



Tuesday, December 02, 2008

MARATHON CLUB GUIDANCE FOR LONG-TERM INVESTING

BEHAVIOURAL ASPECTS OF INVESTMENT MANAGEMENT: LESSONS FROM THE CREDIT CRUNCH

Background

A recent meeting of the Marathon Club was followed by a discussion led by Colin McLean, Managing Director of SVM Asset Management. Colin provided a fresh perspective on long-term company analysis. His paper “Misaligned incentives – digging deeper into company reporting and rewards” is attached. Colin’s presentation stimulated an interesting discussion. In this note, the key issues that emerged with respect to issues for long-term investors have been highlighted. They are offered as aspects of investment management, which Trustees may find it helpful to consider when reviewing the performance of their investment managers and advisers.

Issues

- **Investment professionals may not be capturing enough of the available information**

Investment managers may be too reliant on normal channels of information, e.g. company reporting, EPS, preliminary result announcements, etc. and fail to capture relevant information that may be outside normal channels- “submerged information”. The Northern Rock case described in Colin’s paper illustrates this well. Most sell side analysts focused on positive signals in the normal channel such as director share buying and a prospective dividend increase. How many analysts looked through the bank’s website for its lending criteria?

The Marathon Club defines long-term investment as a fundamental, research-oriented approach that assesses all risks to the business. The Northern Rock case shows that the research job was not done with sufficient expertise and depth. Colin’s paper recommends that investors should gather information as widely as possible, using all the tools available, and evaluate it considering independence versus incentives, and likely knowledge captured, before rating the value of each piece of information. Trustees may therefore wish to test to what extent their respective managers are doing this.

- **Misaligned incentives are widespread throughout the economy and stock-markets.**

There are multiple examples of company’s business models – vertically integrated in structure and business strategy – which will inevitably reflect internal incentives. Within these examples incentives may be misaligned and perpetuate an existing vertically integrated structure or holding on to non-core business. This applies to multiple industries. It may be possible in such

cases to create shareholder value through divestiture or reorganisation. Trustees may, therefore, wish to consider whether their investment managers or advisers are giving sufficient consideration to business models and their continuing appropriateness as circumstances evolve.

- **Company reporting may have distortions due to framing.**

Investment professionals tend to rely on company information, and it is a consistent interpretation of this data that is assumed to underlie market efficiency. A key issue for investors is that companies make use of framing by setting a context for their reports and presentations knowing that presenting a decision in a positive framework produces a different result than a negative one. For example, companies tend to pick out numbers they would like investors to focus on. Investors must watch out for such spin. Trustees may wish to consider, therefore, the analytical capability of their investment managers or advisers – in particular the extent to which they are really able to challenge the perspectives provided through company reporting processes (for example, by testing the reporting against views held by competitors, customers, corporate credit analysts as well as equity analysts, and other relevant parties).

- **Quantitative and passive approaches would have little protection if securities are mispriced.**

Given that securities could be mispriced due to the misaligned incentives, lack of thorough research and distortions in company reporting, passive investors have little protection from loss of capital. Several quantitative managers have also suffered in recent markets due to models that rely on company reported information and market prices or consensus earnings forecasts. Therefore, trustees may wish to reflect on the context being set by the price environment when evaluating manager performance or considering the strategic balance of their portfolio.

- **Pension funds still act short term**

There is a common perception, especially amongst investment managers, that pension funds still act short term. Yet, the evidence on the average tenor of manager appointments and the Club's own experience does not fully support this view. It is possible that the standard practice of quarterly reporting of manager performance has created this perception.

The Marathon Club has recommended that Trustees review manager performance less frequently than a quarterly basis and do so in great depth (while still keeping quarterly or even monthly updates on file so as not to disregard the shorter timescales applied by scheme sponsors and boards of scheme sponsors). The Club's Guidance Note also recommends that Trustees should focus less on the performance relative to a market index and more on the process by which results are produced. The Club suggests the use of portfolio characteristics such as the intrinsic values relative to the market values and metrics that relate to the fundamentals of a business such as the Return on Equity, Operating Margins, Cash Flow Generation. In saying this, it is important that intrinsic value measures are kept-up-to-date and don't rely on older forecasts and multiples which may need revision as further trends emerge.

