Judge Institute
Institutional Investors

g **Capital trumps nationalism.** *That is one message that comes from Daimler Benz's talks with Chrysler and General Electric's purchase of a number of Samsung's core businesses. Prosperity in the U.S., panic in Asia, and unemployment in Europe are eroding powerful attitudes toward "national champions" and barriers to foreign ownership. It would have been inconceivable just a short time ago for the U.S. to sell off one of Detroit's Big Three or for Korea to agree to dismantling one of its chief* **chaebol.** *Capital has become more powerful than nationalism today.*

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1. We need a new vocabulary to talk of Institutional Investors. We will start with a political mode and recognize that the hegemony of Institutional Investors is a new phenomena. While we have long had insurance companies and pooled funds as significant owners of corporations, the current situation in which institutions own a majority in the U.S. and over 70% in the UK of all publicly outstanding stock is a phenomena with its origins in the immediate post World War II years and its realization only in the last dozen.

2. In the aftermath of the Second World War, the anglophone countries wanted to create a structure that would encourage citizens to save for their retirement. By creating massive tax incentives, government insured that national savings would agglomerate in the pension trusts rather than in the savings banks. The arithmetic is compelling. One way you save pre tax and the other way you can only put money in the bank after paying a tax. Combine this with the ability to realize dividends and gains without tax and it is a wonder that *any* of the traditional savings institutions survived. These tax incentives are in aid of a public purpose. Savings bank deposits could be withdrawn for any purpose; subsidized savings are to be used for retirement. In order to insure that the moneys were actually used for the appropriate purpose, government required that they be placed in trusts. Trust institutions and the percentage of national assets subject to trust discipline were thus hugely expanded by the government, with some important but surprisingly little noted consequences.

3. By trying to achieve one laudable social end, the anglophone countries achieved another whose consequences they could not have anticipated. In the early ‘80s, when I was the American Federal official responsible for administration of the private pension system, I lived in the infamous Watergate in the apartment next door to retired Senator Jacob Javits, who was widely known as the Congressional "father" of pension legislation. I asked him one day: "Jack, how could you have realized that you were creating the greatest of national treasure long term investable funds - when you thought you were simply dealing with old age problems." I will never forget his reply: " Bob, no one ever accused me of being modest, but I must confess to you that we never thought of it." By such quirks human history devolves. Neither the French, nor the Germans, nor the Japanese have developed the vast long term investment reserves that exist conspicuously in the funded pension systems of the United Kingdom, Holland, Canada, Australia as well as the United States.

4. In the post cold war world, from the perspective of advancing the nation’s interests the Seven or so Trillion Dollars of investable capital at century’s end in the American pension system is the equivalent of as many battleships at its beginning. With the virtually free, immediate and universal availability of information; the instantaneous and unfettered transferability of cash; and the freedom from exchange and investment controls, it is not hyperbole to characterize institutional investors as one of the greatest forces for progress in the world today. To take one

example look what is happening with power and communications systems in the Third World. For decades this was the high-risk province of government and international guaranteed financing. We are now finding out that private investors backed by pension fund money have been able to construct and finance more efficient and economical systems than was ever possible in the past. Long-term investment capital may have more impact in determining the nature of the world in the twenty-first century than religion, armies and government.

UK and US funds are now playing a crucial role in the transformation of the European corporate sector - equity culture is unique

Concept of trust law seems unique to the Anglophone countries - not found in Europe and Japan.

Anglo-Saxon

Investment restrictions are for more liberal than those elsewhere (cf Japan - Postal Savings.)

5. We need pause to consider the classes of institutional investor other than public and private pension funds. Most conspicuous are what is called in America the open ended mutual fund, whose aggregate holdings approach those of the pension funds. The Investment Company Act of 1940 proscribes that these funds operate in a trust mode. It is thought that mutual funds are more "short term" in orientation than pension funds because of the need always to be in the position to buy back any investor’s position. Insurance companies invest their own money, but they are significant principally managers of pension funds. There are university and endowment funds with vastly increasing totals Harvard University, for example, is not far from $10 BB. Education and foundation trustees are increasingly sensitive to the importance of corporate support in carrying out their programs, so are not inclined as one might expect - to be leaders in setting the standard for ownership of portfolio companies.

