Marathon Club

Guidance Note for Long-Term Investing

Spring 2007

The Marathon Club is a direct follow-up project to the competition run by USS Ltd and Hewitt entitled 'Managing pension funds as if the long-term really did matter'. The Club is comprised of approximately 20 members, ranging from institutional fund trustees, senior executives or senior specialists, representing combined fund assets of approximately £170bn.

The overall aim of the Club is to stimulate pension funds, endowments and other institutional investors and their agents to be more long- term in their thinking and actions, place a greater emphasis on being responsible and active owners and increasing knowledge about how their investment strategy and process can improve the long term financial and qualitative buying power of fund beneficiaries.

The content and guidance encapsulated in this document is a result of a broad and detailed industry consultation and the Club would like to extend its thanks to all those market participants who contributed to its creation. In particular the Club would like to thank Yusuf Samad and Giustino Palazzetti of Hewitt for their considerable contribution in organising this note; Peter Dunscombe, Reg Hinkley, Roger Emerson, Stephen Moore and Peter Scales for actively contributing their thoughts and their time to the preparation of this Guidance Note and Sandy Nairn of Edinburgh Global Partners for providing some useful ideas on manager monitoring.

For more information on the Club's activities, or to enquire about how to become involved, go to: **www.marathonclub.co.uk**

Foreword

The Marathon Club was formed to stimulate institutional funds to be more long term in their thinking and actions, and to place a greater emphasis on being responsible and active owners.

A fundamental issue arising from earlier research and discussions between Club members is how best to overcome the apparent barriers to long term investing, particularly in an environment where funds face deficits and funding problems.

The Marathon Club has received a wide range of responses to the consultation paper it issued in March 2006. This dialogue has greatly assisted us in developing the guidance contained in this document. This is not put forward as a simple solution to the problem nor as a common approach for all funds. However, it is clear that a successful approach to long term investing rests primarily on the mindset of trustees and their beliefs, and on how the investment process is structured, implemented and managed. There is also a heavy responsibility placed on those who advise funds and on those who manage the investments to deliver long term investing.

The Marathon Club plans to research in more depth some of the components expressed in this guidance. In the meantime, I hope you find this document helpful in developing your investment approach and strategy.

Peter Scales, Chairman

Marathon Club

Spring 2007

Contents

Executive Summary

This note seeks to provide practical guidance to trustees and their advisers on behaviour consistent with a long-term approach to investing. In the **Introduction** we note the problems and causes of short-termism identified by Myners and others. We explain what a long-term approach to investing means – an emphasis on capital protection and return over one or more business cycles of at least five years, underpinned by deep fundamental research including understanding long term threats and opportunities – and why pension funds should approach investment in this way. We also identify **6 key components** of a long-term mandate.

We explain firstly why trustees' **investment beliefs** are a fundamental component, which affect all others. We propose that trustees' beliefs should be formally recorded as a standing guide, which should incorporate the trustees' attitude to risk, preferred sources of return, and views on investment styles, governance and ethical issues. We give an example of a beliefs document in Appendix A.

The Marathon Club recommends that clear **objectives** for risk and return should be set, based on the trustees' beliefs and long-term goals, and we list some suggestions. Objectives should be communicated clearly to advisers and investment managers.

Appropriate **selection** of investment managers depends upon determining how each candidate's approach best fits with the trustees' long-term investment beliefs and objectives, together with the establishment of clear mandate parameters. The Marathon Club recommends that trustees ensure that sufficient time is taken to select the right manager. We highlight the advantages of site visits to gain in-depth knowledge of a manager's philosophy and culture. In Appendix B, we set out the likely attributes of a long-term investment manager.

We believe that **alignment** of trustee and manager objectives for the long-term is best achieved through individual managers owning a stake in their business and through the manager's co-investment. We support the wider use of appropriately structured performance fees.

In building and managing a long-term **relationship** between trustee and manager, the Marathon Club places greater emphasis on the content, rather than the frequency, of review meetings. The emphasis of periodic reviews should be on testing the continuity of or changes to philosophy, process, systems, people and internal compensation, and why the manager owns the stocks he does, rather than on quarterly performance. We give examples of possible reports in Appendix C.

Implementation of these recommendations requires strong **governance** and leadership by the trustees, to control strategy and objectives consistent with their beliefs and to withstand the short-term ups and downs of the wider investment market which long-term investing necessarily entails. Trustees therefore need to communicate their beliefs, objectives and strategy clearly and should ensure transparency in implementing strategy and in monitoring outcomes.

