CEOs always want to know how the market will react to new strategies and other major decisions. Will a company’s shareholders agree with a particular move, or will they fail to understand the motives behind it and punish the stock accordingly? And what can management do to improve the outcome?

Trying to predict stock price movements is necessary, of course. After all, when stock prices fall, the cost of borrowing and of issuing new equity can rise, and falling stock prices can both undercut the confidence of employees and customers and handicap mergers. Unfortunately, however, most of these predictions are no more than rough guesses, because the tools CEOs use to make them are not very accurate. Net present value (NPV) may be useful for estimating the long-term intrinsic value of shares, but it is famously unreliable for predicting their price over the next few quarters. Conversations with sample groups of investors and analysts, conducted by the company or by investment bankers, are no more reliable for gauging market reactions.
But executives can dramatically improve the accuracy of their predictions. By adopting a more systematic, rigorous approach, corporate leaders can learn to understand individual investors as thoroughly as many companies now understand each of their top commercial customers. It is possible to know such customers well because there are only so many of them. Equally, only a finite number of investors really matter when it comes to predicting stock price movements.

Every CEO knows that when buyers are more anxious to buy than sellers are to sell, share prices rise—and that they fall when the reverse happens. But fewer CEOs know that not every buyer or seller matters in this equation. Our research on the changing stock prices of more than 50 large US and European companies over two years makes it clear that a maximum of only 100 current and potential investors significantly influence the share prices of most large companies. By identifying these critical individual investors and understanding what motivates them, executives can predict how they will react to announcements—and more accurately estimate the direction of stock prices.

Armed with these new and solid insights about how critical investors behave in specific situations, executives can make strategic decisions in a different light. Knowing what makes crucial investors buy, sell, or hold the company’s stock allows the CEO to calculate what its share price might be after an announcement and to factor this calculation into their strategic and operating decisions. To head off short-term selling, a company could manage the timing, pace, or sequencing of strategic announcements. It could introduce a new management team before announcing an acquisition. It could also test an important new product in selected markets before the nationwide rollout. How will investors react to a merger announcement and what will the resulting share price mean for a deal? How might a spin-off fare in the market? Does the company need to prepare the market or to consider a carve-out instead?

A CEO even has the choice of forging ahead in the face of adverse predictions, using the information to manage the expectations of the board. An executive may, for instance, consider bold strategies even though they could push some critical investors to sell the company’s stock.

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A maximum of only **100 investors** significantly influence the share prices of typical large companies.

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1The companies in our study compete in a variety of industries, including financial services, industrial services, packaged goods, pharmaceuticals, and transportation. Their market capitalizations ranged from $800 million to $170 billion, and each had institutional ownership greater than 40 percent.
The few that matter

It should come as no surprise that big trades can significantly move the needle on a company’s stock price. When the Bass family of Texas, for example, sold its stake in Disney, in September 2001, in response to a margin call, Disney’s stock fell by 8 percent.

But typically, short-term changes in a company’s stock price aren’t the result of a single big trade. For the 50 companies whose quarterly stock price variations we studied, we consistently found that the majority of unique changes in each company’s stock price resulted from the net purchases and sales of the stock by a limited number of investors who traded in large quantities. (By “unique changes,” we mean those occurring relative to the rest of the market. In other words, they do not include price bumps or falls that coincided with the overall movements of the market or the sector.)

Although the number of crucial investors in a company ranged from as few as 30 to (more typically) as many as 100, in each case this set of actors had a dramatic impact on share prices. In the companies we studied, we could attribute from 60 to 80 percent of all unique changes, quarter by quarter, to the net trading imbalances of these investors.

Consider a snapshot of the trading in the shares of a large European industrial company. Exhibit 1 shows the relationship, over a period of two years, between the net buying and selling of its 100 most critical investors, captured weekly, as well as the fluctuation in its stock price relative to the market index. In 11 of the 14 cases when the company’s stock price moved significantly, the...
price went up or down in concert with the net buying or selling of these very investors.

