistic about the innovation potential of alternative energy (55 percent positive ratings) compared with U.S. respondents (84 percent positive ratings) and European respondents (83 percent positive ratings).

Financial services received the poorest overall innovation ratings. Obviously, this response pattern may reflect the broader erosion of public trust in the industry. In March, we released the results of a WE-RT Strategies nationwide U.S. consumer poll, which found that only about 8 percent of Americans have full confidence in banks and financial services companies.

“The next year or two will be tough for alternative energy and for most industries. But, in the long run, no other industry is better positioned than clean energy to stimulate growth on a large scale.” — U.S. Portfolio Manager



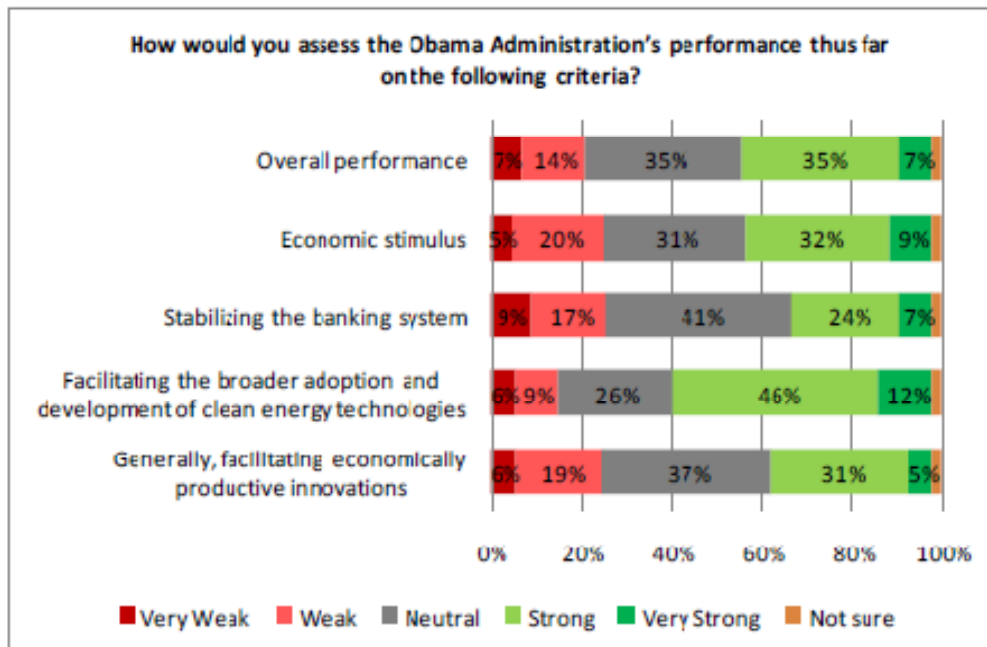
Obama gets kudos for boosting clean technology. We asked the respondents to rate the Obama administration on five criteria that reflect some of the new president’s dominant policy priorities thus far. The administration received its highest relative ratings (56 percent positive) for “facilitating the broader adoption and development of clean energy technologies.”

Interestingly, with regard to Obama’s overall performance, European and Asian respondents provided more positive assessments (46 percent and 50 percent positive ratings, respectively) than their U.S. counterparts (33 percent positive ratings).

Obama gets his lowest relative ratings for his efforts to stabilize the banking system. These responses diverge measurably from consumer perceptions. In a nationwide U.S. consumer poll conducted by WE and RT Strategies in March 2009, 67 percent of the respondents expressed favorable views of President Obama’s efforts to address the current financial crisis.

