Long Horizon Investing and Corporate Governance

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at the

International Centre for Pension Management

Toronto, Canada

June 7, 2006

The Battle for the Soul of Capitalism

OWNERS' Capitalism – Ownership Society

↓

"Pathological Mutation"

↓

MANAGERS' Capitalism – Agency Society

↓

Advance in Investment Values

↓

TRUSTEES' Capitalism – Fiduciary Society

15 Largest Holders of U.S. Equities

		Value (mil)	Cum. Share of All U.S. Equities	% in Mutual Funds
1	Fidelity Investments	$575,079	4.2%	83%
2	Barclays Global Investors	537,824	8.2	7
3	State Street Global Advisors	447,039	11.5	10
4	Capital Group Cos.	414,268	14.5	66
5	Vanguard Group	297,007	16.7	97
6	AXA Group	261,385	18.6	10
7	Wellington Mgmt Co.	233,601	20.3	45
8	Northern Trust	232,462	22.0	3
9	Mellon Financial Corp.	198,611	23.5	15
10	J.P. Morgan Asset Mgmt	168,059	24.7	5
11	Citigroup	168,039	26.0	27
12	T. Rowe Price Group	153,658	27.1	65
13	Legg Mason	138,112	28.1	34
14	TIAA-CREF	124,878	29.0	4
15	Amvescap	115,031	29.9	48

25 Largest:	$5.0 tril	37%
100 Largest:	7.8	57%
300 Largest:	8.4	62%

12 Largest Public Fund Holders of U.S. Equities

Overall Rank		Value (mil)
37	California Public Employees' Retirement System	$60,875
46	New York State Teachers' Retirement System	48,484
48	Teacher Retirement System of Texas	47,562
49	New York State Common Retirement Fund	44,374
51	Florida State Board of Administration	41,664
57	New Jersey Division of Investment	35,382
68	Ohio Public Employees' Retirement System	26,792
71	State of Wisconsin Investment Board	25,355
76	Michigan Retirement Systems	24,167
79	State Teachers' Retirement System of Ohio	23,093
84	California State Teachers' Retirement System	19,312
96	Pennsylvania Public School Employees' Retirement	15,661

