The Better IR

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Sell-Side Research Staffing Changes During the Financial Crisis

Every part of the investment management universe has undergone drastic staffing changes since the onset of the financial crisis. Buy-side managers have seen consolidation as managers owned by banks looked to cut costs to help balance out their books. Hedge funds have seen massive contraction in asset sizes and lower leverage (as well as the desire to “cash out and start over” to reset performance hurdles) add to staff movements. Mutual fund managers, in particular, have consolidated large numbers of smaller funds to try to achieve cost efficiencies at the expense of customization. Often lost in this process is the impact the crisis has had on the research departments of sell-side brokers and the investment research industry. Simply put, the industry continues to face many of the pressures it faced prior to the crisis, as well as some new challenges brought on by the crisis specifically.

Ipreo’s research team (supporting BD Corporate, BD Advanced, and other products) keeps track of the ongoing changes in staff of both buy-side and sell-side decision-makers, and in the process is able to capture the total picture of how brokers have allocated their staffing resources over the period. From this information, we can identify a few specific trends worth keeping in mind in day-to-day IR efforts.

Large Firms: Shrinking US Staff, Diversifying Globally
While the wave of changes to the financial world was certainly not limited to U.S. firms, those at the epicenter of the transformation were among the U.S.’s largest companies. A large aspect of this transformation was reducing the amount of domestic coverage to coincide with a Darwinian reduction of financial players, and focusing on diversifying global coverage. Wall Street titans like Goldman Sachs, Citigroup, J.P. Morgan, Credit Suisse, Barclays and UBS were among those to reduce domestic coverage while building international coverage and presence.

Currently, J.P. Morgan and Citigroup rank first and second in terms of analysts based in the U.S. with 238 and 219 analysts, respectively, while both have roughly 130 analysts in the U.K. Goldman Sachs has strong U.K. coverage relative to its size in the U.S.; the sell-side firm has 138 analysts in London and 211 centered in the U.S. Goldman Sachs is the largest sell-side entity in terms of total analysts in both the U.K. and Australia.

Desk Migrations
The rapidly changing picture of compensation structures at major brokerages within the last year is certainly on the minds of sell-side analysts; while few set guidelines are in place as of publication as to how employee compensation will look as regulators begin to step in, an outsized number of “desk migrations” have taken place over the last year between sell-side firms. The institutions below saw losses of three or more analysts with a similar coverage universe to the same firm:

Fig. 1 – Selected Brokerage “Desk Migrations”, 10/08 – 10/09

Prior Brokerage	Coverage		New Brokerage
UBS Securities, LLC			
	REITs	–>	Banc of America / Merrill Lynch
	Technology	–>	International Strategy & Invt Group
	Financials	–>	Deutsche Bank Securities
Deutsche Bank Securities			
	Financials	–>	Calyon Securities
Canaccord Adams			
	Technology	–>	Brigantine Advisors
BB&T Capital Markets			
	Transportation	–>	RBC Capital Markets
Banc of America / Merrill Lynch			
	Technology	–>	UBS Securities, LLC
	Utilities	–>	Oppenheimer & Co.

Source: Ipreo Research

New compensation guidelines proposed by the U.S. Federal Reserve have the potential to increase migrations away from large bank holding companies; depending on the interpretations, brokerages owned by bank holding companies may be forced to convert large portions of analyst compensation to restricted stock or other forms. While there has been downward pressure on sell-side analyst compensation for some time now, it will be interesting to see if there is a direct impact on research staffing at brokerages that are part of bank holding companies, relative to those that are independent from these Federal Reserve regulations.

Sector / Market Cap Coverages: Reallocation out of Financials, Small Caps

The greatest research turnover noted during the period came from those analysts covering financials, specifically banks and REITs, two of the most volatile sectors as of late. Amid continued consolidation in the pharmaceutical industry, the sell-side appears to have lost a large number of biotechnology analysts. Utilities, oil and gas exploration, and consumer goods were among sectors to see new analysts adding coverage since last September.

On a sector breakout basis, brokerages appear to be allocating more coverage towards the materials and industrials sectors, while decreasing coverage of utilities and financials; Figure 2 shows this movement for the number of estimates on the S&P 1500 constituents. However, if you were to expect the allocation decisions made by brokerages to mirror the total market cap of each sector (as financials shrink in overall investment size, the amount of analysts should shrink by a similar percentage), it appears that brokerages have not moved as quickly as the market to change their coverage structures. In particular, healthcare stocks' allocations in the S&P 1500 have decreased by 1.3%, while over the same period published estimates on healthcare companies increased from 9.7% to 10.0% of all estimates.