The **Way Forward** requires trustees and advisers to work together to implement these recommendations and to develop a long-term approach appropriate to each set of trustees' circumstances.

Marathon Club - Guidance Note for Long-Term Investing

> *"We have a large pool of long-term capital, but do we invest it with a sufficiently long-term view?"*
>
> **Paul Myners, Review of Institutional Investment, 2000**

Introduction

Paul Myners' remarks echo a concern that is shared by many observers within and without the global investment industry. An obsession with short-term outcomes can result in investment choices which may damage or thwart the long-term development of the wider economy, a healthy corporate sector and the financial performance of investment portfolios.

The corporate sector is continually being influenced by the need to satisfy analysts' quarterly earnings expectations. Moreover, active fund managers, when selecting potential investments for their portfolios, are keenly aware that their clients – not least the pension funds of the companies that are being evaluated in this short-term manner – are assessing their performance on a quarterly basis. This obsession with short-term performance measurement is deep-rooted in the investment system and is reflected in a fixation with quarterly earnings guidance, deviations from consensus earnings forecasts, and a focus on a narrow set of performance statistics. The danger, to both investors and the companies in which they invest, is that pursuit of such short term goals may jeopardise long term growth opportunities.

These obstacles to long-term investment – focus on quarterly performance, over-use of stock market indices, and measurement of long term liabilities on a short term basis – have been well documented in various studies. Recognising this, some commentators have recently advocated that companies should give less frequent earnings guidance and shift focus towards longer-term indicators of the health of a business, while investors' attitudes should also change to take a longer term view.

While the need for a change in investors' behaviour has been recognised, the Marathon Club has seen little in the way of proposals as to how it might be accomplished. This guide is intended to help fill that gap - to inform institutional investors and their investment managers of the key elements of long-term investment and to provide advice on successful implementation of a long-term approach. This guidance has been prepared primarily for those people directly involved in making decisions on how the assets of pension funds, charities and endowments are invested. We refer to these decision makers collectively as "trustees".

Why invest long-term?

Generally pension funds and endowments must meet their obligations to members and beneficiaries over a long period. Even the most mature pension fund will likely have expected future liabilities which span more than 30 years. The investment objectives of trustees for the assets invested to fulfil their long-term obligations should recognise and complement this. Broadly speaking, trustees can seek to make money in two different ways: they can endeavour to take advantage of short-term opportunities, effectively to "win" against other investors, or they can seek to nurture genuine economic growth in which they can participate. In the first instance, both winners and losers will emerge as a result of market participants trading against each other. In the second, trustees will be winners if they allocate capital efficiently to businesses within the economy.

Peter Drucker summarised the case for long-term management as follows:

"*…by definition, pensions are long-term. Pension fund management therefore requires long-term strategies for true performance. It is an axiom proven countless times that a series of short-term tactics, no matter how brilliant, will never add up to a successful long-term strategy*".

Peter F. Drucker, The Pension Fund Revolution

Any investment represents an interest in the ability of a business to generate cash flow. This cash flow is ultimately the source of return to investors, in the form of interest, dividends or capital gain. Long term investors are concerned with not only the current return generated by a business but also the capital it must invest to survive, grow and meet future threats.

The contribution of income generation and reinvestment to the total return from equity and bond markets is often overlooked. A study by Brandes Partners shows that, over rolling 20 year periods from 1926-2003, the income component averaged over 60% of total return for UK and US equities.

Recognising the importance of income generation, the essence of a long-term approach should be to seek investments in businesses that have strong earnings potential. To protect against loss of capital, it is important to analyse these businesses carefully to be satisfied that returns are sustainable over a long period of time. Success with this approach requires a deep understanding of the business, its strengths and weaknesses, its capital requirements and risks. Above all, trustees will want to avoid the misallocation of capital which commonly arises from market bubbles.

The Marathon Club defines long-term investment as a fundamental, research-oriented investment approach that assesses all risks to the business and which has a focused discipline of seeking positive returns over the long-term business cycle.

The important elements of this definition are:

- an emphasis on protecting capital and seeking a positive real return over a business cycle, which is typically five years or more;
- thorough research around the fundamentals of a company including the impact of the wider economy, industry structure and trends, quality of management and competitive strength;

- a proper assessment of all risks, including threats due to the competitive environment, the factors of supply and production, labour, technology, regulation, political and economic stability, governance, environmental, social and reputation costs.