In evaluating performance, Trustees should consider the impact of their conclusions on the behaviour of their investment managers or advisers. In particular, they may wish to consider the extent to which a particular approach or style, which may be appropriate in the long-term, has been impacted by prevailing market conditions, and distinguish that from outcomes which been created within the framework of management discretions that they have set.

Conclusion

The recent dramatic failures of financial institutions and the stress suffered by some of the icons of the corporate world have shown that the issues raised in this discussion are very relevant. Trustees should consider how long-term investors tackle the issues. This consideration could focus on two themes. Firstly, long-term investors need to look to their investment managers to protect them from loss of capital arising from incomplete analysis, misaligned incentives and distortions in corporate reporting. Secondly, the governance of companies, mainly in respect of non-executive directorships, needs to be made more accountable.

The Marathon Club notes that some of the most recent events such as the failure of Lehman, HBOS and AIG are likely to lead to calls for further tightening of governance standards, especially on setting incentives for company executives and compensation but also in the areas of internal risk monitoring and external regulatory review.

Your feedback

The Marathon Club would welcome feedback on the issues highlighted by this paper, and would be especially interested to learn about Trustees'/Investment Committee's own experience of their application in practice. Please send your comments or requests for more information to:

Peter Scales, Chairman, Marathon Club (peter.pjsa@btinternet .com)

Yusuf Samad, Secretary, Marathon Club (yusuf@belfieldcapital.com)

**MARATHON CLUB
LONDON HILTON, 8 JULY 2008**

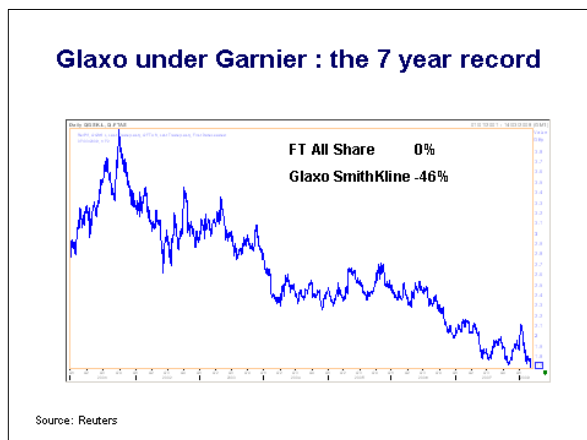
**“Misaligned incentives - digging deeper into company reporting & rewards”
*A new perspective on long term company analysis***

Colin McLean, Managing Director, SVM Asset Management

- i. Is governance achieving its aims, reducing agency risks? What more can be done?
 - ii. What can governance learn from the lessons of behavioural finance?
 - iii. Are the governance and misaligned incentive issues in banks also a problem for other sectors?
 - iv. What are the risks of growing distrust of company reporting?
 - v. Can talking-up results and outlook become misinformation and market abuse?
 - vi. Is there a need for governance to join up more closely with the actual practice of investment and longer term metrics?
- i Is governance achieving its aims, reducing agency risks? What more can be done?**

There is evidence amongst large cap companies, as well as small, that incentives and rewards have not reflected genuine business growth over longer periods. Increasingly, shareholders are recognising this disconnect through share price underperformance of apparently growing companies, and a de-rating of shares in terms of reported earnings and dividends. GlaxoSmithKline, the UK's fifth largest listed company, has underperformed the stockmarket averages for many years. Relative to the FTSE All Share Index, the share price is well behind over seven years and is no better than it was twenty years' ago. The Index is level (23.5.2000 to 31.3.2008) against a 46% fall in GlaxoSmithKline's share price. (This period as it starts with the appointment as director of the current chief executive, and he retired from that position in May this year). The last major merger boosted bonuses, but has delivered no lasting benefit for shareholders. Total shareholder return over seven years is negative.