The two strong outliers in the exhibit were not random events. The point at the bottom right occurred when the company announced the acquisition of a major competitor—a move that large traders applauded by purchasing more of the company’s stock but that analysts, small institutions, and retail shareholders rejected. The top left outlier occurred when the government made a crucial regulatory announcement whose impact appeared, on the surface, to be positive, thus attracting a large number of smaller investors, but was actually neutral to negative, something the largest investors understood.3

Why should the size of the imbalance between asks and bids matter?

At any instant, the market consists of a series of graduated offers to buy (in other words, A has an outstanding offer to buy 1,000 shares at $60, and B offers to buy 2,000 shares at $59.875) as well as a similar set of offers to sell (C offers to sell 1,500 shares at $60.50, and D offers to sell 1,000 shares at $60.75). A sale is made only when one side surrenders across this bid-ask spread (that is, A agrees to buy 1,000 of C’s shares at $60.50). When buyers collectively want large amounts of a stock, they have to keep surrendering to successive layers of sellers up the offer curve. Sellers who unload large numbers of shares move along the curve in the opposite direction.

Of course, the correlation between the buying or selling of large investors, on the one hand, and the price of a stock, on the other, can never be perfect. Smaller investors sometimes act in sync and overpower larger holders—as happened twice in two years with the shares of the European industrial company News, rumors, and world events can spark broad market swings. But among the companies we have studied, the correlation is remarkably persistent (Exhibit 2).

Industrial marketing for investors

Few companies today get to know their top investors well enough to predict with any accuracy what will make those investors buy or sell more of their shares. The CFO of a large financial company, which was about to announce the divestiture of a major division, believed that he was “right on top of 4Smaller investors can move at variance with larger ones for many reasons. To cite just a few, small investors may pay less attention to the company on a daily basis; they may be more influenced by the opinions of high-profile analysts; and large investors who actively invest in a stock may sometimes make more sophisticated trading decisions.
[our] investor base." Indeed, in a general way, the company’s executives knew the big investors well—what they thought of management, the creditworthiness of the company, and so on. But executives didn’t know what investors thought about specific potential strategies, such as a divestiture. Was the offer price that executives were considering above or below the value investors attributed to the unit when those investors calculated the company’s total value? Or did investors think that the company benefited from cross-divisional synergies that would end with the divestiture?

To develop the ability to make predictions about shareholders, companies should identify their stock price movers and calculate how many additional shares would be offered or sought in reaction to specific announcements. Through background analysis and interviews, the companies must then analyze in depth the trading behavior of these movers, developing trading profiles for each of them. Finally, companies should use the information in the profiles to predict which movers would be likely to react to specific corporate announcements by selling or buying in the short term and then calculate what this would mean for share prices.

For example, occasionally an investor will make big trades for reasons that have little or nothing to do with corporate announcements and everything to do with the investor—such as the Bass family’s sale of its Disney stake. Only by understanding the investor deeply can one even hope to anticipate these kinds of actions.

EXHIBIT 2
A persistent correlation

Correlation between quarterly unique changes in stock price and trading imbalance among most critical investors.\(^*\), percent

<table>
<thead>
<tr>
<th>Company</th>
<th>(r^2)</th>
<th>(\Delta P)</th>
<th>(\Delta S)</th>
<th>(\Delta B)</th>
<th>(\Delta R)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apple Computer</td>
<td>65.3</td>
<td>50</td>
<td>-25</td>
<td>25</td>
<td>0</td>
</tr>
<tr>
<td>Guidant</td>
<td>65.3</td>
<td>50</td>
<td>-25</td>
<td>25</td>
<td>0</td>
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<tr>
<td>Lyondell Chemical</td>
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<td>50</td>
<td>-25</td>
<td>25</td>
<td>0</td>
</tr>
<tr>
<td>Mentor Mining</td>
<td>65.3</td>
<td>50</td>
<td>-25</td>
<td>25</td>
<td>0</td>
</tr>
<tr>
<td>Norfolk Southern</td>
<td>65.3</td>
<td>50</td>
<td>-25</td>
<td>25</td>
<td>0</td>
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<tr>
<td>Union Pacific</td>
<td>65.3</td>
<td>50</td>
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<tr>
<td>Newmont Mining</td>
<td>65.3</td>
<td>50</td>
<td>-25</td>
<td>25</td>
<td>0</td>
</tr>
</tbody>
</table>