Analyzing the total number of current fiscal year EPS estimates provides the most complete picture for the universe of sell-side coverage in the US. Using data from Factset Research Systems, Ipreo looked at the change in the total amount of estimates for the S&P 1500 constituents (as currently constructed) from October 2008 versus October 2009. This data showed an increase in the total number of estimates across all cap ranges (exceeding the potential effect of survivorship bias inherent in the data), with large cap (S&P 500) total estimates increasing 7.5%, mid cap (S&P 400) total estimates increasing 13.9%, and small cap (S&P 600) total estimates increasing 5.0%. On the balance, this continues to show a net allocation away from research on smaller-cap companies (possibly following the increase in volumes seen in large caps).

Fig. 2 – Total S&P 1500 Current FY Ests, 10/08 vs. 10/09

Sector	Current FY Estimates (Oct 2009)	Current FY Estimates (Oct 2008)	Chg in # Estimates	% Chg In Estimates
Basic Materials	781	667	114	17.1%
Capital Goods/Conglom.	1,117	951	166	17.5%
Consumer Cyclical	533	520	13	2.5%
Consumer/Non-Cyclical	608	549	59	10.7%
Energy	1,293	1,136	157	13.8%
Financial	1,991	2,008	(17)	-0.8%
Healthcare	1,522	1,361	161	11.8%
Services	3,482	3,179	303	9.5%
Technology	2,861	2,662	199	7.5%
Transportation	405	354	51	14.4%
Utilities	569	592	(23)	-3.9%

Source: Factset Research Systems

Fig. 3 – Allocation among S&P 1500 Estimates

Sector	Allocation (% of all Ests)		
	Oct 09 Allocation	Oct 08 Allocation	Change in Allocation
Basic Materials	5.2%	4.8%	0.4%
Capital Goods	7.1%	6.5%	0.6%
Conglomerates	0.3%	0.3%	0.0%
Consumer Cyclical	3.5%	3.7%	-0.2%
Consumer/Non-Cyclical	4.0%	3.9%	0.1%
Energy	8.5%	8.1%	0.4%
Financial	13.1%	14.4%	-1.2%
Healthcare	10.0%	9.7%	0.3%
Services	23.0%	22.7%	0.2%
Technology	18.9%	19.0%	-0.2%
Transportation	2.7%	2.5%	0.1%
Utilities	3.8%	4.2%	-0.5%

Source: Factset Research Systems

Small Firms: Adding Experience

While most of the large sell-side firms were forced to downsize amid the challenging market environment, the recessionary changes to the industry resulted in new opportunities for smaller firms. A number of research groups used the past year as a time to add new analysts and grow its muscle in the competitive market. The firms below added to their analyst teams by five or more.

Fig. 4 – Small Research Firms Adding Analysts – 10/08 – 10/09

Prior Brokerage	Coverage	Total Added Since 10/08
NorthCoast Research Holdings, LLC	Industrials, Consumer	+ 8
Sterne Agee	Finance, Chemicals	+ 8
Brigrantine Advisors, LLC	Technology	+ 7
Wisco Research, LLC	Consumer	+ 7
Green Arrow Capital Management, LLC	Consumer, Utilities	+ 5
International Strategy and Inv. Group	Technology, REITs	+ 5
Janney Montgomery Scott, LLC	Technology, Consumer	+ 5
Wunderlich Securities, Inc.	Energy, Finance	+ 5
Longbow Research	Consumer	+ 5

Source: Ipreo Research

Northcoast Research and Sterne Agee both hired a number of analysts who used to work for FTN Equity Capital Markets with varying coverage. Northcoast covers retail, business services, farm machinery and construction, as well as portions of the health care industry, while Sterne Agee claims coverage of basic materials, China internet and media, consumer, energy, financials and global industrial infrastructure. Brigantine

Advisors, which focuses solely on the technology sector, hired four analysts from Canaccord Adams, while the Wisconsin-based Wisco Research, which was formed in July 2008 and focuses on small and mid-cap consumer stocks, many of which have Wisconsin roots, hired seven analysts.

Independent Research: Under Pressure

July 2009 represented the expiration of the Global Analyst Research Settlement, originally negotiated by the SEC in 2003 to help remedy the conflicts of interest seen in the collapse of the technology bubble and Enron in 2001. In total, direct payments to independent research providers were scheduled to exceed $400mm, which represented a constant source of cash flow that has over the period produced a number of startups and small research providers. With the sunset of these cash flows, many independent providers have sought other outlets, such as proprietary trading and new execution desks, to make up for the revenue losses.