Clearly, an incentive structure is intended to influence performance, and at the same time the actual ex post rewards gained under the incentive plan should reflect real achievement. However, a more serious issue is that a company's business model – such as Glaxo's vertically integrated structure and business strategy – will inevitably reflect the incentives. Moreover, this is more likely to be reinforced



over time in the governance culture. I believe this also applies to some other pharmaceutical groups, as well as to other sectors, including some of the larger banks and the major integrated oil groups.

Might it be that shareholder value would be created, not by perpetuating an existing vertically integrated structure in these businesses, but instead by the greater clarity that restructuring might afford? Yet, it is not clear that demergers or unbundling would be rewarded in the same way as grand mergers.

Misaligned incentives may be pointing a company in the wrong direction. A chief executive of a large FTSE 100 company that has a successful division (e.g. GlaxoSmithKline with pharma sales down 4% last year and consumer products up 11%) has little incentive to demerge a winner if that means he will subsequently no longer get a carry on its performance. He and the corporate structure and brand may be bringing little to such a business. Similarly, there may be incentives within the reward structure that encourage acquisitions. A change in a business model to split research from distribution might also be kept off the agenda for similar reasons.

Impact of misaligned incentives

- Driving the wrong strategy
- Encouraging acquisition / discourage break-up
- Compromising leadership and confidence in governance
- Encourages internal appointments
- Disconnect from stockmarket

Are adjusted EPS worth all this?

Rewards drive behaviour and that in turn drives corporate structure. Bad rewards over time create the wrong business structure. Other more subtle effects involve the impact on all the thousands of other staff created by any impression of compromises at the top. Internal appointments may be more likely. And, the growth of non-executive pay across the board typically inflates at a similar rate to executives. Shareholders may not value the objectives set – earnings per share has been devalued in the ratings of many top 10 FTSE companies.

ii What can governance learn from the lessons of behavioural finance?

Behavioural finance is gradually providing a better framework for understanding much of stockmarket and business behaviour. There are two issues that stand out; framing and gaming. Framing appears designed to encourage investors to anchor their views on partial or incorrect information.

We assume the frame or context is providing additional information. That may suit real life reflexive actions, but we need to know when reflection and calculation is better. And companies take advantage of this in their reporting, setting a context of their choice for readers to review the numbers. We tend to anchor our analysis in an initial position, and so are unduly influenced by early parts of a presentation.

Companies make use of framing by setting a context for you to read company reports, with “guidance” at the start. Some put a context in prelims that does not find its way into audited accounts, but most analysts write their notes on the prelims. Sometimes there are substantial differences between prelims and the annual report, or the report has to give more prominence to statutory earnings per share which may not appear on the bullet points of the prelims. The point of framing is to make the spin so prominent that it forms a favourable framework for what is to come, guiding our expectations and diverting us from detailed analysis. We tend to anchor our views with initial information.

Investment professionals tend to rely on company information, and it is a consistent interpretation of this data (rational expectations) that is assumed to underlie market efficiency. Yet, framing and language all point to the difficulty of extracting objective and unemotional data.

Accounts of the largest companies can run to almost 200 pages, challenging analysts. The rewards for a chief executive are complex - pay, options, share sales, pension and sometimes rewards for external non-executive work. And, incentives can comprise short term bonus as well as medium and long term incentives. These may be based on a range of factors, sometimes changing from year to year and the value of rewards in any one year may not be fully recognised in the accounts if incentives are left within a pool, or deferred stock is involved. The reporting of this can span several pages in accounts and be very hard to aggregate.

Gaming involves the compromising of incentives or regulations, delivering unintended results and unreasonable rewards. This has become easier with a ready acceptance by the analyst community of adjusted earnings, combined with other flaws in earnings per share.

iii Are the governance and misaligned incentive issues in banks also a problem for other sectors?

Issues of investor and management behaviour, misalignment of incentives and misleading reporting, are all factors in today's troubled stockmarkets. The failure of incentive arrangements – effectively, collateral-lite business relationships, is widespread in the economy. Bank executives with little genuine long term incentive to create real value have created products in which entrepreneurs can borrow with little personal collateral. Hedge funds and other participants in the shadow banking system have been able to game against flawed risk models, delivering attractive patterns of results over a period too short to reflect the underlying negative expected return on the strategy.

