

# Los Angeles Department of Fire & Police Pensions

## *Corporate Governance Background*

January 2009

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# *What is Corporate Governance Investing?*



# What is Corporate Governance Investing?

- The guiding principle of corporate governance investing is identical to traditional investing:
  - increasing risk adjusted returns.
- Security selection is typically of “deep value,” and highly concentrated in a few firms.
- Corporate Governance investors tend to hold investments for long periods, typically 2-3 years.
- Corporate Governance strategies emphasize direct engagement with a portfolio company’s management and board to influence policies and practices to improve the long-term shareholder value.
- Some of the tools advocacy investors use to achieve their desired returns include:
  - advocacy for Board accountability,
  - increasing transparency, and
  - disentangling entrenched boards, often via proxy voting.

# What is Corporate Governance Investing?

- The relatively long holding periods often result in a second objective of increasing equity value over the long-term.
- Corporate Governance investing can broaden the opportunity set of the System's public equity investment portfolio.
- Corporate Governance investing adds a complementary investment tool to the Plan's Corporate Governance efforts.
- Corporate Governance investing does not explicitly concern itself with political or social issues.



# *Evolution of Corporate Governance Investing*



# Evolution of Corporate Governance Investing

- Corporate Governance market has grown significantly over the past decade.
- CalSTRS, the City of New York, Oregon Investment Council, Virginia Retirement System, Maryland State Retirement Agency, the World Bank and LACERS invest in this market segment.
- CalPERS has grown its program from an initial \$200 million allocation in 1999, to \$12 billion in 2007, with a policy limit of not more than 8% of global equities.
- LACERS launched its first efforts in 2005, and in 2007 increased its allocation to Corporate Governance Funds.

# *Evolution of Corporate Governance Investing*

- An increasing body of academic and practitioner research, and plan sponsor results has shown the efficacy of well conceptualized and implemented Corporate Governance investment and activism.
- The number of well-qualified and experienced practitioners has increased.
- As the number of firms has expanded, so has the variety of approaches and strategies.
- What was once a limited market with few players and limited approaches has become more robust.
- Today, there are Corporate Governance Funds that specialize in Large Cap stocks, Small Cap stocks, and in geographic regions across the globe.



# Evolution of Corporate Governance Investing

SUMMARY OF U.S. CORPORATE GOVERNANCE FIRMS AND PRODUCTS*				
Firm/ (Headquarters & Offices)	Year Firm Inception		Assets: Corp Gov	Mandate/Benchmark
<b>U.S. Large Cap</b>				
New Mountain Capital (New York)	2000		\$1.2B	US Mid to Large Cap/S&P500
Pershing Square (New York)	2003		\$6.3B	US & CA Large Cap/S&P500 or R1000
Relational (San Diego, CA)	1996		\$7.1B	US Large Cap/S&P500
<b>U.S. Small/Mid Cap</b>				
CI-Blum Capital (San Francisco)	1975		\$3.7B	US Small to MID /R2000
Breeden Capital (Greenwich, CT)	2005		\$1.0B	US Mid Cap/S&P500

\* From LACERS' 2007 Corporate Governance Search

- A handful of Corporate Governance Funds that have existed for over ten years.
- Today there are funds that specialize in large cap and mid to small cap investing

# Evolution of Corporate Governance Investing

## SUMMARY OF NON-U.S. CORPORATE GOVERNANCE FIRMS AND PRODUCTS\*

<b>Western Europe</b>				
Governance for Owners (London)	2004	6	\$0.3B	European Large Cap/FTSE All World Developed European Total Return
Hermes Europe ex-UK (London)	2001	11 (6 dedicated)	\$3.2	Europe ex-UK
KnightVinke (NY, Eldorado, Monaco)	2003	5	\$1.5B	Large Cap Western Europe/FTSE Europe
<b>U.K.</b>				
Hermes UK large cap (London)	1998	12 (7 dedicated)	\$2.1B	UK Large Cap
Hermes UK small Cap (London)	2002	11 (3 dedicated)	\$0.4B	UK Small Cap
Principle Capital Fund (Geneva, Switzerland)	2004	11	\$0.3B	UK SMID/FTSE All Share
<b>Japan</b>				
Nissay Hermes Stewardship Fund (London, Japan)	2005	28	\$0.3B	Japan All Cap/Topix
SPARX (Ohsaki, Japan, New York)	1989	24	\$1.4B	Japan Mid-Large Cap /Topix
Taiyo Pacific Partners (Monterey, CA)	2003	22	\$1.3B	Japan Small Cap/Topix

\* From LACERS' 2007 Corporate Governance Search

➤ Geographic regions of coverage have expanded.

# *Risks and Returns*



- Does “good” corporate governance achieve the goal of increased returns?

## Academic Studies

- Gompers et.al studied a sample of 1,500 firms and 24 corporate governance “provisions” such as poison pills and other anti-hostile takeover devices, found that in the 1990’s corporate governance was positively and strongly correlated with stock returns.
- The study shows that corporations with the highest shareholder rights (“good” corporate governance), outperform firms with low shareholder rights by 8.5% annually.
- Bebchuk (2004) isolates 6 “entrenching provisions” that are negatively correlated with firm performance, such as golden parachutes.
- Bebchuk’s findings show that the entrenching provisions corresponds negatively with firm valuation and with a reduction in stock returns from 1990-2003.

## Studies of the CalPERS' Corporate Governance Program

- “The ‘CalPERS Effect’ on Targeted Company Share Prices,” a 2007 report by Wilshire Associates, studies 128 companies targeted by CalPERS between 1987 and 2006.
- The study finds that prior to CalPERS’ involvement the companies on the list had a -13.8% annualized return.
- Immediately after being contacted by CalPERS, stock prices actually increase for some companies as this may indicate to the market that their governance is about to improve.
- Anson notes that some companies that are told they will be on the list are actually able to improve governance enough in the time between being notified and the list being published that they do not make it onto the final list at all.
- Another study found that on the day that the CalPERS list comes out, there is a positive market reaction of 23 basis points for firms on the list.
- After 5 years inclusion on the CalPERS Focus List, the Wilshire report found a company produced “12.2% above their respective benchmark return on a cumulative basis, or 2.3% per year on an annualized basis” [Wilshire].
- Barber calculates total wealth creation of \$3.1 billion between 1992-2005 attributable to CalPERS’ activism.
- The Focus List makes a more significant impact on large cap (S&P 500) companies than those with a small market cap.
- Anson finds that large cap companies earn an “excess return of 68% while small cap companies earn 38.3%.”

## Specific Risks Associated with Corporate Governance Investing

- The market is new, and thus lacks a proven long-term track record.
- Corporate governance investing has no substantial track record for such uncertain times as today's markets.
- The performance results of individual funds can be highly volatile, given the concentrated nature of the portfolios.
- In general, Corporate Governance Funds are closely aligned with value investing, and will typically be affected by different style preference periods over a business cycle.
- The funds typically charge fees more standard of private equity funds, because of the active engagement they undertake with investee companies.