In America, the truth is that virtually all institutional investors have severely conflicted interests in functioning as effective monitors of portfolio companies. The trustees of private company plans have a kind of Golden Rule " Do unto your portfolio companies as you would have their pension plans do unto you." The mutual fund and insurance conglomerates and pension managers all are in the business of selling products to just those managements who would be affronted and discombobulated by effective monitoring. There are laws in place that recite the solemn centurys’ old trustees’ rules the trustee must manage trust assets exclusively for the benefit of the plan beneficiaries. While this clearly requires an "eye sole" to the plan participant and away from the trustees’ other business interests, the law is not enforced and, in my opinion, is unlikely to be. If the political will could be summoned, it is interesting to speculate what would happen if the great money managers were required to choose either act as a trustee or conduct your other businesses. You cannot do both.

6. Institutional investors have unique and surprising micro economic characteristics. In words of one syllable they are wonderful niche businesses. The incremental costs for new businesses are virtually zero. Once you are organized to manage a billion pounds, the next billion involves little more than keystrokes on the computer system. Let me start by pointing out there is intense competition; and that the worst performers are in real danger of being sacked.

The fee structure is a capitalist’s dream:

- No correlation to cost;
- Virtually no correlation to performance; and
- Price is not a significant competitive factor.

There are many examples of profit sharing, but I have never encountered an arrangement whereunder a manager was required to rebate losses. The economic attributes of institutional investors might best be understood as being a "legislated monopoly". Access to the tax savings (also apparent in the case of mutual funds) can only be earned by organizing the vehicle in the manner stipulated by law. Companies organizing funds want nonetheless - to keep some control over them. A company that is obligated to pay out "defined benefit" pensions quite properly is concerned as to how the funds are managed which it has contributed for those purposes.

At the end of the day, the persons affected by the level of fees are the plan participants in employee benefit schemes and the beneficial owners of mutual funds. No one has devised a way of overcoming the "collective action" problem for these huge groups. What makes sense for the group as a whole lower fees does not make sense for an individual to commit resources to achieving. This problem, which is also called the "free rider" problem, will crop up later in our analysis, when we consider shareholder activism.

Plainly, a fee structure based mainly on performance above the index would be appropriate.

1. Institutional Investors are a macro economic anomaly. It is well known, though not widely published, that the cumulative results of "active management" of institutional portfolios is negative. Put another way, if all pension fund assets were invested in index funds, performance would be better than it is today. When you consider that the aggregate size of pension funds in the U.S. is pushing 7 trillion dollars and the average management fee can be taken as 1⁄2 of 1%, it is apparent that $35 BB is being siphoned out of the economy without adding value. Clients always hope that their manager will turn out to be another Warren Buffett and it is a fact that some managers over surprisingly long periods of time outperform the market significantly. Characterizing the impact of money management on the economy as a whole, one is driven to style it a tax associated with providing a retirement system.

2. Money managers and consultants are among the most highly paid classes of worker in the world. You should see a rather splendid film WAG THE DOG, if for no other reason than to appreciate its Beverly Hills location which is the $52 million house of Wilshire Associates principal Dennis Tito. Ned Johnson, the inheritor and builder of Fidelity, is thought to be worth in excess of $5 billion. If you wonder why institutional investors have failed so utterly in their indispensable role as monitors of corporate conduct where managers have conflicting interests quintessentially in the area of setting their own pay it is well to remember that level of compensation is really not a subject that lies well in their mouths.