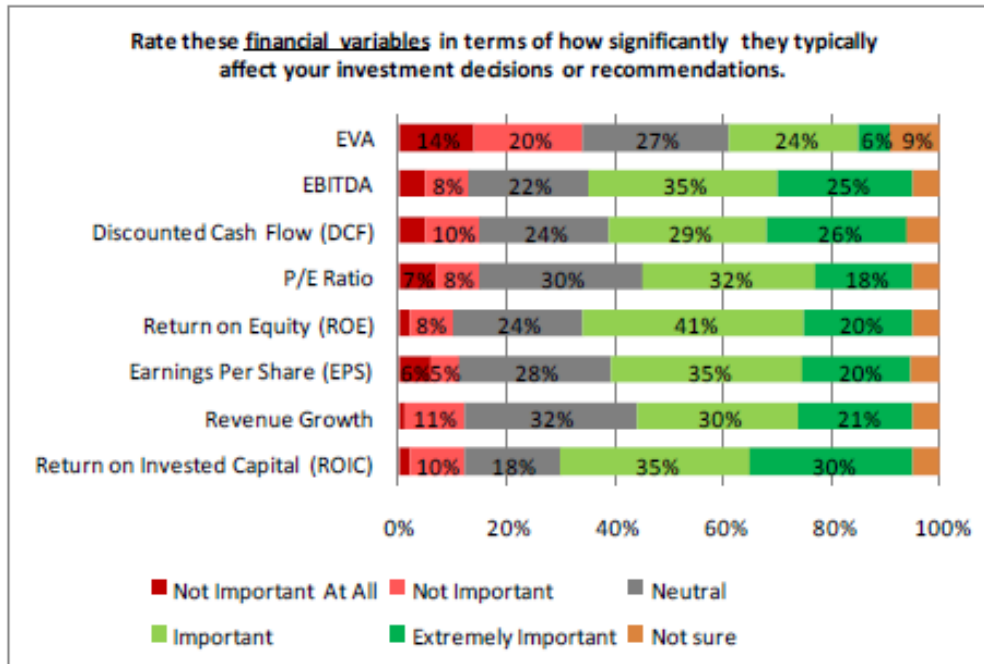
“I like what Obama has done so far, although it’s really too soon to judge. I’m impressed with his progress in improving transparency and gutting the old boys’ network. The claims about Obama moving toward socialism ... I think they are unfounded. He respects capitalism.” — U.S. Buy-Side Respondent

“So far so good, I think. Time will tell. However, I do think that the stimulus package could have been more stimulative.” — European Portfolio Manager

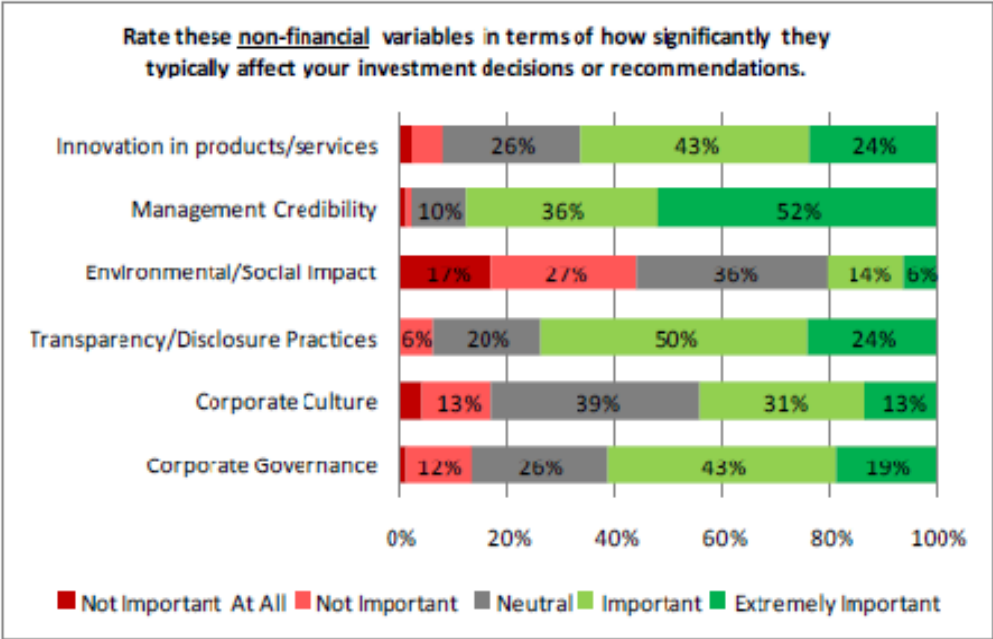


Measures of management effectiveness lead financial variables that affect investment decisions. Return on invested capital (ROIC) and return on equity (ROE) received the highest importance ratings, higher than traditional metrics such as revenue growth, EPS or PE. This finding suggests that analysts and investors want tangible results and evidence that senior management teams are deploying cash wisely.