\(r^2\) = the proportion or percentage of variance explained by a regression. Stock prices indexed and deflated by the S&P 500 index, adjusted for splits and other corporate changes. Calculated as net purchases + net shares repaid – sales – net shares borrowed. Source: Thomson Financial; ShareWorld; LionShares; Yahoo! Finance; McKinsey analysis.
Getting to know investors isn’t a one-shot process. Companies must continually reexamine who is moving their shares—investors come and go. An ongoing dialogue with the movers deepens the knowledge of these companies and, over time, sharpens their ability to predict the actions of their critical investors. However, most companies will need to beef up their investor relations capabilities to get the job done. The good news: getting started isn’t a mammoth task. Two to three months should be enough to develop an initial set of profiles of the most important investors.

**Identify the critical investors**

A company should begin its assessment by asking who has the potential to move its stock price. Some of the movers could be among the company’s largest current shareholders. Some may be smaller holders who want to increase their ownership. And some are potential large players who do not yet own any of the company’s stock but could purchase or short it in large quantities. What do these movers have in common? They are active stock-portfolio managers who regularly buy and sell large quantities of shares in the company or in similar companies—typically, managers of mutual, pension, or hedge funds or even individual large investors.

In other words, investors who count have both weight and a propensity to throw it around. Although the actual calculations needed to put together the list of movers are complicated—requiring more discussion than we can present in this article—a likely mover is someone who does or could reasonably account for at least 1 percent of a stock’s trading volume for one quarter.

Movers are not necessarily a company’s largest investors. Shareholders (such as family holdings or trusts) that have owned big blocks of the company’s stock for a long time don’t move it quarter to quarter. Neither do index funds unless the company is added to or dropped from an important index (or unless the fund’s assets change dramatically). Among the largest 20 investors of one big pharmaceuticals company we studied, only 10 were movers, and this proved to be typical of the companies we studied. What is more, nearly half of the large movers of the stock of the pharmaceuticals company over eight quarters from 1999 to 2001 weren’t listed among its 20 largest investors during any single quarter.

Moreover, companies should add potential investors to the list of movers. For a large chemical business in our study, we analyzed the way the positions of
investors in other chemical businesses changed over time. One investor, a $22 billion investment fund, had been an active trader in other, similar chemical companies and liked to buy assets at the bottom of a cycle. At the time, the sector was depressed, so for this and other reasons we added the investor to the company’s list of movers. A few months later, the investor purchased more than five million of the company’s shares.

Potential movers include those who have made money investing in other industries in similar circumstances. Investors who bet on the right players in an industry that consolidated, for example, may now be eyeing investments in other sectors on the verge of consolidation. Potential movers may also be investors who purchased shares in a company’s upstream or downstream suppliers and have a history of investing more broadly in the value chain. Some may have a taste for betting on companies that use certain capital models (high cash flow, say, or high leverage), have new CEOs, or face particular market changes or competitive conditions.

To determine how many investors should go on the list—40? 70? 100?—a company should test the accuracy of its predictions over previous quarters to arrive at the number that works best. Too few will yield poor correlations between activity and stock prices; too many will add to the cost and complexity of the process. In addition, the list changes frequently. Our experience suggests that a mover typically stays on such lists for six quarters—long enough to give the company time to become familiar with it but short enough so that there will always be new movers to study.

Moving the movers

Once a company has identified its movers, the next step is to develop thorough profiles of all of them. Companies begin by conducting an “outside-in” analysis of each one, including its stated investment criteria and objectives and its trading patterns. Discussions with every investor give a company a chance to fill in the gaps in its understanding of its movers and to confirm its hypotheses about what they trade and why.

The resulting profile should first describe how an investor makes decisions. What does the investor want to invest in, using what valuation methodologies? How is it likely to react to events or to data, which after all can be interpreted in many ways? Are its investments subject to any constraints,
such as their size and frequency? Second, the profile should describe each investor’s views on issues that the company might face—such as any new strategies (for instance, whether the company should go into China), earnings surprises, and changes in management.

To get this kind of information, companies must phrase the questions carefully in view of a US Securities and Exchange Commission (SEC) regulation that prohibits companies from disclosing material information to some but not all investors.