# Risks and Returns

**Corporate Governance Manager Gross Returns (Periods Ending Sept. 30. 2008)**

	Quarter	1 Year	2 years	3 Years	4 Years	5 Years
Breeden -Corp	2.6	1.7	4.1	NA	NA	NA
Blum Stimson-Corp	-7.5	-22.4	-3.2	1.3	5	3.4
<b>Russell 2000 Index</b>	<b>-1.1</b>	<b>-14.5</b>	<b>-2</b>	<b>1.8</b>	<b>5.6</b>	<b>8.1</b>
New Mountain- Corp	-14.4	-13.2	-4.1	NA	NA	NA
Pershing Corp	1	15.5	20.9	23.9	33.7	NA
Relational-Corp	-5.7	-28.2	-9.7	-5.4	1.9	6.1
<b>S&amp;P 500 Index</b>	<b>-8.4</b>	<b>-22</b>	<b>-4.7</b>	<b>0.2</b>	<b>3.1</b>	<b>5.2</b>
Hermes Eur.-Corp	-22.1	-40.9	-16.8	-4.4	5	6.9
<b>MSCI Europe ex UK</b>	<b>-20.6</b>	<b>-30</b>	<b>-4.2</b>	<b>4.7</b>	<b>10</b>	<b>13.1</b>
Hermes UK-Corp	-9.4	-33.6	-17.5	-7.5	0.2	5.3
<b>MSCI United Kingdom</b>	<b>-21</b>	<b>-31.5</b>	<b>-8.4</b>	<b>-0.1</b>	<b>4.7</b>	<b>8.6</b>
Knight Vinke-Corp	-4.2	-15.9	-3.9	9.7	19.3	NA
Gov4owners-Corp	-32.2	-48.5	-17.1	NA	NA	NA
<b>MSCI Europe</b>	<b>-20.7</b>	<b>-30.5</b>	<b>-5.6</b>	<b>3</b>	<b>8.1</b>	<b>11.5</b>

- Few Investment Managers with 5-year track record
- Gross Returns vs. Benchmark Mixed.
- Time periods too short to make long-term judgment on performance.

# Risks and Returns

## Risk Return Statistics (Two Years Ending September 30, 2008)

	Avg # of Holdings	Annualized Return, %		Annualized StdDev, %		Alpha, %	Beta	MPT Statistics		
		Total	Excess	Total	Excess			R-Squared, %	Sharpe Ratio	Batting Average
New Mountain- Corp	24	-4.09	0.6	14.2	10.01	-0.76	0.8	53.23	-0.48	0.38
Pershing Corp	15	20.93	25.61	17.37	18.51	19.7	0.37	7.55	0.98	0.63
Relational-Corp		-9.7	-5.02	18.89	11.46	-3.17	1.17	64.1	-0.64	0.54
S&P 500 Index		-4.68	0	13.07	0	0	1	100	-0.59	0
Blum Stimson-Corp	16	-3.21	1.47	19.48	13.74	2.97	1.06	49.71	-0.26	0.54
Breeden -Corp	7.5	4.11	8.8	15.59	10	8.64	0.93	59.32	0.1	0.46
Russell 2000 Index		-1.98	2.7	14.98	6.64	3.31	1.03	80.26	-0.31	0.63
Knight Vinke-Corp	5-10	-3.88	0.81	17.49	10.94	1.91	1.05	60.79	-0.35	0.54
Gov4owners-Corp	10-12	-17.15	-12.46	25.29	23.29	-13.32	0.76	15.15	-0.76	0.54
MSCI Europe		-5.65	-0.96	18.08	9.23	1.33	1.2	75.41	-0.44	0.54
Hermes Eur.-Corp	16	-16.79	-12.1	22.97	13.15	-7.47	1.54	75.99	-0.84	0.5
MSCI Europe ex UK		-4.23	0.45	18.86	10.06	3.26	1.24	73.72	-0.33	0.54
Hermes UK-Corp	12	-17.53	-12.85	19.07	14.26	-13.6	0.97	43.43	-1.11	0.46
MSCI United Kingdom		-8.42	-3.73	17.24	9.13	-2.41	1.12	72.05	-0.64	0.5

- Highly concentrated number of holdings.
- Greater volatility than benchmark is typical.
- Time periods too short to make long-term judgment on performance.

# Fees



## Corporate Governance Funds – (Fees assume \$50 million under management)

Product	Annual Core Fees (% of Assets Under Mgt)	Annual Performance Fees
<b>U.S. Large Cap</b>		
New Mountain Capital	2%	20% net of mgt fees on 'absolute high water mark return or on net of benchmark return
Pershing Square	1.5%	20% absolute with a high water mark
Relational Investors	1.5%	20% of net of fees outperformance over benchmark
<b>U.S. Small Cap</b>		
Blum Capital	1%	20% net of fees absolute return with high water mark provision, 1-year lockup
Breeden Capital Mgt	2%	20% absolute return with high water mark
Evercore Asset Mgt	1.5%	20% net of fees absolute high water mark return
<b>Western Europe</b>		
Governance for Owners	1%	20% of net of fees outperformance over benchmark
Hermes West Europe	1.5%	20% net of fees subject to high water mark w/ 7% compound annual hurdle.
Knight Vinke	1.5%	20% net of fees subject to high water mark w/ 10% IRR annual hurdle; 20% clawback clause'. Or 20% net of fees outperformance over benchmark
<b>U.K.</b>		
Hermes UK LgCap	1.0%	20% net of fees outperformance over benchmark – highwater marked
Hermes UK SmCap	1.5%	20% net of fees outperformance over benchmark – highwater marked
Principle Capital Fund	1.5%	20% net of fees subject to high water mark w/ 7% compound annual hurdle.
<b>Japan</b>		
Nissay Hermes Japan	1.0%	20% net of fees outperformance over benchmark – highwater marked
SPARX Asset Mgt	2.0%	20% net of fees absolute high water mark
Taiyo Pacific Partners	2%	20% net of fees outperformance over benchmark

- Corporate Governance Fund fee structures are similar to those of private equity funds.
- Typically, these funds charge an annual management fee and a performance-based fee.

# *Conclusion*



# Summary and Conclusion

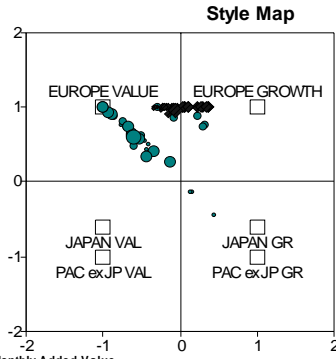
- Corporate Governance investing is relatively new.
- The profiles are generally highly concentrated, deep value investors that work actively with a small number of companies over several years to improve corporate governance and thereby increase shareholder returns.
- The Risk/Return Profiles are unproven.
- There is little experience with corporate governance investing in a deep recessionary market.
- There have been positive returns from this type of investment strategy.
- The fees have been structured more like private equity managers due to the active nature of the manager involvement with the public companies.
- The additional risks of corporate governance investing should be well understood prior to adding to an institutional portfolio.