Managements across a wide range of sectors have gamed earnings per share. Latterly, this has remunerated executives for “growth” that has reflected little more than share buy backs, releveraging, accounting adjustments and mergers – whilst avoiding genuine and consistent measures of long term value creation. The underperformance of these mega caps – astonishing against the background of the current flight to liquidity – shows investors are beginning to recognise that earnings per share and dividend yield are now much less useful investment metrics. The issues of misalignment of incentives, and a ready ability to game that by adjustments to earnings per share, share buy backs and additional leverage – helped by easy credit markets – apply to most sectors.

iv What are the risks of growing distrust of company reporting?

The key to efficient markets is widespread dissemination of unbiased information. Indeed, so important is transparency that it is a primary focus of regulation. Anyone compromising market integrity with insider information risks severe penalties. So, why should it seem, as the credit crisis has evolved, that some investors knew more than others? That knowledge drove down bank share prices, but many professionals who relied on reporting from bank boards struggled to understand why.

Boards and bank executives seemed uncomfortable with the "crowd wisdom" - surprised by the big discrepancy between their valuation of their own businesses and others' perceptions, as reflected

in falling share prices. This contrast between bank boards and external analysis was highlighted by one bank chief executive in February, who said: "It becomes a bit difficult to have a reasonable and rational conversation when people invent their own ratios." Investors and regulators need to understand that boards do not have the monopoly on wisdom.

In the case of Northern Rock, it was clear during 2007 from feedback on bulletin boards that many individual investors had found evidence on websites of some of the risks it was running. This potential for relevant facts to be overlooked by experts might be termed submerged information. Wisdom lying within the crowd may be expressed in share prices long before analysts and institutional investors can identify the real issues. There may be no intent to trade on inside information - simply it is the enormous scale of information on the internet, and amongst all those who interact with a business publicly, that challenges transparency.

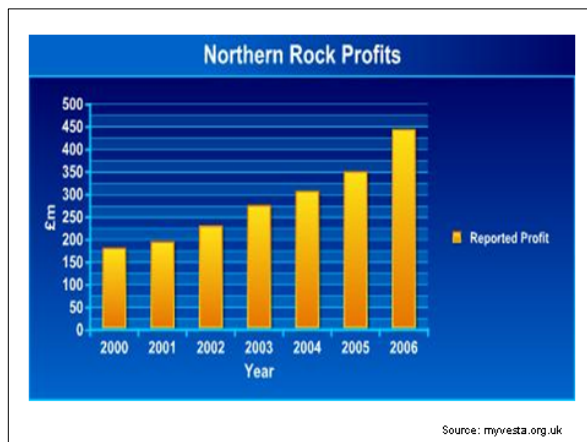
Regulators, analysts and risk managers must now recognise the changing nature of information. No longer is there a clear dividing line between public and inside information - the internet, and other informal ways of sharing information, has compromised that. Share price patterns may indeed be revealing an underlying truth not evident in conventional analysis. Information may even acquire meaning simply through a ratio that is championed by the crowd, but rejected by most experts.

New, stricter definitions of banks' core Tier 1 ratio would be one example. The few who first focused on this in 2007 gained little public attention. The failure of some fundamental analysis and risk models over the past year might be best explained by the new impact of submerged information. Imperfect capture of information in share prices increases the risks for all; regulation by itself cannot address that.

The growing distrust of company reporting has moved from bulletin boards to mainstream press. A number of statements by companies have been quickly proved to be wrong or unrealistic. This may make it much harder to turn round market sentiment, or restore credibility to boards. It is clear that many shareholders and the public do not believe they are getting candour from companies.

v Can talking-up results and outlook become misinformation and market abuse?