The Marathon Club recognises that the elements of this approach are neither new nor unique. It does believe however that true long-term investment will likely be resource intensive and require particular care in the selection and monitoring of investment managers to ensure that they have the skill, depth of knowledge, experience and, most importantly, mind-set required to really understand the long-term prospects and risks of different business sectors.

The long-term approach of allocating capital based on a fundamental understanding of a business is applicable to a wide range of asset classes that are suitable for trustees.

This financial perspective is consistent with a broader view of the responsibilities of trustees as the ultimate owners of the assets they hold – in particular the equity shares of limited companies, and physical assets, such as property, which they may hold directly or indirectly. One of the central tenets of this guidance – that corporate executives respond to the signals sent by investment managers, who in turn respond to the incentives and boundaries set by the primary investors – applies to both financial and what may seem, at least at first sight, to be non-financial considerations. While the Myners Report is primarily concerned with the institutional aspects of investment, it is inherent in its thinking that the decisions taken by trustees - or in some instances the decisions they do not take – are influential in defining the capital marketplace, and ultimately the shape of the broader economy.

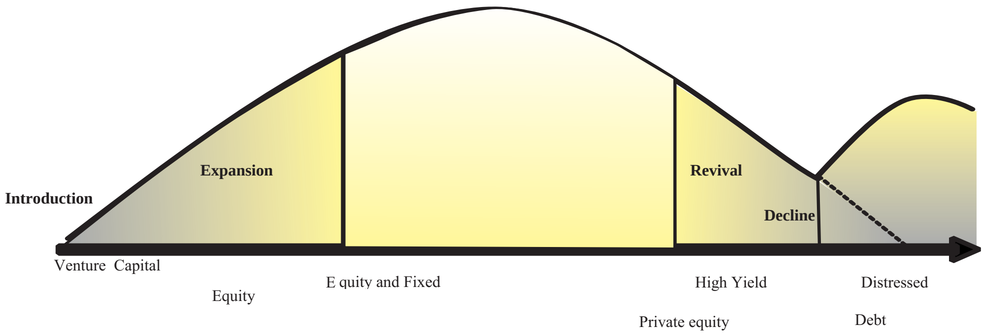
This guidance note is not intended to make a case for a particular social or political agenda, but the concept of 'socially responsible investment' is relevant. In the short-run promoting a certain ethical code, making certain environmentally-sensitive investments, may be viewed as incurring inadequately remunerated costs. But in the long-run such issues impact the firm's licence to operate and/or demand for its goods and services, so what appears as a cost in the short-run can produce genuine shareholder value in the longer-term, given the change in the commercial environment that has been created. Accordingly trustees need to weigh narrow short-term sources of advantage against the long-term impact of their decisions, conscious or unconscious. In this context decisions include broad investment allocation, the holding of individual assets and the exercise of ownership rights through voting policies, not just the timing of buying and selling. Trustees need to ensure that their ownership rights are exercised by investment managers with long-term benefits in mind.

Trustees can allocate capital to businesses within the economy at different stages of their life cycle - introduction, expansion, maturity, revival or decline. In each stage, businesses offer various forms of participation in their economic growth in which trustees can participate, as exemplified below.

- Venture capital investment in companies at early stages of their formation;
- Equity and fixed income investment in companies during their growth and maturity phases;
- High yield fixed income investment, typically in the late maturity phase;

Distressed debt and private equity in companies that are in decline or recovery.

Investment and corporate life cycle



There is a strong rationale for a disciplined long-term approach to investment across a wide range of asset classes, in recognition of the long-term nature of funds' obligations.

Is long-term investing appropriate for all pension funds?

Is a long-term approach only suited to pension funds which are well funded and supported by a financially strong sponsor? The implication of this question is that funds which are not well funded and which have weak sponsors could not adopt the mindset of a long-term investor, because they cannot accept the short-term volatility in asset values that may arise from a long-term strategy.