3. We need think of institutional investors in a political mode. Because of their control over the investment of funds, institutions exercise vast power over the lives of individual citizens. Hayek forcibly reminds us that this power must be confined to the economic sphere. The citizenry has conferred no authority on companies to set standards of for example pollution, safety, fairness in hiring. We expect the institutions, as owners, not run portfolio companies they are neither paid nor competent to do so but to monitor management. This means that the owners are responsible that "their" companies are competitive, that they obey the law, disclose information about their functioning that has a material impact on society, and are restrained in their dealing with the political process.

4. Now lets think of Institutional Investors in personal terms. Who are they? The trustees of private pension plans are apt to be corporate officers; the trustees of public plans are appointed and elected according to a myriad of protocols; and the trustees of mutual funds are in fact selected by the manager. Almost invariably, the trustees choose to delegate the responsibility for managing assets to professional money managers. Exceptions such as the Public Employees Retirement System of the State of California are conspicuous. Two American anthropologists [O'Barr and Connally] were commissioned to study and write a book about institutional investors. Their conclusion is that this is a system designed to avoid accountability. Trustees have long term appointments, money and power. They are part of a system that gives the appearance of working

well. They will need incentive from outside if they are significantly to change their mode of operation. The money managers, as we have earlier mentioned, are among the most clever and the best paid individuals in society their cleverness lies in doing indoor work with no heavy lifting and no requirement for performance, all for unimaginably large sums of money.

5. A significant number of people are extremely well paid - corporate officers, trustees, money managers, professional advisors, consultants (remember Dennis' $52 million house) - under the present system. There will continue to be effective, if polite, resistance to any significant changes. The monitoring of portfolio companies requires expense and more importantly challenge to a self reinforcing power structure that appears a seamless web of pure gold. We cannot expect individual institutions to accept this burden, until

o It is cost / effective;
o The 'free rider' problem is mitigated; and
o Conflict of interest laws will be enforced to the extent that monitoring institutions do not run the risk of commercial retribution.

1. Increasing evidence is available from the American experience that shareholder activism creates value. McKinsey Quarterly 1996-4 surveys institutional investors and corporate managers to conclude that good "board governance" is considered to be worth upwards of 10% of value. Several investment funds, like my own LENS, have demonstrated the ability to add value to underperforming companies. This creases a theoretical framework within which it might be possible to claim that trustees who are not activist should be liable for failing to take appropriate steps to enhance the value of trust assets. Value is not the most difficult problem. That is how to make it attractive for institutions to involve themselves in the trouble and expense of getting information and taking action with respect to underperforming portfolio companies. This is the subject for several speeches, but let us just consider what I will call the Buffett solution. When Warren Buffett is known to be a shareholder in a company, a great many people want to buy the stock. Buffett in situations like Solomon Brothers where he personally went to work for nothing in order to pull the company out of threatened liquidation has demonstrated the ultimate ability of effective monitoring. What he has done in several situations is to involve himself through the issuance of a special class of stock - usually convertible preferred that compensates him for the undoubted value that his presence confers on to the shareholders generally. Whether or not this model becomes more widespread, it clearly signals the need to create an incentive system whether carrot or stick for owner involvement.

2. Peter Drucker wrote a book entitled "Pension Fund Socialism" some twenty years ago and speculated that Karl Marx would be a happy man to witness that employees own 30% of American industry through their pension plans. One might say there is ownership and there is ownership. While the plan participants certainly benefit from the funding of their retirement promises, they can hardly be considered "owners" of a scheme of which they know little and can affect less. One of the great challenges confronting Governance in the twenty first century will be to inform and to reflect the views of the beneficial owners of the Institutions. This problem is only rarely articulated; nothing has been done to address it. It is of the utmost importance because the legitimacy of corporate power may well be established through the informed involvement of up to half of the citizens (Upwards of 100,000,000 Americans are estimated to have beneficial ownership in publicly traded companies through pension and mutual funds).