## *Appendix – Corporate Governance Manager Report Cards*

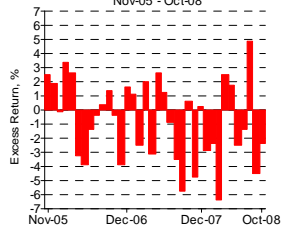


# Appendix - Corporate Governance Manager Report Cards

## Hermes Eur.



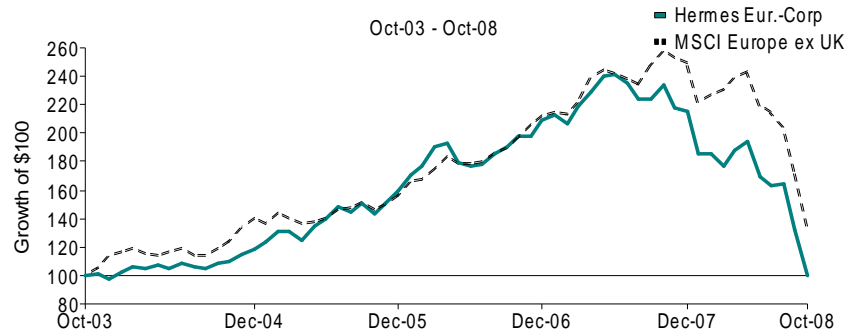
Monthly Added Value



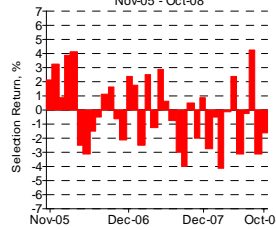
Annualized Return, % -8.9  
 Annualized StdDev, % 9.8  
 Information Ratio -0.9  
 Significance Level, % 94.6

## Cumulative Excess Performance

Oct-03 - Oct-08

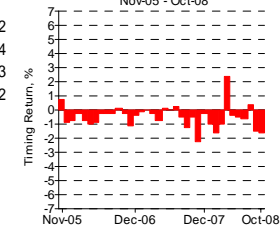


Monthly Added Value from Selection



Annualized Return, % -2.2  
 Annualized StdDev, % 8.4  
 Information Ratio -0.3  
 Significance Level, % 69.2

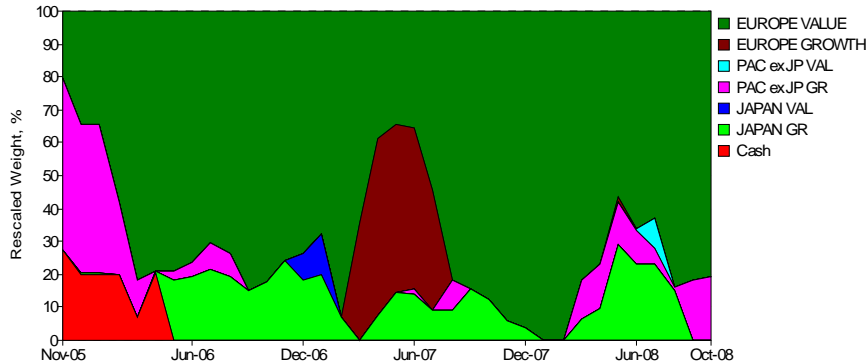
Monthly Added Value from Style Timing



Annualized Return, % -5.7  
 Annualized StdDev, % 2.7  
 Information Ratio -2.1  
 Significance Level, % 100.0

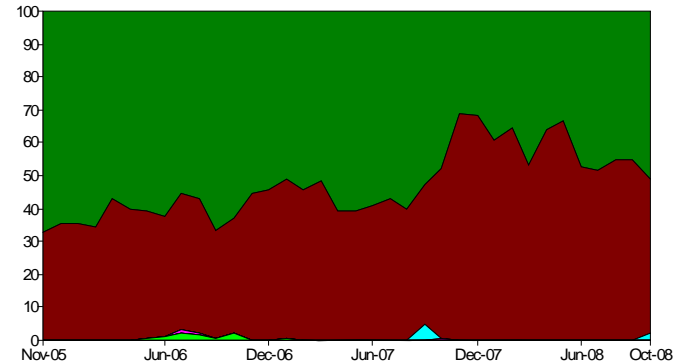
## Asset Loadings - Manager

Nov-05 - Oct-08



## Asset Loadings - Benchmark

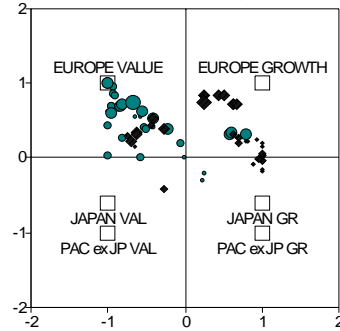
Nov-05 - Oct-08



# Appendix - Corporate Governance Manager Report Cards

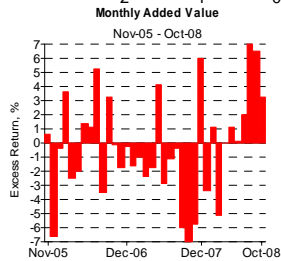
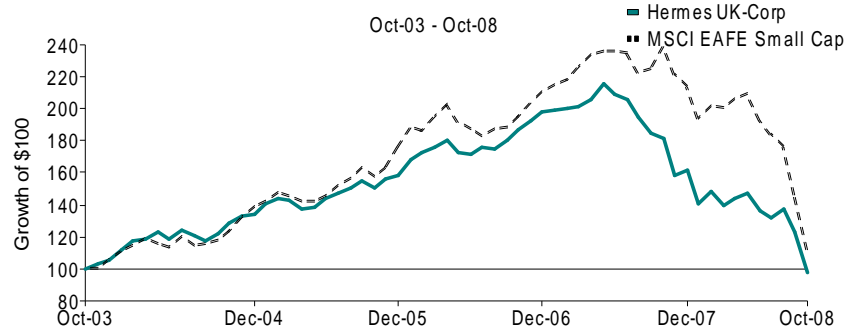
## Hermes Eur.