Despite the expiration of the settlement, a number of independent firms were actively adding to their research teams in the past year. Morningstar was the most aggressive, hiring over 20 analysts with varying coverages for a net increase of 13 analysts during the year. Longbow Research, a relatively large independent firm with broad coverage and offices in New York City and Ohio, added five analysts to its team. Boutique firms like ConsumerEdge Research, which has heavy focus on consumer staples, and Union Gaming Group, a Las Vegas-based gaming research firm, were also among the independent firms expanding in the past year. Northcoast and Wisco (mentioned above) also represent independent firms increasing their research team base. Conversely, some firms reduced their net coverage in light of the current environment; Tudor, Pickering, Holt & Co. Securities, Sidoti & Co Securities, Standard & Poor's Equity Group and Value Line securities all decreased their analyst teams in the last year.

Where Are We Headed?

Noted Rochdale Securities financials analyst Dick Bove summed up some of his recent experiences working on the sell-side in an discussion posted on the site efinancialcareers.co.uk:

> *"You give away research for free for six months to a year in the hope that someone will pay you," he says. "And in many cases they won't. They take it for free and refuse to pay – there are people that we've dealt with in Britain who think it's their right to get the product and that we have an obligation to send it to them… Traders can decide that the profits they make are due to the wonderful job they're doing for execution, rather than the advice they're getting from research, and therefore the money doesn't filter through. No one in their right mind wants to go into a business where the payment trail is so convoluted," Bove confides.*

Obviously, anyone involved in the IR profession for at least the last decade has seen the sell-side's business model changing for a long time, financial crisis or not. If trading continues to decouple from research, and the buy-side clientele for third-party research diminishes, it stands to reason that more of the job of raising the profile of the issuer will fall onto the shoulders of the IRO. However, as things stand currently, the IRO may be able to take advantage of some of these existing trends to gain an edge in a fragmenting market.

First, maintain relationships with sell-side professionals during and after firm changes. In smaller research shops with tighter budgets, it's more likely that research analysts will need to produce an immediate impact in terms of new client exposure and new commissions – if an analyst you have a relationship with attempts to "hit the ground running" at a new firm, he or she will often start off coverage in similar spaces and familiar names. This can be an opportunity to expose your story to new buy-side names, and a chance for the analyst to build their name.

Second, take advantage of the trend towards global sourcing of research by maintaining relationships with international research groups. Anecdotally, we've heard stories of issuers covered by a US broker maintaining a casual relationship with the UK, European, or Asian coverage teams in similar sectors; this can lead directly to greater exposure to the buy-side on your future overseas outreach and non-deal roadshows.

Finally, be aware of the impact that independent research can have on the company; especially in more specialized sectors (technology / healthcare) an experienced and knowledgeable analyst may actually be more likely to face buy-side firms willing to directly pay cash for excellent research instead of relying purely on the soft-dollar arrangements of the past, as the buy-side rethinks the value of the research it receives.

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The Equity Connection – Do Long-Term Credit Ratings Affect Equity Ownership?

"Business Model Stressed, Balance Sheet Isn't"
-Rod Petrik & Simon Yarmak; Stifel Nicolaus

"On Track for FY10, placing strengthens balance sheet…"
-Graeme Clark & Rajeev Bahl, Piper Jaffrey

"Q3 below estimates due to timing. Financing removes balance sheet concerns at least into 2011…"
-Richard Ryan; Dougherty & Co.

As is the case in any slowdown, the economic downturn has brought balance sheet strength to the forefront of equity analysis and caused many investors to sacrifice growth for stability. The above headlines are from recent equity research reports published in late October and early November. With analysts increasing their focus on the balance sheet, investor relations professionals may become concerned that their long-term debt rating will affect the ability of an investor to hold their equity. This concern becomes especially pronounced when an issuer's rating is lowered into non-investment grade territory, as this can signal a weakening future access to capital or other weakness in the company that could affect equity investors.

To determine if there are equity investors that cannot hold the equity of an issuer with a non-investment grade rating Ipreo looked at the holdings of all U.S. investors. Portfolios were analyzed for holdings in U.S. domiciled issuers with a non-investment grade rating.

Currently all 75 of the largest active U.S. investors hold the equities of at least one issuer with a non-investment grade rating. Furthermore, of the over 1800 active U.S. investors with over $100 million in equity, only 168 do not hold a security issued by a firm with a below investment grade credit rating. This confirms that despite the focus on balance sheet strength, few if any firms have a broad stipulation to not invest in equity issued by below investment grade issuers. However, there appears to be some stratification with certain firms being more heavily invested in this equity group than others.

Credit rating downgrades from low-investment grade into non-investment grade territory draw attention to a company's balance sheet and may represent an appropriate time to reach out to current shareholders that exhibit risk tolerance toward lower grade issuers and target investors with a history of holding equity of lower rated issuers. The main goal of this outreach is to quell investor concerns and assure them that cash flow and balance sheet issues are a fixable problem.