3. At this point it is well to introduce another player the Government. Following a series of bankruptcies and other financial disasters in the '70s, Lord Henry Benson committed the Bank of England to the effort of identifying and helping companies before collapse was inevitable. With help from Sir Adrian Cadbury a non-executive director of the Bank and Jonathan Charkham, a series of steps were taken. PRO NED was organized to provide for fully professional non-executive directors; the Bank spoke out, often in the voice of Sir David Walker, about the need for involvement by the owners institutional investors in the affairs of troubled companies. Walker

spoke in the idiom of the process of privatization which was then taking place. He asked what difference does it make whether the government owns a company or whether it is owned by private institutions? Does it make a difference? Everyone assumes that it does. This must be based on the conclusion that private institutions organize themselves to relate to portfolio companies in a manner different than the government. Exactly what does this mean? {This, of course, is a drama that is being played out in France today.} It means that the rather fuzzy (because of government's flexible definition of "profit") accountability to a government agency is replaced by the survival instincts of a self perpetuating cadre of executive and non-executive directors. To a certain extent these directors are perceived as living in the real world of reported earnings, annual meetings, the financial press and owners. The theory is that if they perform badly, the company will be taken over or they will be replaced. The reality is somewhat different.

4. Everyone agrees that owners need to be involved in monitoring these areas of corporate functioning where management has interests that conflict with those of the owners. Executive compensation is the apotheosis of conflicted interest the conflict could not be more clear. {I wrote a rather angry speech for the American Bar Association on this subject at the end of last year. It will be published in a forthcoming edition of CORPORATE GOVERNACE an international journal} In the United States today, managements have used their power to

o Change accounting practices so that the amount of their compensation is not reflected on the company's books of account - ***stealth***;
o Dominated the world of compensation professionals to the extent that no established voice is raised about the levels and terms of executive pay ***force*** ; and
o Acquired through options (that can be repriced if the market turns south) in excess of 10% of all the outstanding stock of publicly traded American companies - ***confusion***.

The current situation of executive compensation in America represents one of the largest non-violent transfers of wealth from one class to another in recorded history.

1. One is forced to conclude that in precisely that area where informed and effective monitoring is most appropriate how much the agent is paid for running the principal's business the results suggest that it is ineffective. The conclusions to be drawn from this appear to be real power continues to exist in the self perpetuating management; ***on issues that are really critical management can do what it likes***; on less sensitive issues management accepts the perception, and sometimes even the reality, of effective monitoring by institutions. Business is demonstrating a sensible political judgement. While society in the anglophone world is disenchanted with state ownership of industry, it will not tolerate a business sector that is accountable to no one. It appears that management will acquiesce in shareholder activism so long as it does not affect "pay" and, possibly, other critical areas. Is this an acceptable situation in a free society?

2. Sir Ronald Hampel for the business sector has recently concluded that "All is for the best in this best of all possible worlds." Enter Margaret Beckett she has unmistakably called for a "step up" in institutional monitoring. In a world where the stock markets are booming, there is little energy for calling attention to such inconveniences as conflicting interests. In the United States, the most prominent shareholder activists are the Public Pension Plans epitomized by CalPERS and the State of Wisconsin Investment Board presumably because they uniquely among institutions do not have crippling conflicts of interest. There is an irony here, because public plans are limited by civil service hiring standards and are not staffed by individuals with any particular business experience. Those trustee organizations who are staffed with highly experienced business executives simply are not going to put themselves in the position of losing business or place by "volunteering" to "step up" their corporate monitoring efforts. What is needed is to raise the bar. So long as trustees are free to function with their conflict of interest and to decide whether they chose to take up the responsibilities of ownership, there may be the appearance but there certainly will not be the reality of governance. If all trustees know that they will be held to

account on an "exclusive benefit" basis, then each trustee will be able to act without concern for commercial blackmail.

Every once in a while, a legal device is helpful suppose the government let it be known that the present situation of conflicted interest trustees would not be disturbed, but that these trustees would have the burden of proving that their conflicting interests did not derogate from the value of the trust estate.

3. We are talking huge sums of money, here, and of the most profitable business in the world today. Changes will not come easily. Hopefully, we will not need a serious downturn or depression in order to begin the process of setting right the governance system.