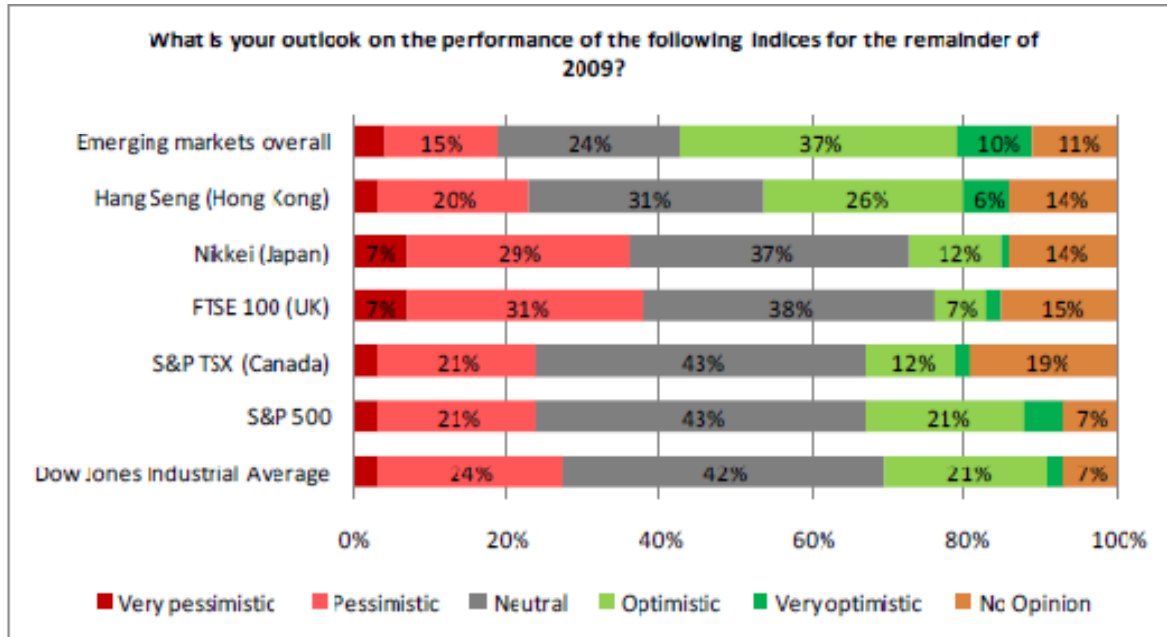
“I consider DCF the best method of valuation. Therefore mark to market, where the price is set by the last manic buyer or seller, is not a true reflection of value.” — European Buy-Side Respondent



Respondents rated management credibility as the most important nonfinancial variable affecting investment decisions, followed by transparency, innovation and corporate governance. Clearly, respondents are especially focused on nonfinancial variables most likely to contribute directly to financial performance and mitigate investment risks. Environmental/social impact, by itself, does not rank as an important variable.



Outlook on the performance of leading market indices for the remainder of 2009 is generally pessimistic or neutral. This finding is in line with similar recent findings. The Bloomberg Professional Global Confidence Index fell to 5.95 in March from 8.5 in February. A reading below 50 means pessimists outnumber optimists. Sentiment about Europe and the U.S. slid, while respondents in Asia were less pessimistic about their region. The respondents to our IIR survey were most optimistic about emerging markets and least optimistic about the U.K.