Largest Holders of Equity from Non-Investment Grade Issuers

	Investor Name (Investor)	Value Non-Investment Grade Issuers ($mm)	Value Chg. Non-Investment Grade Issuers ($mm)	Number Non-Investment Grade Issuers Held	% U.S. Port Non-Investment Grade	Equity Assets ($mm)	Style	T/O	City (Investor)
1	Fidelity Management & Research Company	32,412.5	2,127.8	254	9.35	$503,241	Growth	46%	Boston
2	T. Rowe Price Associates, Inc.	12,646.3	261.3	250	6.46	$229,601	Growth	31%	Baltimore
3	BlackRock Advisors, LLC	9,974.9	850.4	308	8.37	$149,768	Value	42%	New York
4	Wellington Management Company, LLP	9,196.3	574.0	148	4.95	$244,485	Value	48%	Boston
5	Capital World Investors (U.S.)	8,083.4	791.0	45	3.61	$356,308	Value	38%	Los Angeles
6	AllianceBernstein, L.P. (U.S.)	7,478.5	-1,116.4	303	5.95	$207,243	Value	60%	New York
7	Columbia Management Advisors, LLC	5,029.8	245.5	273	5.03	$109,466	Value	41%	Boston
8	Davis Selected Advisers, L.P.	5,018.4	72.8	11	9.15	$65,491	Value	24%	New York
9	Neuberger Berman Management, LLC	4,820.1	-58.4	169	9.59	$60,653	Value	49%	New York
10	Capital Research Global Investors (U.S.)	4,721.2	-213.3	41	2.54	$369,415	GARP	33%	Los Angeles
11	Goldman Sachs Asset Management, L.P. (U.S.)	4,673.0	-274.5	251	6.56	$87,085	GARP	68%	New York
12	J.P. Morgan Investment Management, Inc.	4,228.6	1,220.1	248	6.08	$86,058	Value	50%	New York
13	Southeastern Asset Management, Inc. (U.S.)	3,931.3	28.4	6	21.07	$27,532	GARP	39%	Memphis
14	Dodge & Cox	3,900.0	-190.7	26	7.01	$105,498	Deep Value	25%	San Francisco
15	Lord Abbett & Company, LLC	3,678.3	13.2	83	9.31	$43,689	Value	73%	Jersey City
16	OppenheimerFunds, Inc.	3,283.3	-411.2	288	7.13	$81,133	Growth	58%	New York
17	Jennison Associates, LLC	3,203.8	271.8	74	7.19	$54,468	Growth	54%	New York
18	Janus Capital Management, LLC	3,178.0	241.6	96	7.67	$69,405	Agg. Growth	58%	Denver
19	Barrow Hanley Mewhinney & Strauss, Inc.	3,116.7	11.5	22	8.06	$43,088	Deep Value	24%	Dallas
20	Putnam Investment Management, LLC	2,759.0	232.1	225	9.01	$40,653	Value	70%	Boston

The above firms are the largest holders of equity issued by non-investment grade issuers. A majority of these firms are value investors or growth/GARP investors that utilize a number of strategies including value investing. Fidelity, J.P. Morgan Investment Management, and BlackRock are some the largest holders and buyers of these equities. Certain investor relations officers may find Janus' presence among the largest holders and buyers of such equity a little off considering the firm's history as a strict growth investor, however since the credit crisis began, Ipreo has noted Janus as a very risk tolerant investor capable of taking significant positions in firms undergoing short-term distress.

Many times the top holders of any type of equity will be the institutions with the largest equity assets. For this reason companies undergoing distress and experiencing rating downgrades should consider contacting any of the below firms. This list is a select list of firms that are either heavily invested in this equity group or have been recent large buyers. Fidelity has been a large buyer of non-investment grade issuer's equity, but it is difficult to explain this move by pointing to size bias. A further examination of the firm's mutual funds shows that Fidelity has been a buyer of these equities through the Fidelity Capital & Income Fund, Fidelity OTC Portfolio, Fidelity Leveraged Company Stock Fund, Fidelity Low Priced Stock Fund, and the Fidelity Small Cap Stock Fund. A firm like Tradewinds, which finds its portfolio nearly 35% invested in equity of non-investment grade issuers, is a prime target for firms experiencing downgrades. Tradewinds seeks to invest undervalued companies undergoing restructurings or operating in industries due for a turnaround.