Style Map

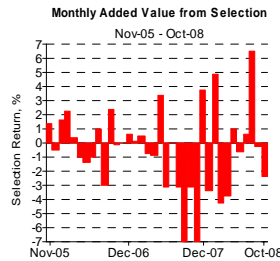


● Hermes UK-Corp  
◆ MSCI EAFE Small Cap

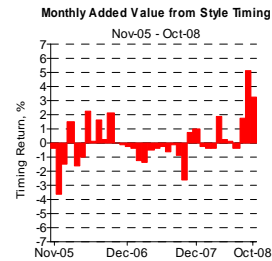
Cumulative Excess Performance



Annualized Return, % -2.4  
Annualized StdDev, % 13.1  
Information Ratio -0.2  
Significance Level, % 63.7

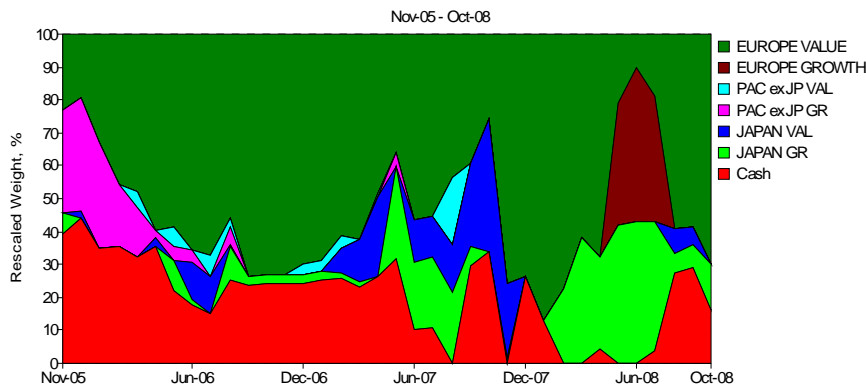


Annualized Return, % -6.4  
Annualized StdDev, % 10.5  
Information Ratio -0.6  
Significance Level, % 87.0

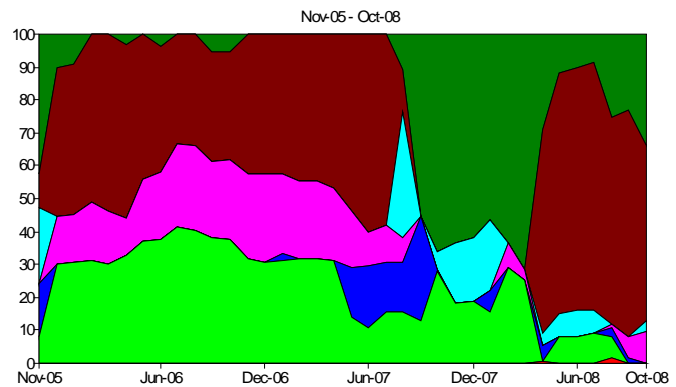


Annualized Return, % 1.8  
Annualized StdDev, % 5.6  
Information Ratio 0.3  
Significance Level, % 71.0

Asset Loadings - Manager



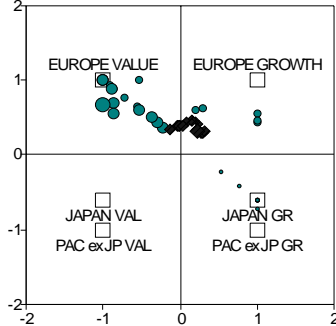
Asset Loadings - Benchmark



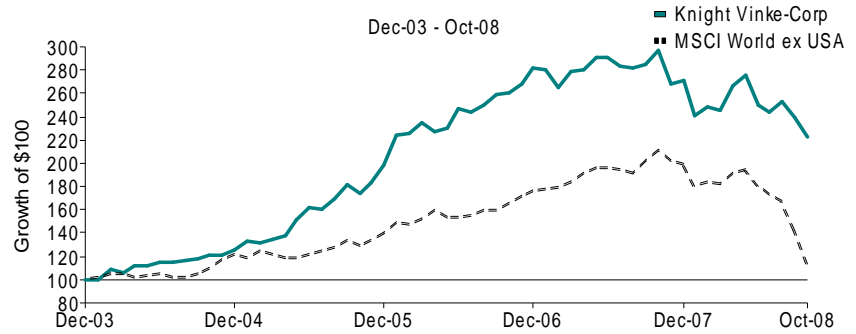
# Appendix - Corporate Governance Manager Report Cards

## Knight Vinke

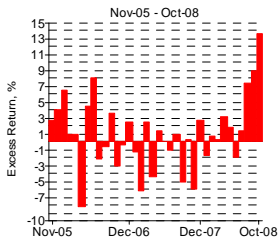
Style Map



Cumulative Excess Performance

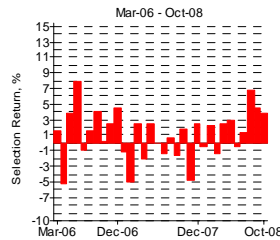


Monthly Added Value



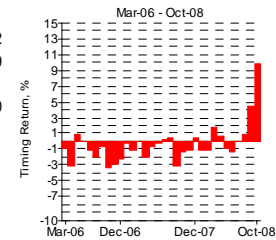
Annualized Return, % 13.0  
 Annualized StdDev, % 15.5  
 Information Ratio 0.8  
 Significance Level, % 90.8

Monthly Added Value from Selection



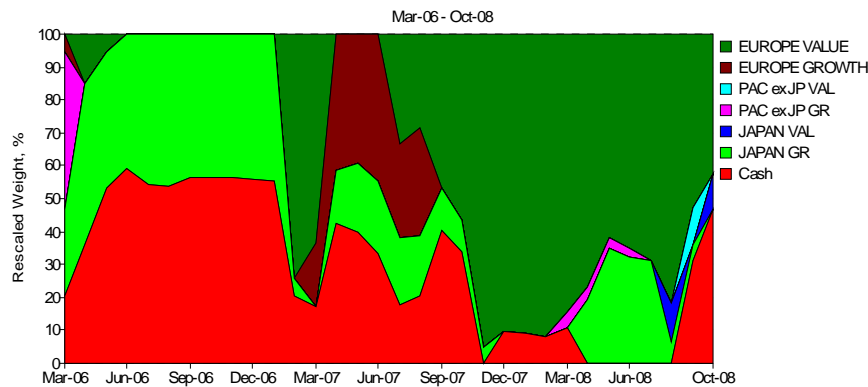
Annualized Return, % 12.2  
 Annualized StdDev, % 10.9  
 Information Ratio 1.1  
 Significance Level, % 97.0

Monthly Added Value from Style Timing

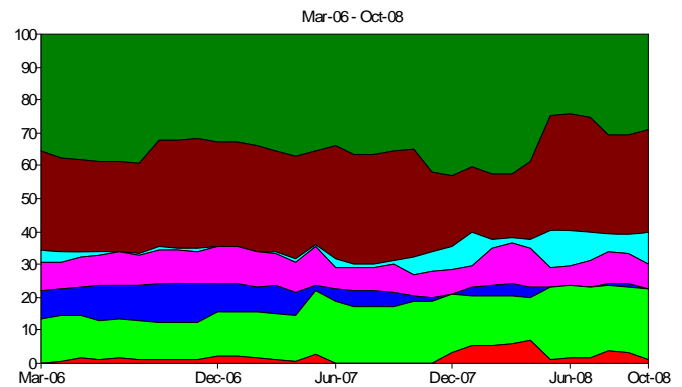


Annualized Return, % -2.6  
 Annualized StdDev, % 8.5  
 Information Ratio -0.3  
 Significance Level, % 69.6