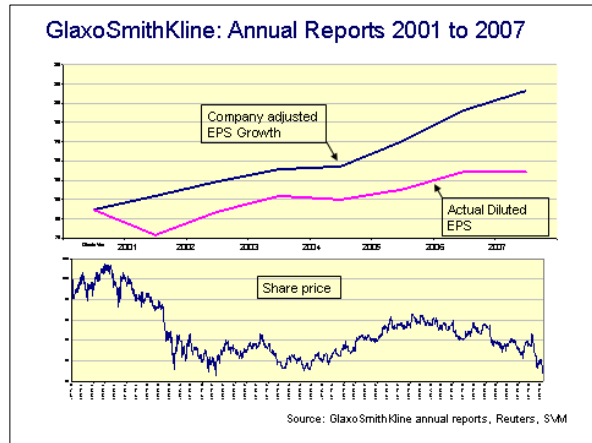
Northern Rock's board clearly hoped the market would pay attention to director share buying, a prospective 30% dividend increase and an astonishing historic record of earnings per share growth. These official signals seem designed to disarm growing concern in the crowd. For Northern Rock, most sell-side analysts focused on those positive signals from the board, although we now know that the bank breached its capital requirements in March 2007 and told the Regulator on April 19, 2007. So presumably the board was aware of the true position.



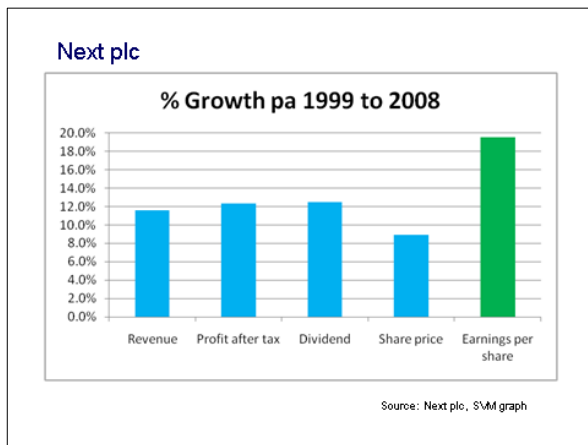
More recently, it is clear that signals given by other banks in terms of dividend increases or capital adequacy were unfounded. The press appears increasingly willing to highlight some of these contradictions.

vi Is there a need for governance to join up more closely with the actual practice of investment and longer term metrics?

The cumulative effect of Glaxo's framing is shown in a slide, where the blue line represents the cumulative growth represented by linking the principal reported figure each year, over seven years. The actual statutory diluted earnings per share is shown by the red line. That lower underlying rate of growth would achieve little under an incentive target that requires earnings per share to beat inflation by 9% over three year periods. The smoother management provided path of growth also fits in more with our concept of Glaxo as a growth stock. Yet, as we can see from the share price moves over the same period, increasingly investors have been unimpressed by this.



There is good reason to be wary of earnings per share and price/earnings ratios. But, there is a more serious impact. Over long periods, earnings per share can detach itself from fundamentals. Wagon plc's finance director, for example, saw nothing surprising in reporting 8.0p of adjusted earnings per share, whilst at the same time attempting to raise new capital in a 10 for 1 share issue at 4p.

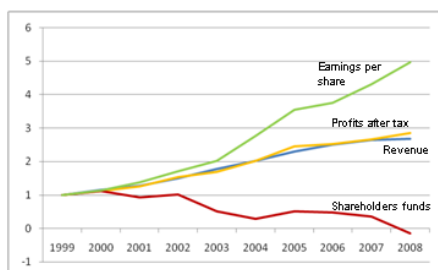


Whilst many recognise that earnings per share might not be a true reflection of the change in a company's value in any one year, the colloraries are not as widely recognised. Problems with earnings per share can also mean that growth rates are misunderstood, and there can also be misrepresentation of volatility and risk. For example, Next plc is widely recognised as a growth stock, with a compound growth of 19.5% per annum in its EPS over the last 10 years. However, as can be seen from the bar chart, revenue growth over this period has been little more than half this figure. Profit after tax and dividend growth were also no more than 12%, and share price performance is also lower,

possibly indicating a degree of scepticism over the sustainability or credibility of the earnings per share figure. I say that this lacks credibility not because the figure is not properly audited and reported, but because it may not be a realistic measure of the change in the value of the enterprise attributed to shareholders that is actually sustainable.