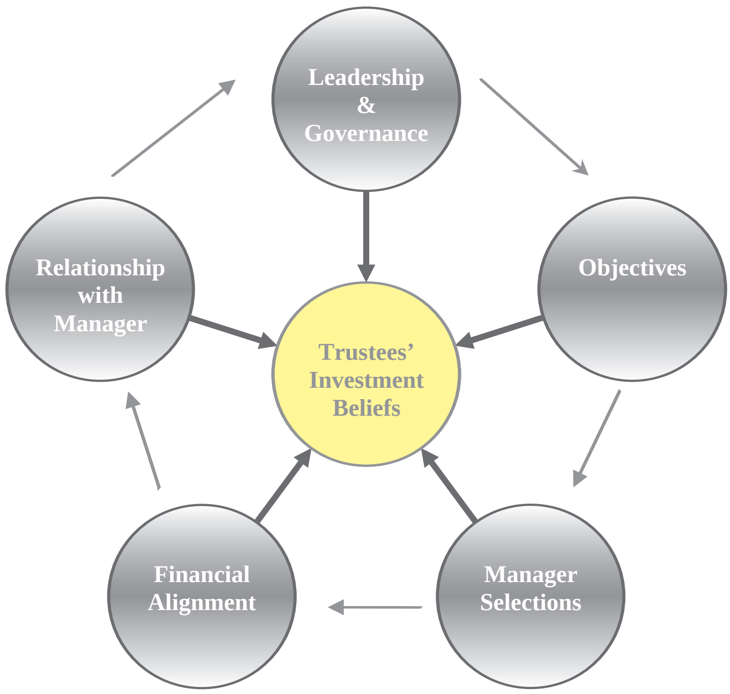
Clearly there is a link between the trustees, the sponsor and the regulator in the environment in which pension funds are managed. The financial position and regulatory requirements of individual funds or their sponsors will influence the assessment of risk, which impacts upon trustees' choice of asset classes, asset allocation and management of liabilities. However, these considerations should not detract from the need for long-term investment thinking within each asset class.

The Marathon Club considers that the issue trustees need to consider when deciding whether or not to employ a long-term approach to each asset class is their time horizon and not the financial position of the fund or the sponsor. The reasons for this view are:

- The risk implications for a pension fund, with respect to its liabilities, of investing in a particular asset class are broadly similar regardless of how the asset class is managed. The risk level associated with investment in equities, for example, will be considerably higher than investing in long-term government bonds that are a closer match for the liabilities. But the level of risk associated with managing the equities with a short or a long-term approach will be within a narrow margin. Thus, the selection of different asset classes has a much greater bearing on managing the risk with respect to pension fund liabilities than the form of management.
- A long-term approach, as defined by the Marathon Club, with its emphasis on preservation of capital and absolute return, should imply less downside risk than a short-term approach.
- The Marathon Club believes, like Peter Drucker, that a series of short-term approaches is unlikely to generate the desired return.

To the extent that a fund has a short-term horizon, it will need to divest assets in the short-term to fulfil its obligations. This should be reflected in its asset allocation: a fund in this position will need to invest in assets that it can sell easily and bear little liquidity risk, e.g. government or investment grade corporate bonds.

Components of long term mandate



In contrast to some observers of the investment industry, the Marathon Club does not believe that merely extending the formal term of investment management contracts will lead to a long-term approach.

The components of a long-term approach highlighted in the definition proposed by the Marathon Club have to be embedded within the philosophy and process of the investment management organisation. Crucially, for such an approach to be successful and not abandoned mid-course, trustees must buy into the beliefs that underpin this definition.

Central to a long-term approach are the trustees' own investment beliefs. Trustees should endeavour to articulate their **beliefs** before venturing into long-term investing. Furthermore, the **leadership and governance** of the trustee or investment board has an important influence in forming, implementing and sustaining these beliefs. Implementation is achieved through setting clear investment **objectives**, ensuring appropriate **manager selection** and **alignment of financial interests** and through managing the **long-term relationship**.

“'You damn sadist,' said mr cummings, 'you try to make people think'.”

Ezra Pound

“The little girl had the making of a poet in her who, being told to be sure of her meaning before she spoke, said: ‘How can I know what I think till I see what I say?’”

Graham Wallas

Trustee Investment Beliefs -Why are they critical?

The Marathon Club considers that the formulation and articulation of trustee investment beliefs is a fundamental building block in the setting of a coherent investment policy. Our contention is that the approach to managing institutional assets is driven by the beliefs trustees have about investment in general.

Putting these beliefs in writing establishes a reference that will help trustees in withstanding the uncertainties and challenges created by market movements. Devoting sufficient time to determining core beliefs is critical to establishing and reaffirming the overall approach to investment, ahead of decisions on strategic asset allocation, selection of investment managers and mandate structure. It also provides a solid foundation for maintaining good relationships with managers. Furthermore, the governance of trustee boards has to be such that these investment beliefs, whatever they are, are referenced and applied over the long term.