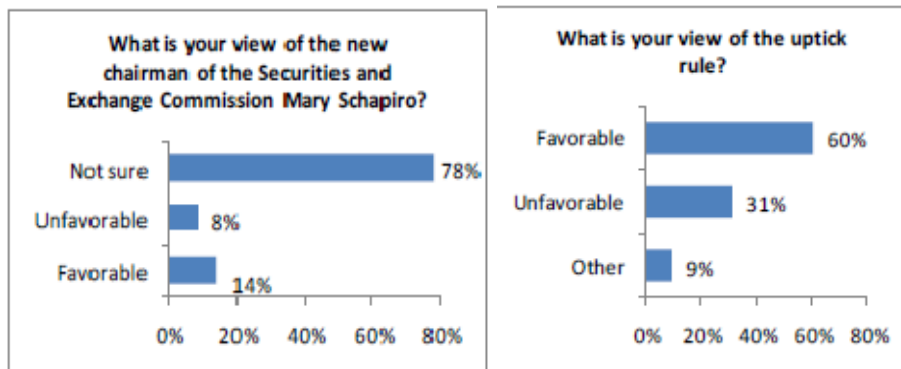


Survey responses reveal marked reticence about the new SEC Chairman Mary Schapiro. Only 22 percent of the respondents could say whether they held a favorable or unfavorable view of the new chief securities regulator. In part, the ambivalent responses probably reflect the recency of Chairman Schapiro’s appointment and the marginalization of the SEC in the recent months as the Treasury Department assumed the central leadership role on the most pressing issues facing capital markets. None of this may be surprising, but these findings do underscore the need for the SEC to provide bolder and more visible leadership on challenges that rightly fall within the agency’s purview.

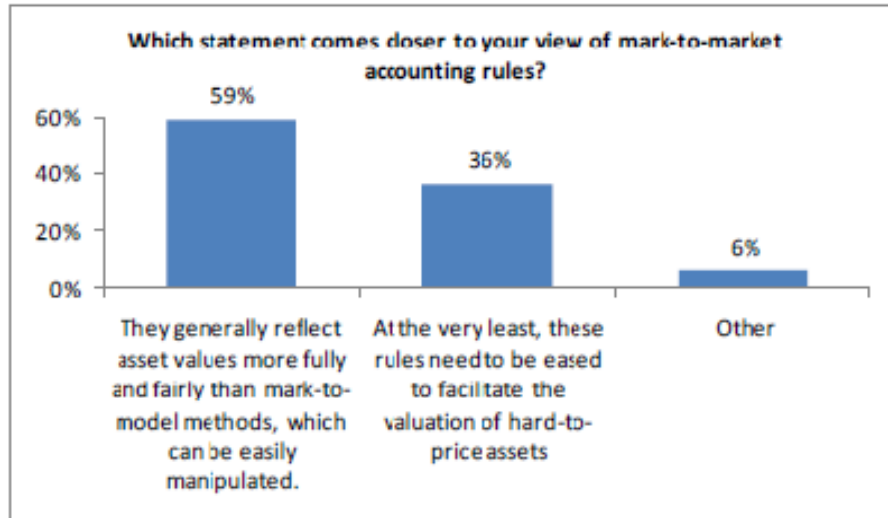
Most respondents hold favorable views of the “uptick” rule. The respondents who provided qualitative responses acknowledged the complexity of the underlying issues, but most of them felt that establishing reasonable restrictions on short selling was important in the current market environment. Others painted a more menacing portrait of short sellers as market manipulators who can not only profit from business declines but also contribute to them.

“In a normal environment, shorting is fine. It rewards people for predicting problems. But in the current environment, I worry that it can be used by people who would engineer disasters to profit from them. This is really tough, but we need to protect ourselves.”

— U.S. Buy-Side Respondent

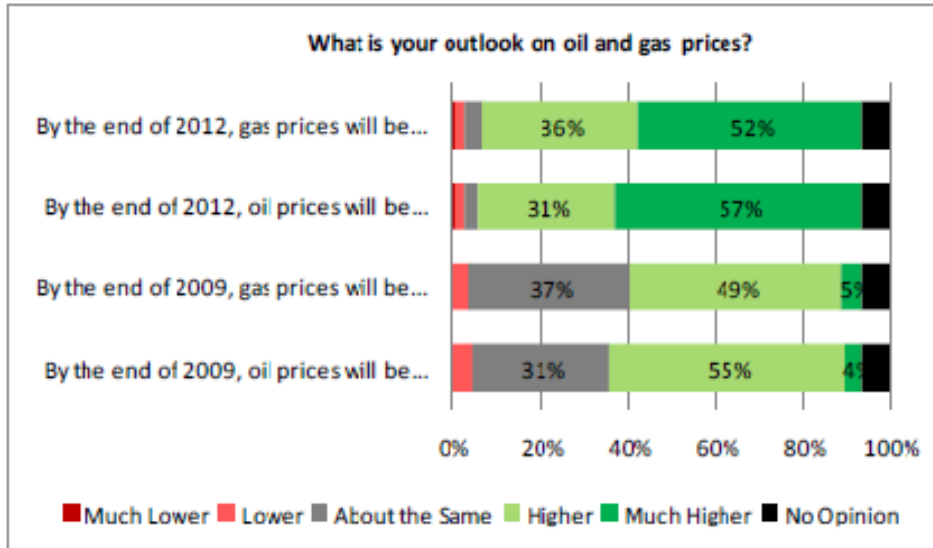


Most respondents hold favorable views of MTM accounting rules. They do acknowledge the challenge that MTM poses for hard-to-value assets, but they generally feel that it would be more sensible to ask companies to explain why these assets may be worth more than MTM would suggest than to allow the wider latitude of mark-to-model methods.