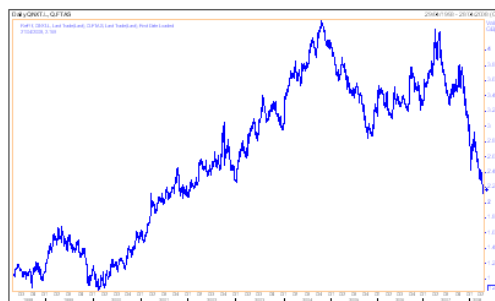
This is clear on the next slide. Here we can see that profit after tax and revenue have grown in much the same way over the past ten years. An increase in physical space has helped this. However, the trajectory of earnings per share is markedly different, and it is only when we look at the lower line that we can see that this has been helped by share buy backs, at the expense of shareholders' funds. I would not view that as an indication of sustainable growth.

Next plc 10 years' revenue, post tax profit, EPS and shareholders' funds



Source: Next plc, SVII graph, indexed to base 1

Next plc 10 years relative



Source: Reuters

We can see from the share price performance of Next relative to the FTSE All-Share Index, that the market is increasingly sceptical about this buy back strategy. The latest chairman's statement says "the continued use of surplus capital to buy back shares has again enabled us to deliver superior growth in earnings per share, our main financial objective". However, the company is also very clever in using contingent contracts – effectively a decision in advance to purchase shares. Over the twelve months to March 2008, this involved buying 5.8 million ordinary shares for £108.8 million. This was a discount, the company claims, of 8.2% compared with market prices prevailing when the relative contract commenced. However, compared with the current market price of 1118p, the shares have been bought at £18.76, or 68% higher! Shareholders looking for sustainable growth, may prefer more of it to come from successful retailing and less from clever capital market operations.

Most analysts work on the numbers, but the context for the numbers is the work of the audit and remunerations committees. Investors would expect to see compliance with the Combined Code, and regular committee meetings – with any remuneration discussions at least matching up with the number of audit meetings. Bonuses and other incentives usually depend on establishing the numbers first. What investors often miss is the table of committee and board attendance.

Autonomy plc, for example, unusually, the committees and board operate with a rotating chairman. The 2007 accounts apparently show that the arrangement was to continue until they identified a suitable new chairman. Despite that, the nominations committee did not meet during the year. This rotating chairman arrangement was also disclosed in the accounts in 2003, 2004, 2005 and 2006. Apparently a broad range of candidates were considered during 2007, but because no formal nominations were received, the nominations committee did not convene formally. It does seem a surprising arrangement. That committee comprises just two people.

The remuneration committee did not actually meet, but clearly approved everything by written consent. The executive directors' bonus targets in 2007 were achieved, but described in terms of organic revenue growth exceeding 15% and adjusted earnings per share growth of at least 35%. Surprisingly, these targets are described as "objective". It is interesting that Zantaz Capital and Meridio apparently lost \$20 million pre-acquisition in 2007, but contributed thereafter. Fortunately, for Autonomy, these two acquisitions cannot have their standalone impact separated out post-acquisition. It is clearly not easy to identify what the genuine organic growth rate was for revenue, and this issue should have exercised the remuneration committee enough for it to have had at least one formal meeting to verify the maximum bonus payout. Because the meetings are not summarised in a simple table of attendance, it is difficult to see whether an audit committee meeting was held prior to the sign off on bonuses.

In summary, earnings per share appear to be being gamed by many companies and mis-stating longer term business growth. This may not be caught by a shorter term governance approach. Also, the approach to governance may need to involve understanding how investors interpret information, and looking at patterns over a number of years as well as assessing text and candour.

SVM Asset Management Limited, its clients and/or employees may have an investment or position in any of the companies mentioned in this article.

This article is for informational purposes only, and to the extent that it is passed on, care must be taken to ensure that it is in a form which accurately presents the information presented here. The information and opinions presented in this article have been obtained from sources believed by SVM to be reliable, however, SVM makes no representation as to their accuracy or completeness and accept no liability for loss arising from the use of the material.

Issued by SVM Asset Management Limited which is authorised and regulated by the Financial Services Authority.

SVM Asset Management Ltd, 7 Castle Street, Edinburgh EH2 3AH Tel: 0131 226 669