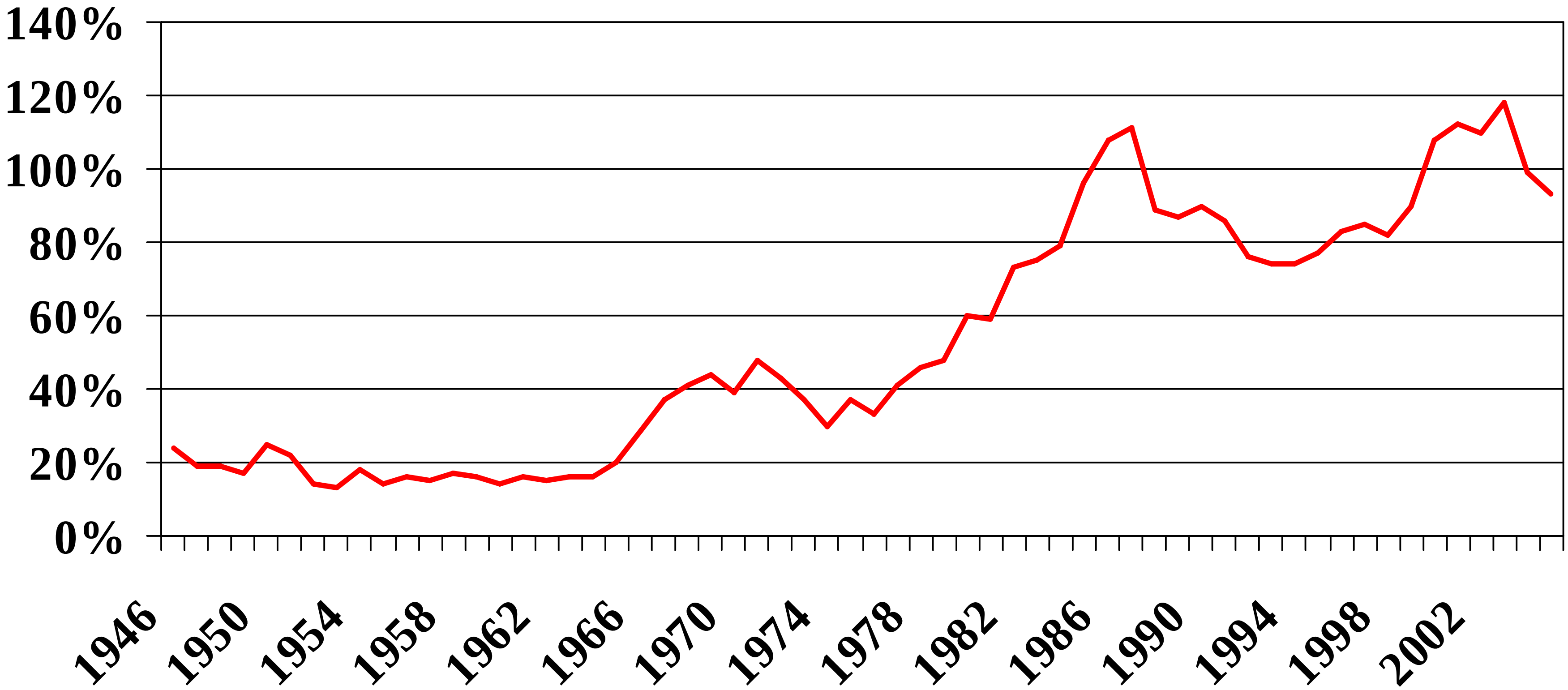
Total: $417.7b

Share of U.S. Stocks: 3%

Hear Adam Smith

"It cannot be well expected that the directors of companies, being the managers rather of other people's money than of their own, should watch over it with the same anxious vigilance with which partners in a copartnery frequently watch over their own. Like the stewards of a rich man, they very easily give themselves a dispensation. Negligence and profusion must always prevail."

Average Equity Fund Turnover



Aggregate Equity Fund Turnover

	w/ Index Funds	w/o Index Funds
2001:	76%	79%
2005:	54%	61%

Warren Buffett on Value vs. Price

"Intrinsic value is the discounted value of the cash that can be taken out of the business during its remaining life . . . When the stock temporarily over-performs or under-performs the business, a limited number of shareholders—either sellers or buyers—receive out-sized benefits at the expense of those they trade with. *But over time, the aggregate gains made by Berkshire shareholders must of necessity match the business gains of the company*."

Portfolio Turnover vs. Annual Returns

942 Equity Funds

(Morningstar Data for 10 Years Ended 2/2005)

	Turnover	Trans. Costs	Exp. Ratio	Net Pre-Tax Return	Risk (SD)	Risk-Adj PT Ret.	Risk-Adj AT Ret.
1Q	13%	0.1%	1.0%	11.5%	16%	11.6%	10.1%
2Q	40	0.4	1.1	11.1	17	10.9	9.0
3Q	75	0.7	1.3	10.1	19	9.5	7.5
4Q	165	1.5	1.3	9.8	21	8.9	6.5
Avg	73%	0.7%	1.2%	10.6%	18%	10.3%	8.3%