Asset Loadings - Manager



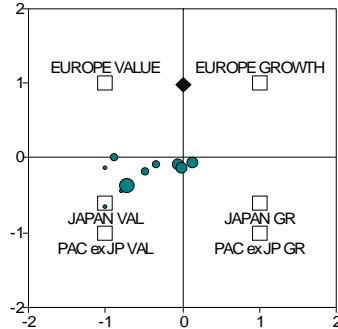
Asset Loadings - Benchmark



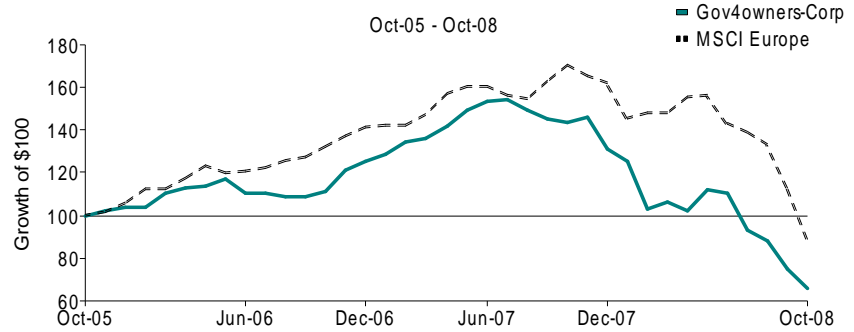
# Appendix - Corporate Governance Manager Report Cards

## Gov4Owners

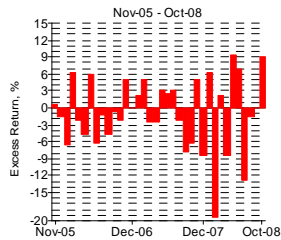
Style Map



Cumulative Excess Performance

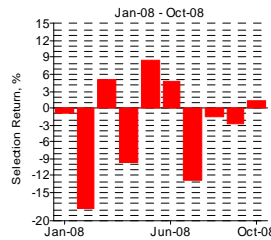


Monthly Added Value



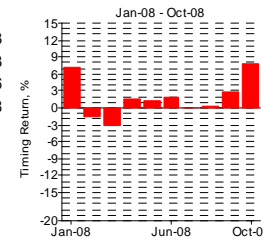
Annualized Return, % -9.2  
 Annualized StdDev, % 21.6  
 Information Ratio -0.4  
 Significance Level, % 77.5

Monthly Added Value from Selection



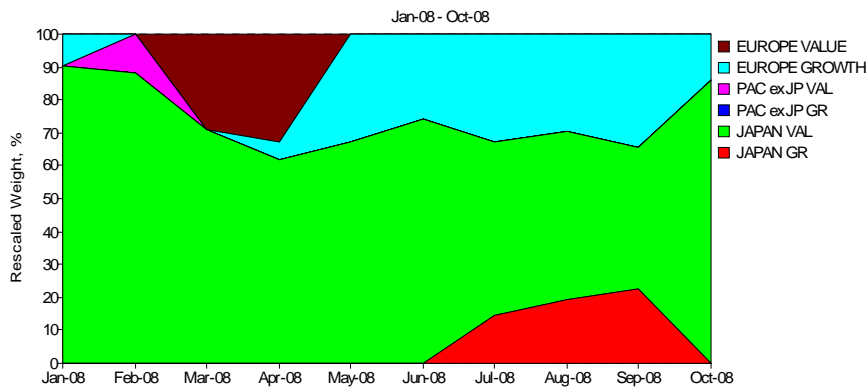
Annualized Return, % -17.3  
 Annualized StdDev, % 29.3  
 Information Ratio -0.6  
 Significance Level, % 83.8

Monthly Added Value from Style Timing

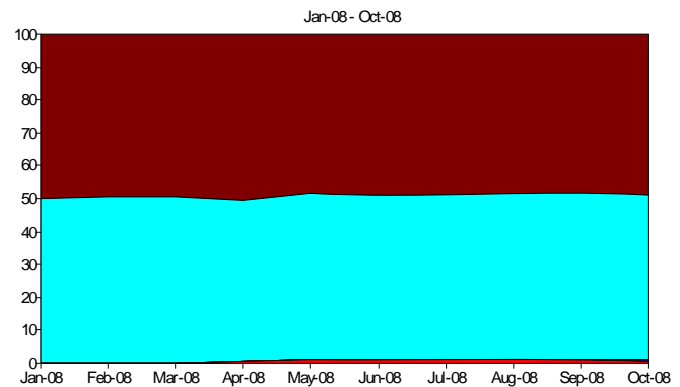


Annualized Return, % 12.8  
 Annualized StdDev, % 11.9  
 Information Ratio 1.2  
 Significance Level, % 94.0

Asset Loadings - Manager

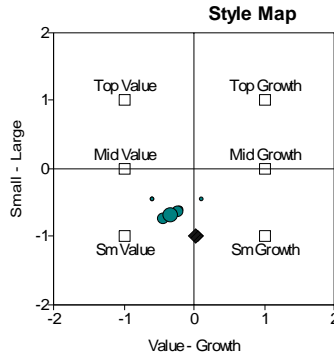


Asset Loadings - Benchmark

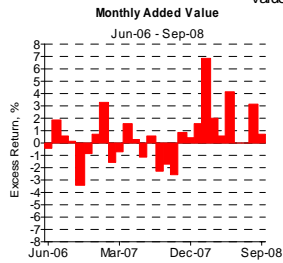
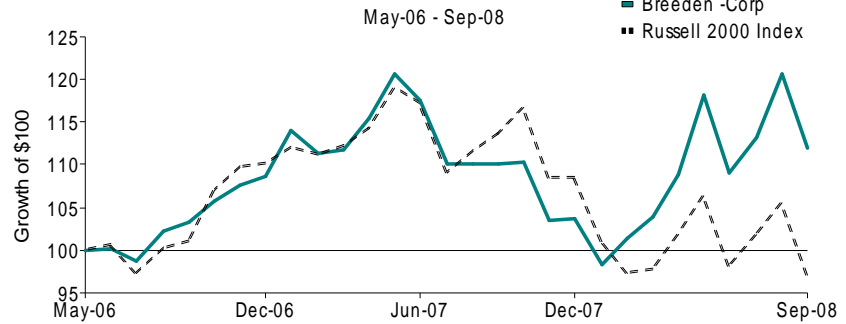


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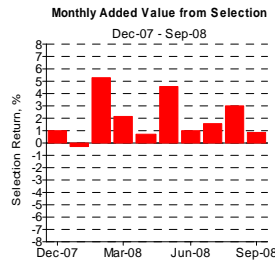
## Breeden



