

The VIEW from BURGUNDY

S E P T E M B E R 2 0 0 3

A RECORD OF FAILURE: FUND MANAGERS AS SHAREHOLDERS

The following issue of The View from Burgundy was initially written as a consequence of the times, but the information contained remains applicable and is considered "timeless." The value philosophy described remains useful today and into the future.

THE FOLLOWING SPEECH WAS DELIVERED BY RICHARD ROONEY, the President of Burgundy, to the Ivey Alumni Society of Toronto, on June 18, 2003.

About four years ago, I gave a speech to the Canadian Institute of Chartered Accountants' Financial Reporting Conference in which I examined the role of the auditor and accountant in the late 1990s. The way I framed my argument was in terms of lines of defence for the shareholder. According to that metaphor, the Board of Directors is the first line of defence, followed by the auditor. If neither the Board nor the auditors are doing their jobs, then the final line of defence is the securities regulator.

Something always bothered me about that description. In the aftermath of Enron and Worldcom, I figured out what it was. The unspoken assumption of my speech was that the shareholders were like the fair maiden tied to the train tracks by a 1920s silent movie villain – objects of considerable sympathy, but not actors in their own fate. Yet shareholders are not some amorphous mass – shareholders are represented to a very large degree in the public markets by large, highly profitable and powerful investing organizations – the money managers. These organizations should operate as another line of defence for shareholders, rather than relying on the timely arrival of the cavalry to thwart the villains.

After the big party of the 1990s, most capital markets' participants have been well and truly pilloried. Most are coming under tough new regulatory regimes. Accountants are subject to severe new rules about doing non-audit work for audit clients, and have new oversight bodies to examine independence issues. Boards of Directors are under intense scrutiny about those same issues of independence and conflict of interest. Future managements are going to have to deal with all the red tape from Sarbanes/Oxley and its Canadian variants. Yet the professional money managers have skated through the controversies of the past few years without serious damage. Although they were masters of the universe on the way up, eagerly touting the qualities of the stocks their clients owned on CNBC and ROBTV, somehow they contrived to be victims "just like you and me" on the way down. This is not a credible claim. The fact is that money managers had at their disposal the means to help the system cope with the problems of the last decade, and failed to take advantage of those means.

Unfortunately, the reason that happened is part of the DNA of the investment management business. This morning I would like to walk you through a survey of the structure of the investment business to identify the balance of power between the corporate sector and the money management industry. We will see why money managers have been ineffective and

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reactive in looking after the shareholders' agenda. We will conclude with some suggestions on how that agenda might be better protected and advanced. The key points are that money managers must exercise the powers and prerogatives they already possess, must be willing to invest time and money in collective action to negotiate directly with corporations, and must help to build a better functioning infrastructure for the capital markets. The current road of waiting until an atrocity happens and then letting the regulators and politicians deal with things is not good for business, and will reduce long-term returns if management's ability to manage is compromised.

Investment Agendas

Let's look at the investment industry. The primary division in the investment business is between the buy side, or investing organizations, and the sell side, or brokerage businesses. As the buy versus sell title would indicate, there is an adversarial nature to this relationship. The buy side and sell side are intermediaries for their respective constituencies. Investing organizations represent the consumers of financial products and information, while brokers represent the producers. So behind the buy side is the general public in various degrees of aggregation, while behind the sell side is the corporate sector. Let's look at the agendas of the two main constituencies.

The corporate sector's agenda is quite simple and uniform across companies. At the highest level, their primary purpose in the capital markets is to minimize their cost of capital, which they do by sustainably maximizing the prices of their publicly traded

securities, such as stocks and bonds. They have two main weapons in attempting to reduce their cost of capital – control of information about their company's performance and prospects, and control over the timing and distribution of financings. Over the past two decades, a low cost of capital has become not just a source of competitive advantage for companies but a matter of survival, since in the absence of a control block, a perennially low stock price and inefficient capital structure will attract acquirers like flies to honey.

That leads us to corporate management's other main objective, which is survival. This objective can be reached through two means – management can entrench itself, and management can enrich itself. Most managements will want to do both. Entrenchment can take place through staggering the terms of the Board of Directors, requiring supermajorities on the Board to approve takeovers, or passing a so-called shareholders' rights plan to strengthen management's hand if management doesn't approve of a potential acquirer. Enrichment has usually taken place through the fixed price option grant and the huge severance package, or golden parachute.

So the logic of management's position is that they must impress their shareholders so they get a low cost of capital, and then persuade their Board that this impressive management deserves large financial rewards and job protection. The great majority of managers do it the old fashioned way: by executing for the shareholders. Those people deserve to be generously rewarded. But the wrong kind of incentives can lead to this agenda being hijacked by the Ken Lays and Bernie Ebbers of the world.