Portfolio Turnover vs. Annual Returns

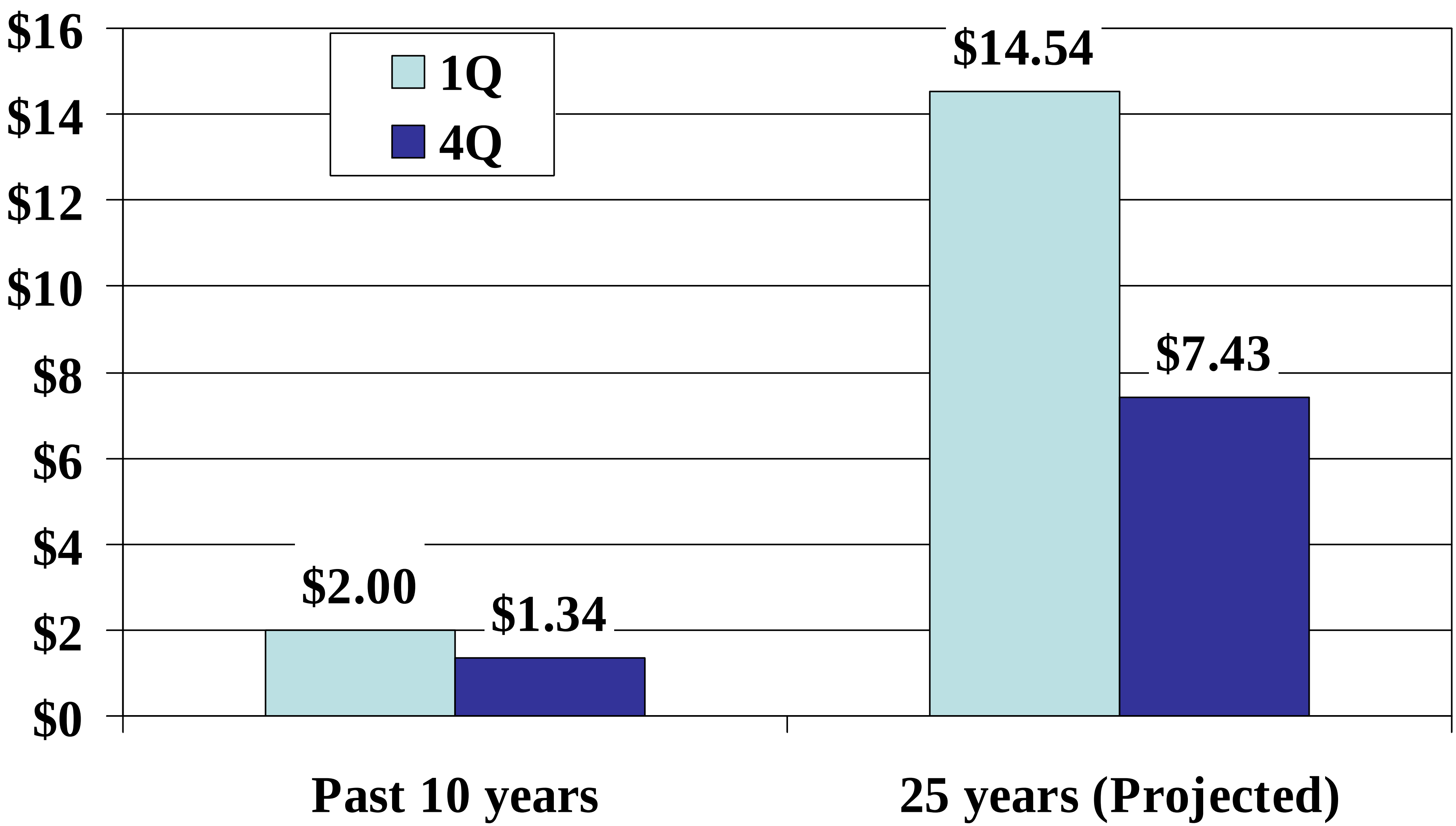
(Morningstar Boxes)

Spread in Risk-Adjusted After-Tax Returns Between High and Low Turnover Quartiles

All Domestic Equity Funds: 10.1% - 6.5% = 3.6%

	Blend	Growth	Value
Large Cap	2.0%	1.4%	2.1%
Mid Cap	3.7	2.7	4.4
Small Cap	1.3	4.0	1.9

Pre-tax Profit on $1 in Low Turnover and High Turnover Quartiles



Participation in Governance Issues by Private Investment Managers

Issue	Number
Sponsor of proxy resolution opposed by management.	0
Congressional testimony on Sarbanes-Oxley.	0
Urging FASB to require expensing of stock options.	0
Rights and responsibilities of institutional owners.	1
Comments on SEC executive compensation release.	1*
Comments on SEC release on director nomination.	0**