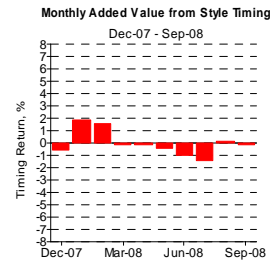
## Cumulative Excess Performance



Annualized Return, % 6.2  
 Annualized StdDev, % 7.4  
 Information Ratio 0.8  
 Significance Level, % 89.3

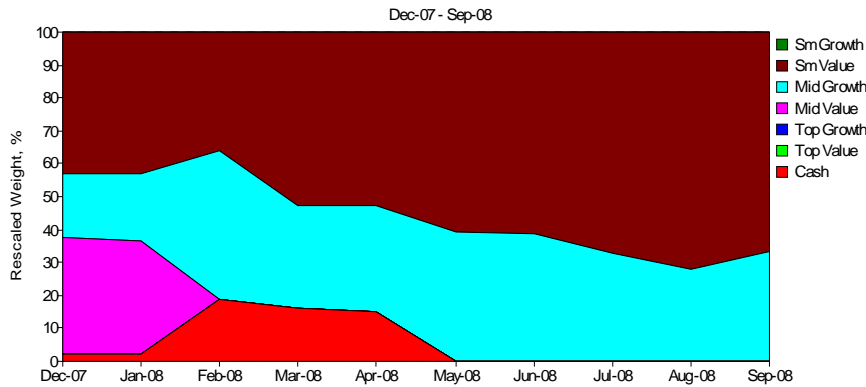


Annualized Return, % 19.1  
 Annualized StdDev, % 6.2  
 Information Ratio 3.7  
 Significance Level, % 99.7

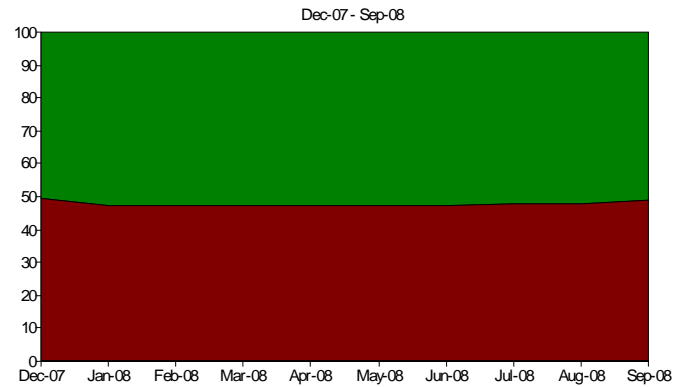


Annualized Return, % -0.4  
 Annualized StdDev, % 3.6  
 Information Ratio -0.1  
 Significance Level, % 54.6

## Asset Loadings - Manager

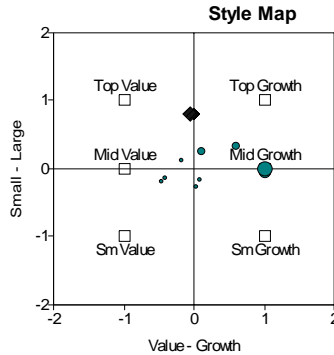


## Asset Loadings - Benchmark

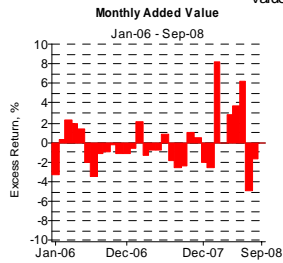
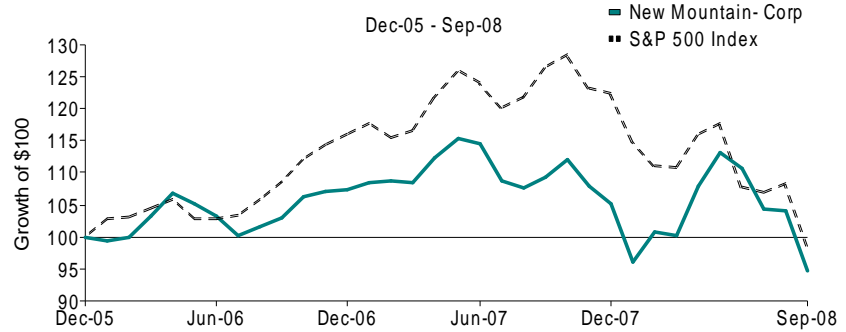


# Appendix - Corporate Governance Manager Report Cards

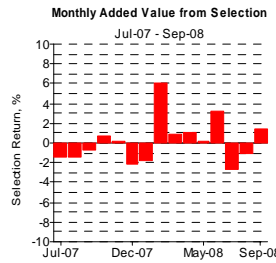
## New Mountain



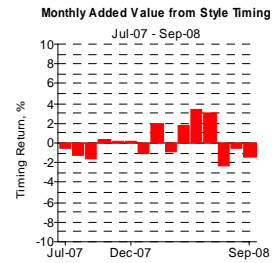
## Cumulative Excess Performance



Annualized Return, % -1.4  
 Annualized StdDev, % 9.3  
 Information Ratio -0.2  
 Significance Level, % 59.9

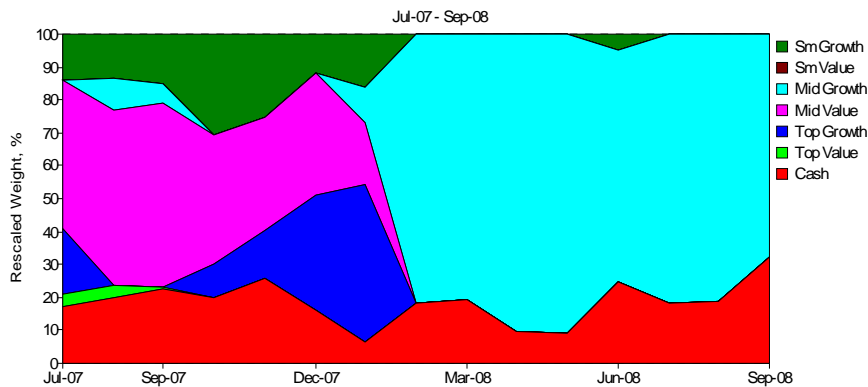


Annualized Return, % 1.6  
 Annualized StdDev, % 7.9  
 Information Ratio 0.2  
 Significance Level, % 60.5

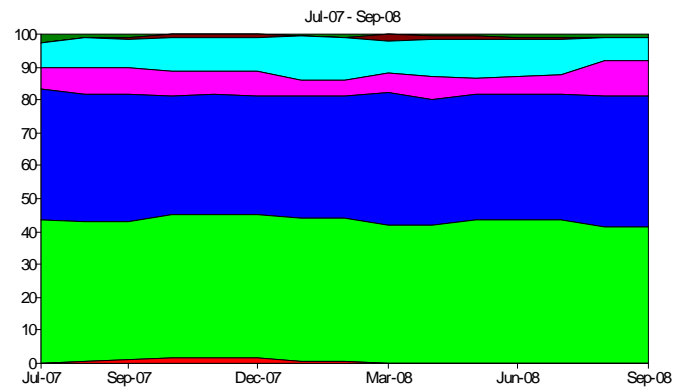


Annualized Return, % 0.8  
 Annualized StdDev, % 6.0  
 Information Ratio 0.1  
 Significance Level, % 57.1