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Let's stop a moment and consider how a rational business owner should respond to this agenda. Presumably the quest for a low sustainable cost of capital is an area where shareholder and management agendas dovetail. The difference may well be in the word "sustainable." A business owner would never resort to short-term accounting tricks to artificially raise the price of his stock – he'd only be fooling himself. He would see to it that the incentive system did not encourage such games. And he would take care to see to it that his managers didn't get filthy rich at his expense. Ideally, management would get rich the same way he would – through long-term stock ownership.

Clearly, given the success of many corporate managers in the past decade at self-enrichment and short-term stock price manipulation, the shareholding public, the other major constituency, has not embraced the approach of the rational business owner. What is the public's agenda?

The investing public is not very coherent in the way it addresses the markets. Given a clear and mutually exclusive choice between safety of capital, growth and income, the public will invariably want all three. Some of them will also want to address social, ethical and health concerns through their investment choices. And they don't want their investments to perform badly, and they reserve the right to define poor performance in either absolute or relative terms. All this adds up to a rather fickle and distracted constituency that wants it all and wants it now.

This incoherence is fully reflected in their intermediaries, the money managers. We can perhaps express the problem of money managers as shareholders in the form of a general proposition – the

more choice and discretion the public has over its investment vehicles, the less likely the money manager is to have the staying power to deal with management's agenda as rational business owners, and the more likely money managers are to concentrate on short-term performance and immediate issues. Conversely, the more locked in the public is, the more the money manager can afford to look at longer-term issues of Board effectiveness, compensation programs and accounting clarity. So there is a hierarchy of effectiveness in corporate governance based on the permanence of the manager's investor base. That

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hierarchy also applies on the basis of the permanence of the investments a manager holds. Clearly, if the time horizon of the investor is long, he will be more concerned with the long-term health of his company

than with short-term noise. But in practice, money managers spend far too much time making meaningless trades, and far too little time thinking about the long-term health of investee companies.

At the bottom of this hierarchy are the investment counsellors and mutual fund managers. They tend to be relatively small and active players. This means that they trade in and out of stocks, and do not have to own anything. They often invest according to the Wall Street Rule: If you don't like it, sell the stock. They are therefore less inclined to stand and fight on long-term shareholder issues. Another bar to their effectiveness is conflicts of interest. They often have large corporations as pension fund clients, and when one of those clients tries to put one over on its shareholders, there is a tendency to put the business interests of the money manager ahead of the interests of the shareholders. Finally, there is ferocious competition among investment counsellors and mutual fund

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companies. This competition can lead to some really counterproductive behaviour. For example, superior insights about ropy accounting or bad governance can be considered a source of competitive advantage, giving the money manager an interest in their continuance rather than their elimination. And even if a manager does care about shareholder issues, but sees that a competitor is already spending time and effort on them, he can take a free ride on the competitor's efforts.

Most effective and formidable in the corporate governance arena are the big public pension funds. They are large pools of captive capital that are so huge they will end up owning everything in the market, and owning it long term. Since they are in for keeps, they have a large vested interest in improving the effectiveness of their investments and making their opinions heard. Due to the reasonably homogeneous nature of their client base, outfits like Ontario Teachers and OMERS (or in the U.S., Calpers and TIAA-CREF) have fewer conflicts of interest than most money managers. If you wondered why they've been at the centre of so many corporate governance initiatives over the years, there is your answer.

Mobilizing the Buy Side

There are a lot of barriers to joint action by buy-side organizations. One you may not have heard of is the concert party legislation, which made it illegal for shareholders to co-operate against management except in the context of a full out proxy fight. So until recently, it was actually risky from a legal point of view to have anything more than an informal discussion of common interests with another shareholder. I think that was more often an excuse than a reason, but as excuses go, it was a pretty good one. Since that legislation is no longer with us, the excuse is gone as well.

Different agendas and organization structures are another barrier to co-operation. Some large organizations have very involved Boards of Directors that do not allow the subcontracting of issues like corporate governance advocacy to others.

Internally competitive, often conflicted and with actual disincentives to co-operate in place, the buy side is in a bad position to confront the purposeful and self-interested corporate sector. The implication is that the buy side will always be reacting to events rather than pro-acting. That is a pretty good description of the buy side as I have known it over the past 19 years.

Well that is all pretty depressing. But it's not all bad news from the buy side. Because the fact is, things are looking up. Some good things are happening in corporate governance land.

The money management industry can be quite effective when it rallies around a single issue with a finite goal. We saw that with the debate over expensing employee stock options, though fanatical management resistance in the U.S. has prevented that issue from being put to bed even now. Right now I think there is an emerging consensus to oppose excessive executive pay, especially golden parachutes, with shareholder opposition appearing in the U.S., the U.K. and Canada. Obviously these single issue advocacy situations should be handled with care – the management compensation issue is less cut and dried than the stock options accounting issue and must be dealt with on a case by case basis. Fortunately, as with stock options, Canada has not reached the level of shameless troughing that U.S. corporate managers have achieved.