Select Potential Buyers Following a Credit Downgrade

	Investor Name (Investor)	Value Non-Investment Grade Issuers ($mm)	Value Chg. Non-Investment Grade Issuers ($mm)	Number Non-Investment Grade Issuers Held	% U.S. Port Non-Investment Grade	Equity Assets ($mm)	Style	T/0	City (Investor)
1	Tradewinds Global Investors, LLC	1,120.0	9.3	13	34.27	$16,745	Deep Value	62%	Los Angeles
2	Iridian Asset Management, LLC	1,305.5	30.2	14	20.34	$6,828	Growth	42%	Westport
3	Keeley Asset Management Corp.	1,227.9	-70.9	51	19.24	$6,650	Agg. Growth	27%	Chicago
4	TimesSquare Capital Management, Inc.	1,438.8	121.3	25	15.18	$10,332	Agg. Growth	49%	New York
5	EARNEST Partners, LLC	1,491.3	-53.1	20	15.03	$10,809	Growth	38%	Atlanta
6	Legg Mason Capital Management, Inc.	2,226.6	52.4	39	14.16	$16,425	Value	56%	Baltimore
7	Baron Capital Group, Inc.	1,794.9	72.9	27	13.94	$13,777	Agg. Growth	27%	New York
8	Schroder Investment Management North America, Inc.	762.5	162.1	75	13.89	$8,257	Growth	74%	New York
9	Hotchkis and Wiley Capital Management, LLC	1,553.4	230.2	21	12.79	$14,263	Deep Value	60%	Los Angeles
10	Rainier Investment Management, Inc.	1,607.8	88.0	31	11.47	$15,491	Growth	93%	Seattle
11	Munder Capital Management, Inc.	1,028.5	164.2	184	10.47	$12,039	Growth	35%	Birmingham
12	Fidelity Management & Research Company	32,412.5	2,127.8	254	9.35	$503,241	Growth	46%	Boston
13	Pyramis Global Advisors, LLC	2,232.8	377.8	186	9.27	$49,380	Growth	53%	Smithfield
14	Principal Global Investors, LLC	1,829.9	304.9	209	8.94	$24,748	Growth	57%	Des Moines
15	BlackRock Advisors, LLC	9,974.9	850.4	308	8.37	$149,768	Value	42%	New York
16	Pioneer Investment Management, Inc.	1,523.6	456.8	80	7.86	$22,601	GARP	45%	Boston
17	Janus Capital Management, LLC	3,178.0	241.6	96	7.67	$69,405	Agg. Growth	58%	Denver
18	Jennison Associates, LLC	3,203.8	271.8	74	7.19	$54,468	Growth	54%	New York
19	T. Rowe Price Associates, Inc.	12,646.3	261.3	250	6.46	$229,601	Growth	31%	Baltimore
20	J.P. Morgan Investment Management, Inc.	4,228.6	1,220.1	248	6.08	$86,058	Value	50%	New York

The list of investors at risk following a credit downgrade is a mix of large sellers of common equity of non-investment issuers as well as large firms with limited exposure to these securities. Yield investors like DePrince Race & Zollo, C.S. Mckee, and Wilmington Trust are concerned with the ability of their investments to maintain a stable and/or rising dividend. A downgrade can likely be used as a leading indicator of a possible dividend cut, therefore making these stocks less attractive to a yield investor. Like Fidelity on the buying side, it is not possible to explain the selling exhibited by Alliance as a function of size biases. Many of the firm's growth funds seem to have some aversion to non-investment grade issuer's equity. The AllianceBernstein – Global Equity Blend Portfolio, AllianceBernstein – Global Growth Trends Portfolio, and EQ/AllianceBernstein Small Cap Blend Portfolio have all been recent large sellers of this equity group.