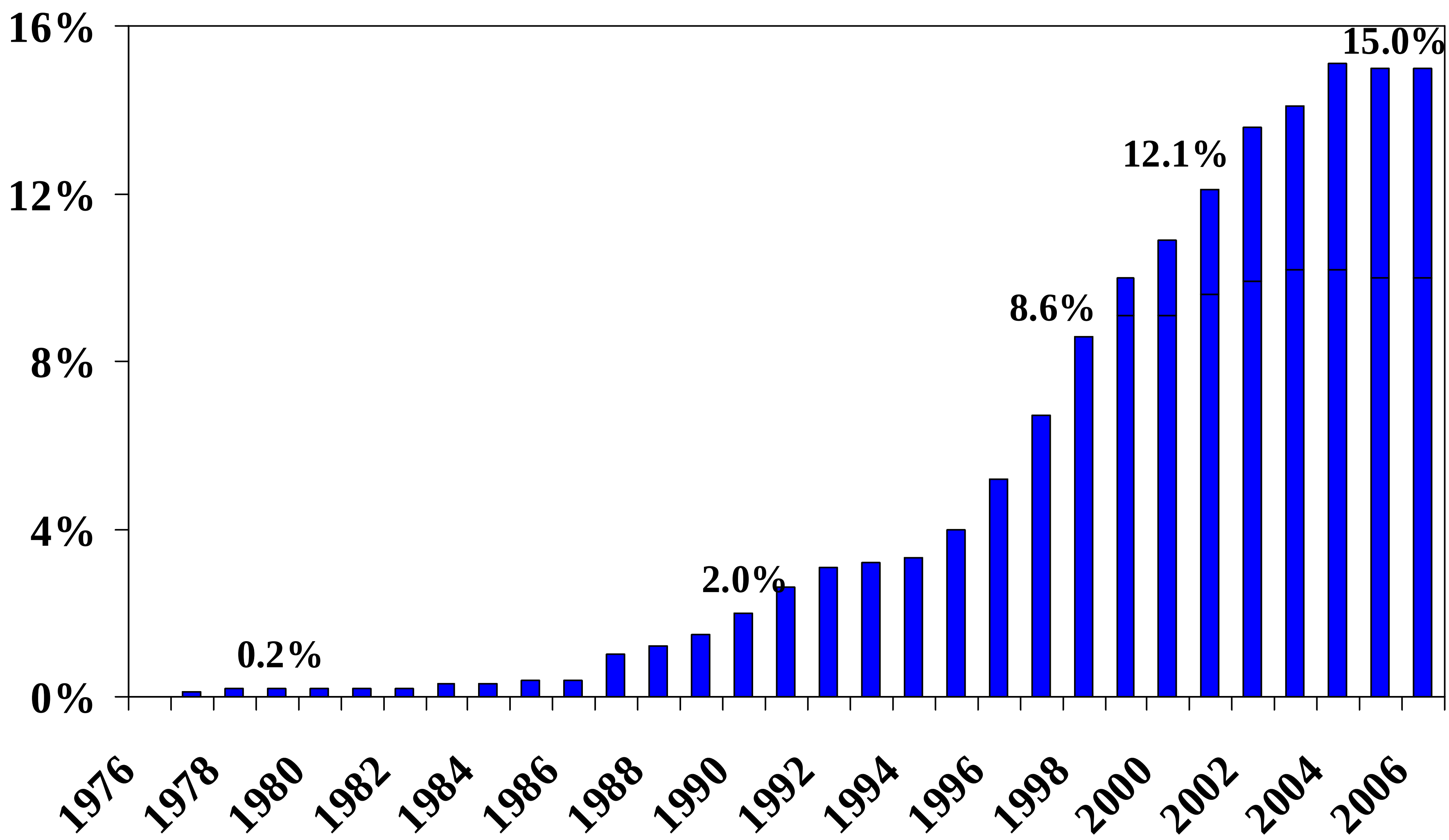
*Made by fund group controlled by labor union.
**17,000 public responses. No major firm sought easier access.