## Asset Loadings - Manager

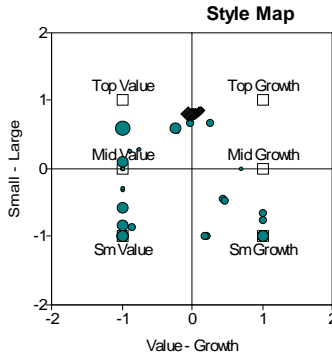


## Asset Loadings - Benchmark

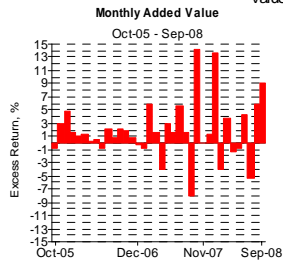
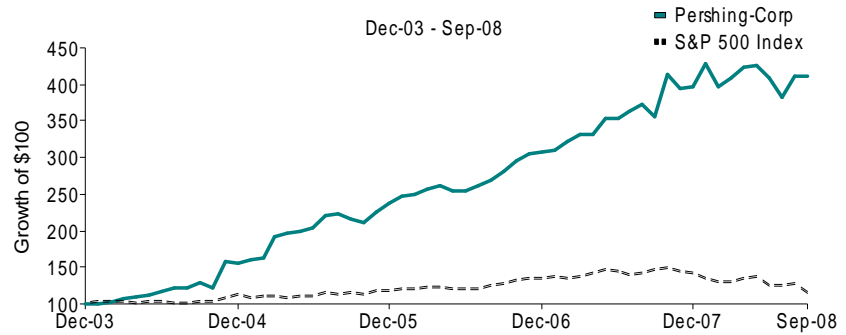


# Appendix - Corporate Governance Manager Report Cards

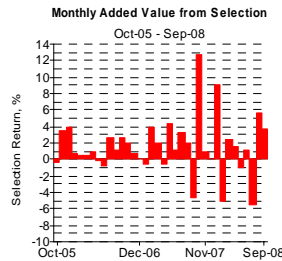
## Pershing



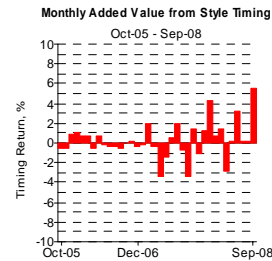
## Cumulative Excess Performance



Annualized Return, % 23.6  
Annualized StdDev, % 15.4  
Information Ratio 1.5  
Significance Level, % 99.0

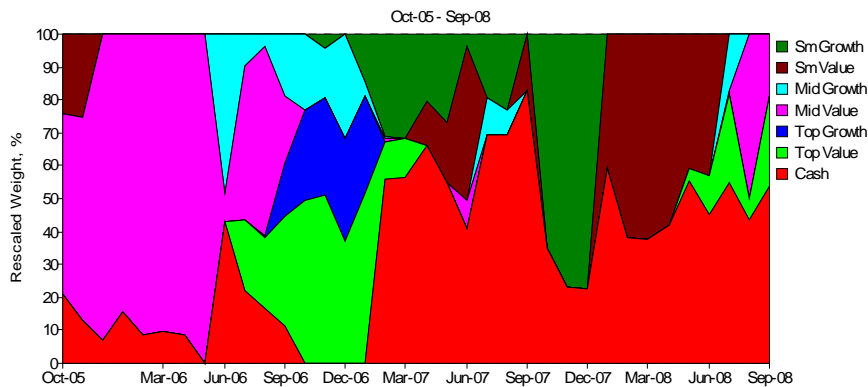


Annualized Return, % 19.6  
Annualized StdDev, % 11.8  
Information Ratio 1.7  
Significance Level, % 99.3

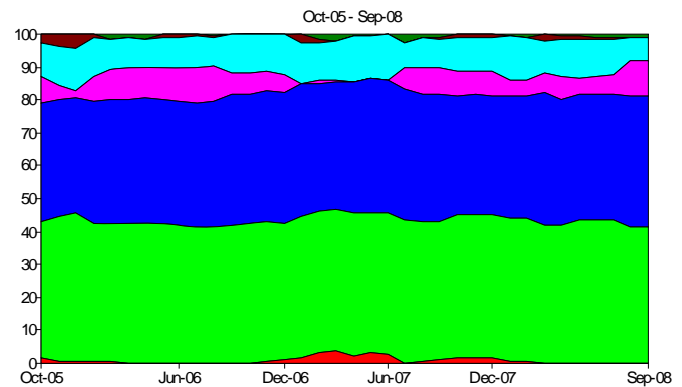


Annualized Return, % 3.9  
Annualized StdDev, % 6.2  
Information Ratio 0.6  
Significance Level, % 85.0

## Asset Loadings - Manager

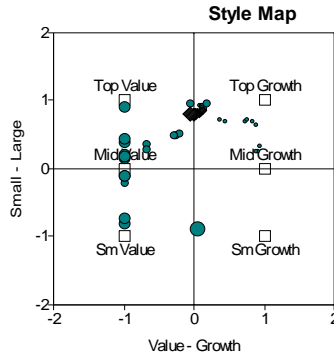


## Asset Loadings - Benchmark



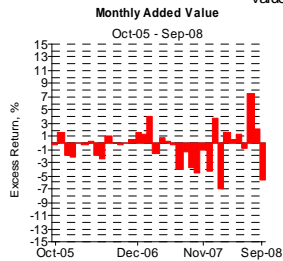
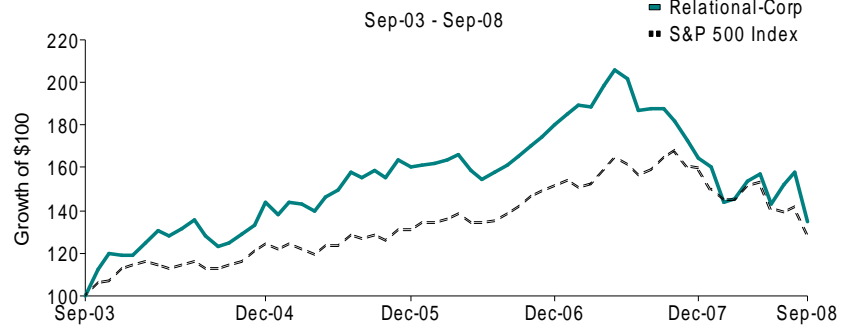
# Appendix- Corporate Governance Manager Report Cards