Select Potential Sellers Following a Credit Downgrade

	Investor Name (Investor)	Value Non-Investment Grade Issuers ($mm)	Value Chg. Non-Investment Grade Issuers ($mm)	Number Non-Investment Grade Issuers Held	% U.S. Port Non-Investment Grade	Equity Assets ($mm)	Style	T/0	City (Investor)
1	AllianceBernstein, L.P. (U.S.)	7,478.5	-1,116.4	303	5.95	$207,243	Value	60%	New York
2	Aster Investment Management Co., Inc.	50.1	-22.5	5	2.40	$2,262	Growth	67%	Larkspur
3	Atlantic Trust Stein Roe	66.1	-17.9	98	2.47	$2,799	Growth	134%	Boston
4	Brown Capital Management, Inc.	7.5	-0.6	3	0.44	$1,842	Growth	27%	Baltimore
5	C.S. McKee, L.P.	45.8	16.3	3	1.04	$4,880	Yield	25%	Pittsburgh
6	DePrince Race & Zollo, Inc.	393.9	-222.2	46	11.45	$3,595	Yield	135%	Winter Park
7	DnB NOR Asset Management (US), Inc.	106.8	-35.9	73	4.68	$2,523	Value	95%	New York
8	Fayez Sarofim & Company	177.4	-0.1	21	1.29	$15,380	Value	12%	Houston
9	Hilliard Lyons Capital Management, LLC	8.4	-2.4	18	0.54	$1,656	Value	29%	Louisville
10	Jensen Investment Management, Inc.	0.4	0.0	8	0.02	$2,779	Growth	25%	Lake Oswego
11	Loews Corp. (Asset Management)	15.3	-1.2	9	0.10	$15,623	Growth	7%	New York
12	Loring, Wolcott & Coolidge Fiduciary Advisors, LLP	23.0	17.1	13	1.05	$2,512	Growth	18%	Boston
13	Mairs & Power Investment Management	19.3	-2.8	9	0.61	$3,181	Value	7%	St. Paul
14	Montag & Caldwell, Inc.	1.1	0.2	4	0.01	$11,410	Growth	34%	Atlanta
15	PNC Capital Advisors, LLC	110.1	-152.0	276	1.11	$10,639	Deep Value	46%	Baltimore
16	Schafer Cullen Capital Management, Inc.	171.0	-2.8	9	3.23	$7,909	Deep Value	62%	New York
17	Teacher Retirement System of Texas	791.2	-327.8	157	3.64	$23,715	GARP	53%	Austin
18	Tweedy Browne Company, LLC	40.0	-1.1	3	3.07	$5,741	Value	26%	New York
19	Westwood Management Corporation (Texas)	253.3	-56.2	12	3.29	$8,132	Yield	83%	Dallas
20	Wilmington Trust Investment Management, LLC	41.0	-4.2	64	1.18	$3,690	Yield	25%	Wilmington

As is the case in any situation regular outreach with investors is the best way to overcome an issue like a credit downgrade. A thorough As is the case in any situation, regular outreach with investors is the best way to overcome an issue like a credit downgrade. A thorough review of one's investor base can help prioritize those investors that will be most concerned about a credit downgrade. When reviewing larger investors like Fidelity and AllianceBernstein, fund exposure is the key to understanding the investor. Even though as a whole Fidelity was a buyer and AllianceBernstein a seller of equity issued by non-investment grade issuers, there were funds doing the opposite at each firm. With smaller firms, an investor relations officer has more of an ability to understand the investor's attitude to change without digging into fund data.

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German AGM Season: Voting Trends of International Investors for 2010

Turbulent times ahead

With economic conditions in Germany throughout 2009 continuing to remain pessimistic, calls are made for corporate governance reform and increased levels of regulation in order to take preventative measures. Due to enforcement of the act of stabilisation of the financial markets (Finanzmarkstabilisierungsgesetz) and the amount of government aid provided to companies in the financial sector, German corporates are being scrutinized carefully by international investors.

International investors play an increasingly important role in the leading up to and result of the German AGM. With foreign ownership of the largest German companies still averaging around 50% of the shareholder base, their vote and voice are vital to a successful IR communication strategy and positive AGM Outcome.

Although many German companies are experienced in communicating with their top foreign shareholders throughout the year, when it comes to establishing their corporate governance agendas and potential concerns, it is still up to the investor to make themselves heard.

Activist investor vs. Active voter

When being approached by an investor, often unknown to the German corporate, the initial reaction is often that of fright. Companies are still sensitive to past activist interventions, such as in the case of Deutsche Boerse AG and TCI in 2005. There is a big difference between an activist investor, who often holds the stock for a period of up to a year before approaching management with suggestions of how to improve the company's structure and management, and an investor which actively votes at the AGM.

This perception is changing, so much so, that recent feedback on activist shareholders engaging with the company has suggested that they play an increasingly important part in motivating the Supervisory Board and Management Board to pay more attention to re-evaluating strategy and creating shareholder value. You can differentiate between an activist investor that utilizes its investment to engage with the company in order to create value and an investor with an active approach to engaging with the company on corporate governance topics, in order to create a long term investment prospect.

With more non-domestic investors realizing the value of their vote, varying activity in voting behaviour can be observed. Whereas in the past, an international investor based in the UK with a diverse investment portfolio including up to 300 European stocks, may have only voted in their home market, market development has shown that these investors are increasingly including local market practice and company specific information into their research process, prior to submitting their vote.

Proxy advisory agencies, such as the US-based RiskMetrics, still retain a large amount of influence over the foreign shareholder base, by issuing vote recommendation reports and analysis on each AGM Agenda, which are populated by comparing the Agenda items against their proxy voting guidelines for the specific market.

There have been occasions when a foreign investor has reached an agreement with a proxy advisory agency to automatically vote with their vote recommendation, once published. This has the effect that a shareholder may be voting blind on an Agenda item that adheres to the local corporate governance code and is common market practise, but the proxy advisory agency has still recommended to vote against, due to some required detail missing in the Agenda item text. The investor is often not aware of their contribution to a pool of against votes, until after the event has happened, and the Agenda item has possibly failed.