Collectively Addressing the Responsibilities of Index Funds

Thamotheram and Wildsmith

Many pension funds now have an index-tracking core, and low margins and economies of scale mean that this market is served by only a few large fund management firms. This concentration creates an important opportunity for the largest pension funds to require these firms to jointly fund permanent teams that focus on enhancing long-term market returns through carefully targeted shareholder activism undertaken on behalf of all their clients. The largest pension funds would play a key role in the governance of these teams . . . staffed by those already engaging on behalf of long-term investors. The teams would focus on a combination of key issues and/or key sectors where value-destroying market failure is evident or likely. Ongoing or intermittent interventions would be possible. The staff would be significantly freed from the marketing and reporting pressures and also the conflicts of interest in their current corporate reporting lines. This would create the context for both healthier, but also more assertive (when needed), relationships with corporations. It is also likely to be a more cost effective solution.

Indexed Share of Equity Fund Assets



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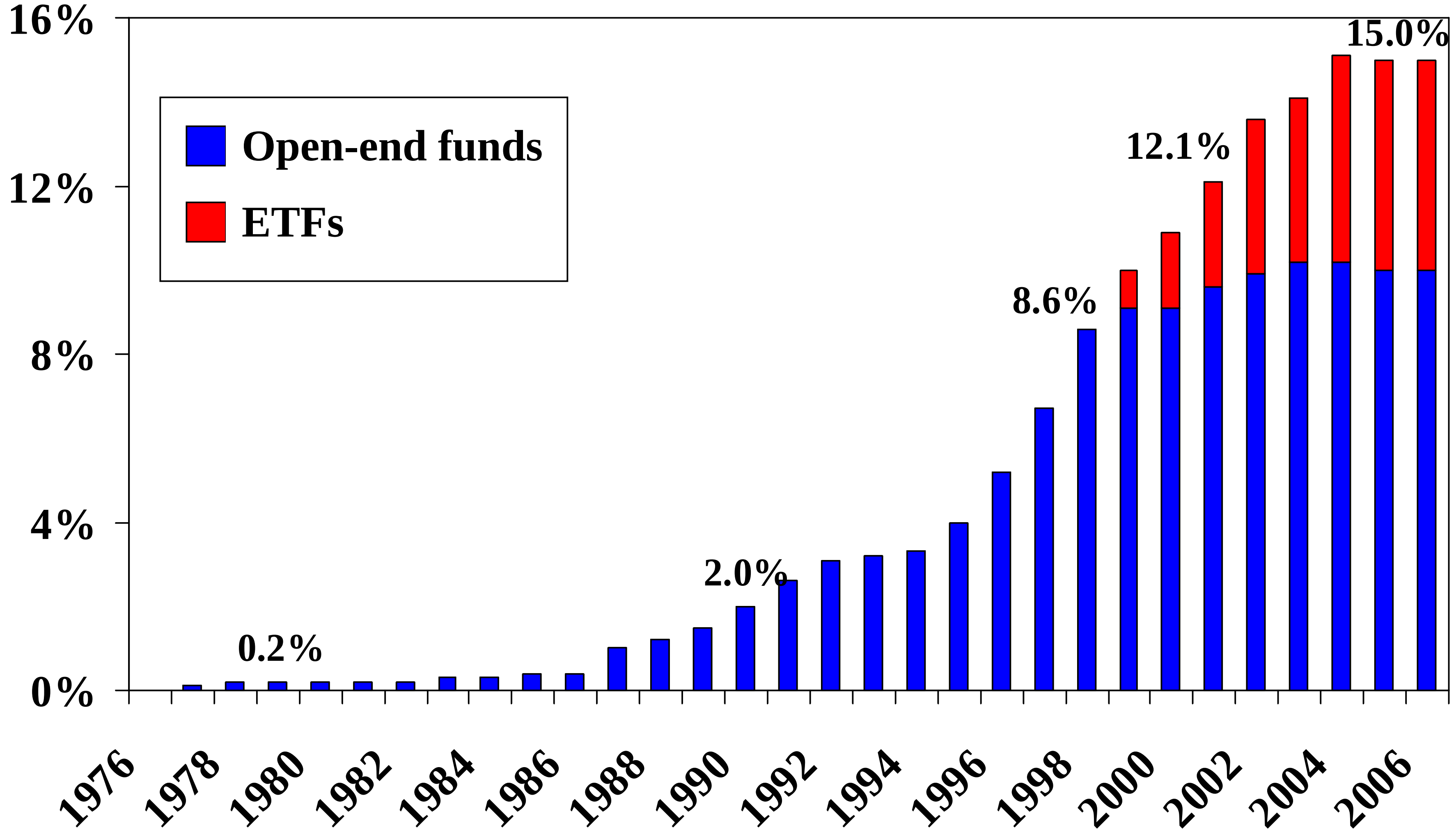
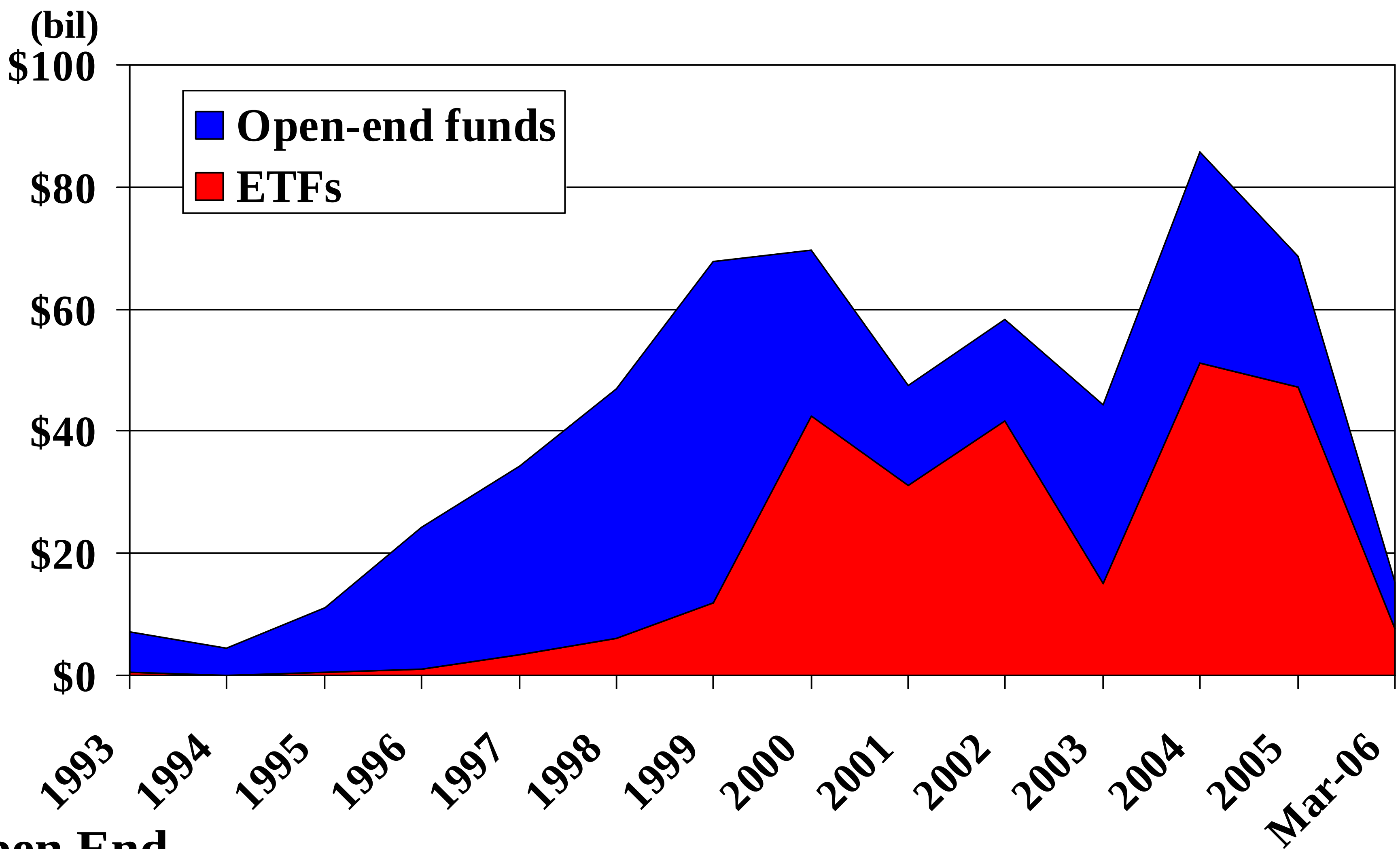