Typically, indirect questions work best. A company might ask investors why they purchased or sold their holdings in a particular business, for instance. But the company would actually be trying to understand why they sold their holdings after the business announced, for example, that it was investing in China. Do the investors dislike the risks that are associated with China, distrust the management team put in place to manage expansion in Asia, or reject specific details of the disclosed plan?

The precise format of the profiles will vary from company to company, depending upon the decisions and events it expects to face. However, the content of each profile should focus on predicting how each investor will make decisions, view announcements, and likely react.
react to specific corporate events (Exhibit 3). Companies will want to collect the information in a database where it can be updated regularly.

**Making predictions**

With the movers identified and profiled, the investor relations staff and executives can make reasonable judgments about who will sell, buy, and hold. This process isn’t merely a mathematical exercise, though it does involve many calculations.

Besides assessing whether each investor will approve or disapprove of a given announcement, executives must estimate how many shares the investor is likely to buy or sell. They can be guided in these estimates by such details as the average trade the investor makes and whether the investor historically “bleeds” (buys and sells incrementally over time) or “blasts” (buys and sells quickly and in large blocks).

This information gives the company an idea of the extent of the trading imbalance that will likely occur as a result of the announcement. Executives, guided by past imbalances in the company’s stock and the way they moved prices, can use this estimate to make a rough assessment of how the stock price will react (Exhibit 4). Secondary, or knock-on, events should also be considered: if the stock price goes up or down, for example, what might momentum players do? This too can be derived from past patterns.

Although the process itself is straightforward, making these predictions can be quite complex. Nonetheless, several companies we have worked with have done the necessary calculations and used the information to guide their
strategic decisions. One company, recognizing that it would take a hit, decided that it could do little about this except to prepare and manage its board. (In this case, estimates of what would happen to the stock price were extraordinarily accurate.) Another company decided to postpone a restructuring when it realized how far its stock price was likely to fall. In a third case, two companies were about to announce that they were merging. But the estimated dip in the acquirer’s stock price after the announcement could have affected the deal (an equity and cash buy), so executives at the two companies used the profiles to identify investors who should be reached immediately and individually. Profiling also helped the companies tailor their communications to those investors.

Even if no immediate decisions are pending, a company should try to predict probable moves by investors on a quarterly basis if not more often. Accuracy improves with practice.

Building the capabilities

Companies that choose to adopt an industrial-marketing approach to investor relations will need to make at least two key changes. The first is to stop viewing the market as a monolithic entity that is judging a company’s performance in an adversarial way. When the company’s stock price changes, executives shouldn’t ask why the market moved; they should pinpoint who bought, who sold, and why. In fact, managers should view investors much as managers in private companies view their corporate owners—and understand them just as well.

Second, companies will need to overhaul their investor relations units. In the vast majority of companies today, the investor relations function is largely administrative: it oversees the production, but not always the content, of regulatory and annual reports; it administers the registry of shareholders and sets up investor road shows, visits by analysts, and conferences; and it talks to shareholders—when they call.

Instead, the investor relations unit will have to take on a more strategic role, almost as an adjunct to strategic planning. It will be responsible for managing the key-account process to identify movers and understand their behavior. Its staff will have to test all major plans and announcements for their effect on the price of the company’s shares and suggest modifications to those plans to bring them into better alignment with the views of key shareholders. Indeed, for the first time, the investor relations unit will become an important adviser to the CEO.
But this approach calls for investor relations leaders who can stand up to the CEO and deliver bad news when necessary. They will also have to be capable of handling tough interviews with investors who are pressing them for information they cannot divulge under SEC regulations or for competitive reasons. Sharp, independent, and analytical investor relations directors may emerge from the ranks of business development, strategic planning, or even, in some instances, internal auditing.

Taking a more rigorous, structured approach to investor relations and stock price predictions clearly requires resources, including the time and attention of senior management. But given the importance of share prices, why would a CEO ever want to be left guessing?

Kevin Coyne is a director and Jonathan Witter is an associate principal in McKinsey’s Atlanta office. Copyright © 2002 McKinsey & Company. All rights reserved.