Ipreo is pleased to report that current trends show an increase in the creation of country specific voting policies to be applied prior to the submission of a vote. Foreign investors are realising how important the time they take to familiarise themselves with the proposed AGM Agenda and the individual nuances of each proposal is for the company they have invested in.

What are the critical Agenda items for the 2010 season?

The subject that has been given the most considerable focus for the upcoming season is the remuneration of boards of companies. With the introduction of the Act on the Appropriateness of the Management Board's Remuneration (Gesetz zur Angemessenheit von Vorstandsverguetungen), which came into force on 5 August 2009, the first step to a Say-on-Pay vote has been taken.

The act currently only allows for remuneration reports of the Management Board, not the Supervisory Board, to be put to an advisory vote. The first Dax 30 member to be putting this item on to their AGM Agenda in January 2010 will be Siemens AG. Shareholders will be reviewing this proposal diligently to ascertain the adequacy of the management remuneration in relation to the company's performance and best practice rules. The passing of this proposal is non-binding but has significant symbolic value as being the first to be put to a shareholder vote in Germany.

Due to the German financial markets being marked by government interventions and company restructurings, the 2010 season will see calls for fresh capital in order to successfully navigate the foreseeable end of the economic crisis. Shareholders will scrutinize potential dilutive effects of excessive capital calls, as well as the limitation of exclusion of preemptive rights.

Discharge votes for Management and Supervisory Boards will receive attention, especially as these have more of a symbolic value and are culturally treated as a vote of confidence. The consequences of a non-discharge of a member of either the Management or Supervisory Board do not often conclude in any immediate reaction by the company.

Supervisory Board elections and composition in terms of independence will remain under close scrutiny.

Prepare for the inevitable

IR Departments and Management are being challenged to take a much more proactive approach to communication with their shareholders. In order to be better prepared to conform and successfully navigate the 2010 AGM season and beyond, German corporates need to reach out and engage with their international investors on an ongoing basis, throughout the year and especially in the run up to the Annual General Meeting. They have to ensure that they do not only speak to their IR contacts such as fund managers and analysts, but also engage with their investors' corporate governance departments to ensure that a dialogue is established.

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BetterIR - Firm Snapshot

Targeted Firm: Waddell & Reed Investment Management Company ($40,257.4 M)

Targeting Profile:
Located in the Midwestern city of Overland Park, KS, Waddell & Reed Investment Management Company oversees a family of approximately 60 mutual funds. Each fund has a fairly limited number of concentrated positions, allowing portfolio managers to maintain appropriate oversight of all securities under management. Despite the firm's moderate turnover of 71%, Waddell & Reed employs an overarching long-term buy-and-hold strategy, retaining investments in its core equity portfolios and small cap funds for some time. Waddell & Reed is characterized by its aggressive growth style, and the firm is willing to pay a premium for companies that are expected to generate significantly above average rates of return and large positive cash flows.

Consistent with such an aggressive growth strategy, Waddell & Reed has nearly 25% of its current portfolio holdings allocated to the technology sector. The firm has increased its exposure to the space even further in the most recent quarter, particularly among the Semiconductors, Communications Equipment, and Computers and Computer-Based Systems micro industries. In increasing its total semiconductor allocation by 7%, Waddell & Reed clearly foresaw a return to profitability and rapid growth, which was confirmed by the Semiconductor Industry Association reporting an industry-wide Q3 sales increase of 19.7%. Furthermore, two of the firm's largest purchases for the quarter, Apple (+$209mm) and Qualcomm (+$141mm), lend strong support to such a trend.

Also of note is Waddell & Reed's proclivity for international securities; specifically higher growth emerging markets. As of most recent filings, the firm reported one-third of assets as being domiciled outside of the United States. In particular, 19.6% of total holdings are from Asian nations including China, Taiwan, and India, with 10% of total securities held listed on the Hong Kong stock exchange.

How to Approach:
If your company represents a large/mega cap investment with significant upside for growth, you will likely have little trouble finding inclusion within one of Waddell & Reed's several portfolios. In order to better these chances, IROs should emphasize a consistent history of investing retained earnings back into the company's balance sheet to fund growth and expansion. In addition, companies within the Basic Materials sector have been gaining significant attention from fund PMs, as Waddell & Reed increased its exposure to the space by nearly 4% in Q3, with significant purchases of chemical companies Dow Chemical (+$200mm) and Monsanto Company (+$178mm). As such, companies within this space need to emphasize their ability to generate consistent EPS growth.