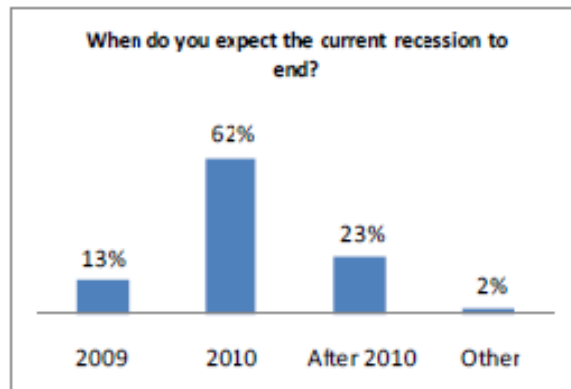


The support for MTM rules and for restrictions on short selling is interesting in that it seems to reveal a tension between two conflicting motives: 1) aligning corporate valuations with economic reality and 2) providing a near-term boost to the market.

Respondents overwhelmingly expect oil and gas prices to stabilize or increase in 2009, and certainly in the long run. Generally consistent with the results of our first III survey, these findings carry special resonance for alternative energy companies, which often fear that a sustained decline in oil and gas prices diminishes the relative economic appeal of clean energy. At least in the view of our respondents, a sustained contraction of oil and gas prices is very unlikely.



Most respondents expect the current recession to end in 2010. In qualitative responses, they generally agreed that they expect to see more negative news on the economy before a sustainable recovery begins.



Conclusions and Reflections

Some of the responses to this survey surprised us. We did not expect, for example, that America's "innovation potential" would draw the most enthusiastically positive responses from Asian respondents, or that the majority of the 130 respondents would favor mark-to-market accounting rules and restrictions on short selling. Neither did we expect the overwhelmingly agnostic comments on the new SEC chairman.

The perceptions of the U.K.'s and Russia's innovation potential also surprised us. Granted, we knew from recent academic and media reports that these countries probably need to bolster their innovation credentials. But the proportion of neutral-to-negative ratings of their innovation potential (85 percent for the U.K. and 86 percent for Russia) should encourage the corporate and political leadership of these countries to act urgently to remedy these perceptions and, more important, the underlying realities.

Responses about the end of the recession may also surprise some readers comforted by the forecast — often aired in financial media — that the recession should end this year and markets should rally soon in anticipation of this recovery. On the contrary, most of our respondents do not expect a recovery until 2010.

Other findings aligned more closely with our expectations, reinforcing earlier survey results. Consensus remains strong, for example, that high oil and gas prices will return, and that alternative energy and technology sectors will produce the most significant innovations in the foreseeable future.

It is also unsurprising (at least to us) that innovation continues to weigh heavily on investment decisions, and that respondents clearly emphasize nonfinancial criteria most likely to contribute directly to financial performance and to mitigate investment risks (e.g., management credibility, transparency). For example, "environmental/social impact," by itself, does not rank as an important nonfinancial variable. This finding reinforces the idea that public companies marketing environmentally friendly products probably cannot hope to win over investors based on the "green" message alone. Rather, they need to show a clear link between the environmental and social impact of their products and the company's bottom line.

And, perhaps the least surprising finding of all is the broad-based pessimism and uncertainty about the near-term performance of global capital markets. The current recession and financial crisis left no industry or asset class unaffected. And despite the recent "glimmers of hope" in key market and economic metrics, the financial community remains understandably timid.

Despite the pessimism, the financial community still values innovation, perhaps now as much as ever. But we would also caution public companies that the "innovation" message easily lends itself to overuse, often rendering it meaningless. We typically advise our clients to frame their innovation message in terms of measurable "inputs" (e.g., R&D spending as a percent of sales, number of R&D projects, etc.) and "outputs" (e.g., revenue growth attributable to new products, ROI in new products, etc.), linking it explicitly to the company's long-term financial and operating goals.