## Relational

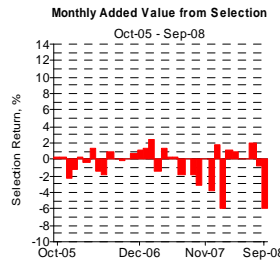


□ Russell Style Indices  
● Relational-Corp  
◆ S&P 500 Index

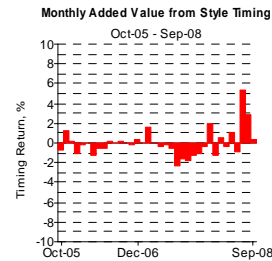
## Cumulative Excess Performance



Annualized Return, % -5.6  
Annualized StdDev, % 9.6  
Information Ratio -0.6  
Significance Level, % 83.9

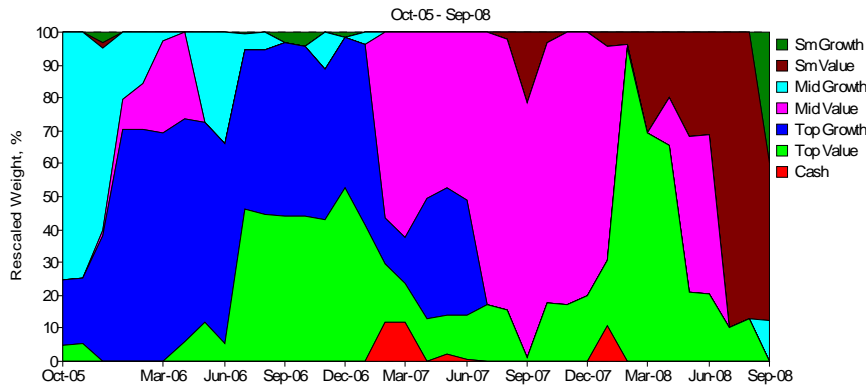


Annualized Return, % -5.6  
Annualized StdDev, % 6.8  
Information Ratio -0.8  
Significance Level, % 91.6

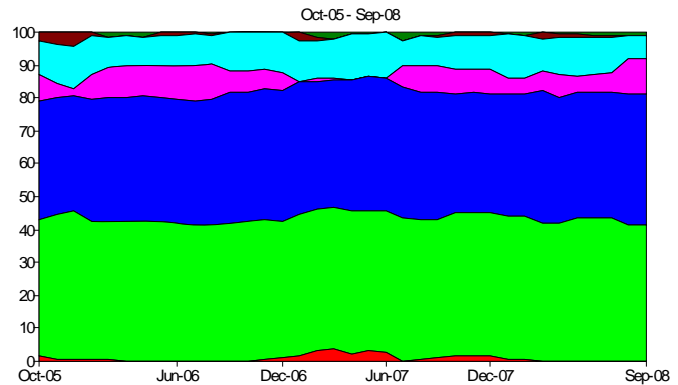


Annualized Return, % 0.0  
Annualized StdDev, % 4.9  
Information Ratio 0.0  
Significance Level, % 50.7

## Asset Loadings - Manager

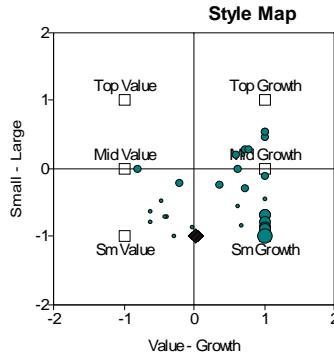


## Asset Loadings - Benchmark

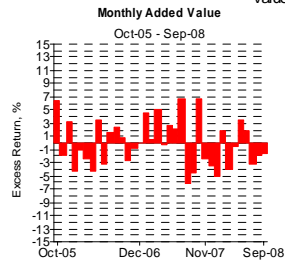
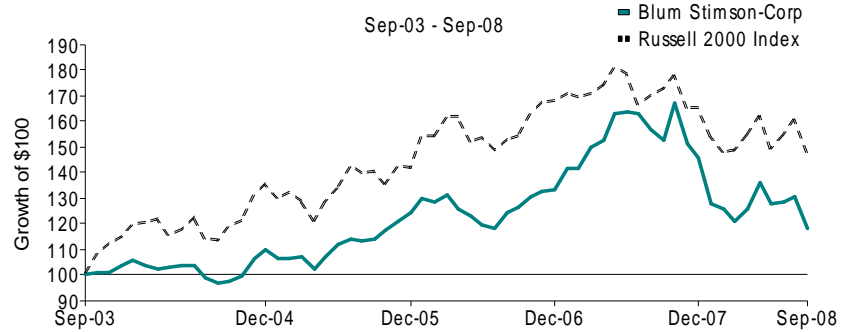


# Appendix - Corporate Governance Manager Report Cards

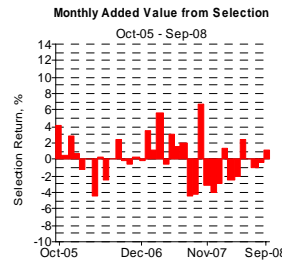
## Blum



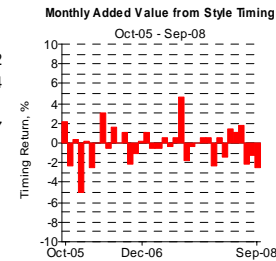
## Cumulative Excess Performance



Annualized Return, % -0.5  
Annualized StdDev, % 12.3  
Information Ratio 0.0  
Significance Level, % 52.7

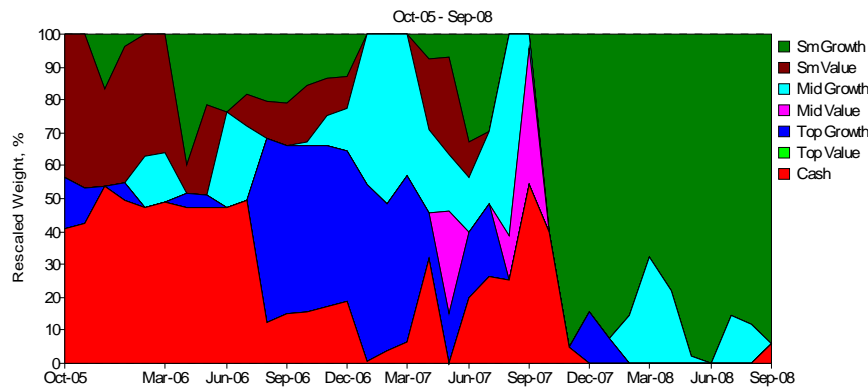


Annualized Return, % 1.2  
Annualized StdDev, % 9.4  
Information Ratio 0.1  
Significance Level, % 58.7



Annualized Return, % -1.6  
Annualized StdDev, % 6.3  
Information Ratio -0.3  
Significance Level, % 67.1

## Asset Loadings - Manager



## Asset Loadings - Benchmark