Consultants and managers are more likely to respond in the right way to what the trustees require if those beliefs are expressed clearly. We suspect that many trustees may not have articulated their beliefs with sufficient clarity. Our recommendations are designed to encourage trustees to state their beliefs explicitly in writing. Such a document can then be used as a guide for the trustees, their advisers and investment managers in making future detailed investment decisions.

The Marathon Club recognises that the preparation of an “Investment Beliefs” document to develop both an understanding of the issues and a real consensus capable of lasting through changes in individual trustees requires an investment of time. However, we believe this to be such a fundamental building block that in the long run it will be time well spent.

Trustees should set aside sufficient time for real discussion. A number of funds now have “away days” where overall strategy is discussed – we applaud this practice. The make-up of trustee boards will inevitably be such that some trustees have greater in-depth knowledge than others, but appropriately facilitated discussions (in which advisers may play an important role) should enable decisions to be reached.

In light of the investment of time required by this approach, it may be tempting for trustees to delegate the formulation of beliefs to a specialist in-house manager or external consultant. We believe that such specialists have a valuable role to play, but trustees must own the investment strategy if it is to be effective and therefore must play a full part in its formulation and application.

We wish to make clear that, in recommending that trustees' investment beliefs be formally recorded as a reference point, we do not consider it necessary that they be included in any Statement of Investment Principles or regulated in any other way. The primary purpose of the beliefs document is as an internal reference to inform trustees, to help them set appropriate investment strategy and objectives and to choose investment managers who will support them. The Statement of Investment Principles should, of course, be consistent with the Investment Beliefs.

The Marathon Club is mindful of the dangers of guidance principles turning into a checklist which might inhibit, rather than encourage, the thinking it wishes to promote. In formulating guidance, we have attempted to avoid a long list of questions and to concentrate instead on what we see as the key issues. These are

- **Attitudes towards investment risk**
- **Trustee preferences on sources of investment return**
- **Attitudes towards investment managers and management styles, e.g. growth, value, small or large cap**
- **Beliefs on governance of corporations and corporate responsibility in management of social and environmental risks.**

A key issue for trustees to consider in formulating investment beliefs is the risk they are prepared to accept, both in absolute terms and in terms of volatility and liquidity. The more short-term the liabilities being provided for are, the greater should be the concerns about volatility and liquidity because of the increased danger of being forced to sell the investment at an inopportune time. Market volatility and liquidity are feared more than they should be by trustees. For these investors it is important to guard against the risk of loss due to company failure or weakness in security covenants. The trustees' attitude to volatility and liquidity, and the extent to which they see those as risks to be minimised or opportunities for reward, will be a strong factor in shaping investment beliefs.

Trustees need to consider the extent to which they see returns being generated through participation in economic growth, through compensation for market volatility or illiquidity, through exploitation of market inefficiencies, or through stock selection. Do trustees believe that equities will outperform bonds over the long term? In terms of stock selection, to what extent do trustees believe that fundamental, research oriented buy-and-hold investing is superior to other styles over the long term? Or should any other style be favoured? Do trustees believe that any investment manager can persistently outperform the market over time and that it is possible to identify such managers in advance?

Keynes expressed his beliefs on investment in 1938 as follows:

"I believe now that successful investment depends on three principles:

1. a careful selection of a few investments (or a few types of investment) having regard to their cheapness in relation to their probable actual and potential intrinsic value over a period of years ahead and in relation to alternative investments at the time;

2. a steadfast holding of these in fairly large units through thick and thin, perhaps for several years, until either they have fulfilled their promise or it is evident that they were purchased on a mistake;

3. a balanced investment position, i.e., a variety of risks in spite of individual holdings being large, and if possible opposed risks (e.g. a holding of gold shares amongst other equities, since they are likely to move in opposite directions when there are general fluctuations)."

Clear and explicitly stated beliefs not only help trustees to decide on their investment approach, but define what they expect to gain from it and determine how they should behave with their agents and how their agents should behave.

It is quite possible that some pension funds and endowments may decide that they are not long term investors, in the sense that they are indifferent to the source of their investment return. For such funds, earning return from active short-term trading or arbitrage ("speculation") would be equally acceptable to investing to capture the benefits of long term economic growth. The recent increase in pension fund mandates for currency and commodities may be an example of such behaviour.