How not to Approach:
Companies in more mature and stable stages of development, offering consistent dividend payments, while representing solid income-generating investments, appeal very little to Waddell & Reed. Furthermore, although small cap firms often have the ability to generate outsized returns, Waddell & Reed invests only 9% of its total portfolios in micro/small cap issues. Apart from small market cap size, Waddell & Reed has also shown a particular aversion to the Healthcare space due to uncertainty regarding industry reform. Recent Q3 selling of Gilead Sciences (-$274mm) and Abbott Labs (-$143mm) has reduced the firm's total healthcare allocation to just 6% of equity assets, down 7% from the previous quarter. Clearly, healthcare companies must now approach Waddell & Reed with particular caution.

Largest Funds Managed:
- Ivy Asset Strategy Fund ($9,469.7M); Michael Avery, Ryan Caldwell
- Waddell & Reed Advisors Core Investment Fund ($2,164.7M); Gustaf Zinn, Erik Becker
- Waddell & Reed Advisors Asset Strategy Fund ($1,900.1M); Michael Avery, Ryan Caldwell

Investment Potential:
- Mega: $136.0M
- Large: $89.1M
- Mid: $34.7M
- Small: $16.7M
- Micro: $3.8M

Average Equity Holding Period: 1.41 years

BetterIR - Fund Snapshot

Targeted Fund: Lazard Emerging Markets Equity Portfolio ($6,635.23 M)

Portfolio Managers:
Rohit Chopra - (212) 632-6232 - rohit.chopra@lazard.com
James Donald - (212) 632-6805 - james.donald@lazard.com
Erik McKee - (212) 632-6178 - erik.mckee@lazard.com
John Reinsberg - (212) 632-6164

Targeting Profile:
The Lazard Emerging Markets Equity Portfolio, founded in 1994, is one of the largest portfolios of its kind. At over $6 billion in equity assets, the fund has grown in size by more than 1000% over the past five years, watching total market value rise from approximately $650 mm in 2004. The fund's four portfolio managers take a bottom-up approach to stock selection, placing emphasis on those securities with attractive relative valuations as well as strong growth potential, representing a middle-ground between value and growth investing. In order to mitigate risk associated with investing in non-US equities, Lazard carefully examines foreign countries' auditing and legal standards for appropriate practice.

While Brazil, Russia, and India make up three of the fund's ten largest country holdings, 72% of portfolio assets remain invested in non-BRIC nations. Also, rather uncommon for an emerging markets portfolio of such size, the fund maintains holdings in less traditional emerging markets like Hong Kong and Taiwan while avoiding mainland-Chinese investments entirely. Although 30% of portfolio holdings are domiciled in countries with low credit risk, 54% of investments carry a moderate risk of default, according to a sovereign debt rating of Baa1 to Baa3 by Moody's. Furthermore, as is characteristic of the emerging markets space, 18% of investments originate from nations including Singapore, Turkey, Egypt, and the Philippines, which can be considered speculative, carrying high credit risk (Moody's sovereign debt rating of Ba1 to Ba3).

According to most recent disclosures, the fund showed large increases to concentrations in the Financials space, consistent with positions across nearly all mutual funds. As financial equities helped lead the most recent global economic recovery, Lazard PMs shifted portfolio allocations accordingly to capitalize on such a trend. Even further, ten large bank positions including Banco do Brasil and Turkiye Is Bankasi currently compose 19% of stated portfolio holdings.

How to Approach:
Mid/large cap companies of approximately $2B - $50B in market cap would fit well into the fund's portfolio, as weighted average market cap for each position is about $13B. If your company represents a strong value play at the moment, characterized by temporarily depressed valuations, you may also appeal strongly to fund PMs. In addition, more growth-oriented investments, as long as they are not priced too highly, could make a strong case. Recent buying has demonstrated an interest in Korean markets across various sectors with purchases of Shinhan Financial Group Company (+$107M), technology services company NHN Corporation (+$58M), and tobacco giant KT&G Corporation (+$41M). Across all markets, current purchases have focused on the Financials and Technology spaces, also highlighting opportunities for such issues.

How not to Approach:
Companies that are too richly valued and lack significant long-term growth prospects are likely to be passed over by fund PMs. Furthermore, as the fund invests almost entirely in emerging market economies, companies in more developed nations will find it more difficult making a case for inclusion. Also, while the fund invests a small portion of its assets in countries with speculative sovereign debt/currency, if your company happens to fall within this category, it would certainly help to illustrate a clear picture of your company's financial stability and creditworthiness. Because all current speculative investments report earnings in local currency, a clear understanding of foreign exchange risk must also be demonstrated.

Investment Potential:
- Large: $95.8M
- Mid: $70.9M
- Small: $66.5M
- Mega: $15.8M
- Micro: NA

Average Equity Holding Period: 2.04 years