What is needed is a rallying point for the industry, and that is what I believe the Canadian Coalition for Good Governance (CCGG) is going to be. Given the constraints on the various players on the buy side, it would be too much to expect that everybody will be

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able to join this organization, which was founded late last year. About 20 large Canadian institutional investors have done so, and a large number of others are associate members. I should declare a conflict here, since Burgundy Asset Management is a full member of the Coalition and our Chairman, Tony Arrell, is on its Board of Directors.

I feel certain that the CCGG can establish itself as a great source of information for concerned shareholders and as an advocate for shareholder-friendly reforms in Canadian companies. The intention is that the Coalition will work quietly and consistently toward a set of goals for Canadian companies to achieve. These goals will in no way interfere with management's right or ability to manage the company for maximum return, but will ensure that the institutional framework is in place for shareholders to act like rational business owners and get value for money from their management teams. Under the leadership of David Beatty, an experienced director and businessman, and Michael Wilson, a deeply respected industry executive and former Finance Minister for Canada, I am confident that it will be a quietly effective negotiator and a great focal point for corporate governance activities in Canada. In time, given good support and continued involvement of good people, the CCGG will gain its own institutional identity and become, we hope, a fixture on the Canadian investment landscape.

Next Steps

So in terms of single issue advocacy and negotiating the governance agenda with Canadian public company managements, the money management industry seems to have learned a thing or two in the last couple of years. Better late than never. We have gotten to know

one another better and have done some useful work for shareholders. But there remains one area where we could and should be doing a much better job.

We should be investing in the infrastructure of our industry, especially in matters like accounting standard setting. Our lack of involvement here is unforgivable.

Let me give you an example. On March 4, 2002, Claude Lamoureux of the Ontario Teachers Pension Plan gave a speech to the Canadian and Empire Clubs entitled "Corporate Governance – Time to Get

Serious." It was an excellent speech and I rarely find myself at odds with Claude on these matters. But among the 11 very sensible recommendations that Claude made, one was phrased in a

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particularly revealing way. Number six said, and I quote: "Canadian regulators should work with the CICA to promote the best accounting standards... as opposed to the least offensive."

The clear implication is that money managers are takers on matters of accounting standards, and that the regulators must look out for our interests in this vital area. That is a widespread opinion among buy side people. Yet the standard-setting process is designed to give financial statement users such as investors as much direct input as they wish to give. I'll go further – the standards setters worldwide are begging for engagement by the investment industry, and getting very little co-operation.

After Worldcom, Enron, Tyco and the fall of Arthur Andersen, anyone who uses financial statements has to believe that accounting really matters. Yet the Canadian money management industry ignores its own standard setter and lets its industry association, the Association for Investment Management and Research, deal with the

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CICA's Accounting Standards Board whenever it has the time. Don't get me wrong, AIMR's advocacy group does a good job, but in the last analysis they are an American organization and it's not their day job.

There are great advantages to our industry helping our own accounting standards setter. There have been differences with U.S. GAAP that have benefited Canadian investors greatly. Pooling of interest accounting on mergers, for example, was never allowed in Canada, and that was one of the several very poor U.S. GAAP treatments that helped expand the bubble in the U.S. The Canadian Board came out in favour of options expensing last October, while in the U.S., the FASB remains tied up in political knots on the subject. Our industry could make great use of the Canadian standards-setting process to push an international agenda, since the Canadian Board is one of the world's most respected standard setters and has substantial influence with both the FASB and the new IASB.

The corporate sector takes great care to ensure that its interests are represented in the standard setting process. Shouldn't the money management industry present the investor's perspective?

This is an area where the new Canadian Coalition for Good Governance could do some useful work. It is already undertaking some initiatives here, but in my opinion there should be a full-time employee from the CCGG on the Accounting Standards Board who can represent the shareholder's interests in standard-setting and alert the industry to issues arising from proposed new standards. As we have seen repeatedly over the past three years, accounting standards on things like options expensing and Special Purpose Entities are meaningful both financially and behaviourally.

I'm sure that there are other opportunities for the buy side to invest in a better framework for the capital markets. If we were to ask regulators and corporate managers the ways in which activist money managers could benefit the system, we could probably get a pretty interesting list. I simply chose accounting to concentrate on because it's something I know a little bit about.

So that's my survey of money managers as shareholders. It's a history of pretty poor performance, but I hope you agree that there are grounds for optimism.

Some of you may have expected a broadside against money managers and all their works in today's speech. Others may have wanted to hear some good hard fixes for what ails the capital markets from a money manager's viewpoint. I fear I have satisfied neither party. Quick fixes are not going to help us at this point. What is needed to restore lasting confidence in the system is a return to an old-fashioned idea stewardship. It is needed in corporate offices, in boardrooms, in accounting firms and in money management organizations. The public has entrusted us with their money and we must do our best to represent their interests. The old definition of the duties of a money manager as simply to provide competitive returns, while necessary, is no longer sufficient. We must remember that all financial businesses are based on public confidence, and public confidence has been badly shaken by the events of the past three years. In order to help restore public confidence, the money management industry is going to have to do some investing – in its own credibility.

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