Index Fund Net Cash Flow



Open End Fund Share	95%	82%	29%	31%

Hopes for an Awakening

1. **Individual investors' economic education.**
2. **Fund manager restructuring.**
3. **Reporting proxy votes *seems* to raise participation.**
4. **Change in focus—earnings to cash.**
5. **The return of the astute analyst.**
6. **Focus on dividends—raise for LH owners.**
7. **Focus on taxes—even for tax-exempt investors.**
8. **Focus on access—open for LH owners.**
9. **Separating chairman and CEO roles.**
10. **Information for Directors.**

Warren Buffett on Short-Termism (1986)

(Daily volume on NYSE: 141m)

What can be done, now that the whirlpool of speculation has engulfed enterprise? Let the government impose a 100 percent tax on any profits derived from the sale of stocks or derivative instruments that the holder has owned for less than a year. Any apply the tax to everyone, including pension funds and other entities that normally are not taxed. It's one of Wall Street's many ironies that such funds, which should have the longest investment perspective, have been transformed by the competitive race on Wall Street into some of the most speculative players around. One result of a 100 percent tax would be certain: the substantial brain power and energy now applied to the making of investment decisions that will produce the greatest rewards in a few minutes, days or weeks would be instantly reoriented to decisions promising the greatest long-term rewards.

Carlyle Group chairman Lou Gerstner on Short-Termism

(Daily volume on NYSE: 1.6b)

The Problem: In a private setting, you eliminate the dysfunctional short-term focus on quarterly results that dominates the market today . . . you have a longer time frame, and you have a direct alignment of the shareholders with the management to fix the company, to build value over time, and to be patient with the changes.

A Solution: To have large investors benefit from [focusing on] the long term, I propose that we should tax gains differently for long-term investors than for short-term investors. Until we figure out a way to get [large investors in public companies] to deal with long-term performance, then all of the other things we're doing will not change the preoccupation with short-term results.

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Robert Monks
"Capitalism Without Owners Will Fail"

"Government involvement is clearly needed in corporate governance to guarantee the nation's citizens the neglected rights of ownership of their stocks. What is needed is a clear and consistently enforced public policy that gives all owners' representatives, the intermediary investment institutions and their fund managers, the clear fiduciary requirement to be active with respect to companies held in their portfolio accounts, and the confidence that they will not be placed at a competitive or reputational disadvantage with their competitors by complying. Above all else, it must be unmistakable that government intends, and is capable of enforcing, the trustee and fiduciary laws for the *sole* purpose and *exclusive* benefit of their beneficiaries' interests—the great part of the funded pensions of most citizens—in an even-handed way."

Words of a Radical?

Benjamin Graham on Shareholder Activism (1949)

1. Shareholders are a complete washout, lacking intelligence and awareness, and voting in sheep-like fashion.

2. If inefficient or dishonest managements exist, “the owners of the nation’s largest businesses must take intelligent action.”

Action 1: Substantial shareholders must recognize the need for change.

Action 2: Other shareholders should consider arguments on both sides.

Action 3: Shareholders call in outside business engineers (at a cost borne by the company).

Action 4: Financial agencies (i.e. NYSE, CFA Inst.) and large investment managers support shareholder demands.

Action 5: Select one or more experienced directors who provide a separate annual report to stockholders.