Equally, some trustees may believe that equities will outperform bonds in the long-term but have less faith in their or their advisers' ability to pre-select successful investment managers. Such trustees would likely place a greater emphasis on passive investment and minimisation of management and transaction costs.

There is an increasing consensus that management or mismanagement of issues such as reputation, corporate governance, the environment and human capital management can play a significant role in long-term value creation or destruction. Societies around the world are becoming more aware of these issues and are increasingly willing to penalise businesses that fail to take proper account of them. As a result, mismanagement of these issues can impact upon asset values. As this is a new and developing area, trustees may wish to formulate beliefs on how they expect their manager to manage these risks and how they would monitor the exposure of their investment to these risks.

The Marathon Club recognises that there are often moral and ethical issues associated with investment, for example in tobacco, gambling or defence companies. Not only are these issues difficult to quantify and assign a monetary cost or benefit but they are also highly subjective. It is up to trustees to decide, within the context of their own fund, how to address these issues within their investment portfolio and set this out in their Investment Beliefs.

We consider that the following beliefs are a prerequisite to long-term investing:

- **Equities will outperform bonds in the long term**
- **Participation in economic growth is a major source of long term equity return**
- **Illiquidity and volatility are short term risks which offer sources of additional compensation to the long-term investor**
- **Fundamental, research oriented, buy-and-hold investing is superior to other investment styles in the long term.**

Appendix A gives an example of the belief set which might formulated by trustees to guide their investment policy.

> *" Far better to dare mighty things, to win glorious triumphs, even though chequered by failure, than to take rank with those poor spirits who neither enjoy much nor suffer much, because they live in the grey twilight that knows not victory nor defeat."*
>
> **Theodore Roosevelt**

> *"The first rule of investment is don't lose money, the second rule is don't forget the first rule and those are all the rules there are."*
>
> **Warren Buffett**

How should the objectives for return and risk be framed and expressed?

Objectives for an investment mandate help to give direction to the manager on what the trustees wish to achieve; they also serve as a tool for measuring progress. The Marathon Club believes that the efficient allocation and preservation of capital should be central objectives of a long-term investing. It is not enough simply to preserve capital; it should also maintain its purchasing power over the long-term.

A pension fund exists to pay the pensions of its members. The pension fund has two sources for providing for these liabilities: contributions from the sponsoring employer and from active members and returns from investment of those contributions. The setting of objectives for investment returns and the time horizon for achieving them will depend upon the maturity of the scheme and the covenant of the sponsor. Doubts over longevity, inflation and real salary growth assumptions are all factors which create uncertainty over the level of future liabilities that even a mature pension fund may have.

Trustees should recognise that return objectives are twofold. The primary objective is the overall return which the pension fund or endowment is trying to earn on its total assets. The secondary objective is asset class specific. In this instance, the greatest challenge arises in defining an appropriate way of measurement which is aligned with the achievement of the primary objective. Given the very long and uncertain nature of pension fund liabilities, we suggest that trustees should consider breaking down the setting of objectives into stages.

Long term return objectives

Pension funds started investing significantly in equities in the 1950s because they saw equity investment as a means of participating in long-term economic growth to offset longevity and real salary growth risks. The Marathon Club thinks that this continues to be sound reasoning: most pension funds will have potential liabilities stretching into the future, so equity investment (and a long-term approach in particular) should play a part in their investment strategy.

An appropriate first stage may be deciding on a long-term aspiration for long-term equity investment. Part of this might be expressed as the aim of creating a sufficient "surplus" over liabilities to cover uncertainties without recourse to increased contributions from the sponsor. Another factor will be the amount and time period of expected contributions from the sponsor, linked with the strength of covenant of the sponsor.

Working backwards, one can then calculate the return needed over the long term to meet the aspirational goal. This might be expressed as an absolute measure, but, more typically, it would be in the form of a real annual return expressed as outperformance, by an appropriate percentage, of liabilities or of an inflation measure such as RPI.

Risk management objectives

A second stage would be to establish risk objectives, to incorporate the level of risk in shorter term valuation movements that the fund and its sponsor are willing to bear. Traditional risk measures such as “tracking error” and volatility refer to market indices rather than the absolute or liability related measures which are more appropriate to pension funds and endowments. Appropriate risk objectives might be set in various ways e.g:

- Absolute, to maintain absolute volatility or lose no more in any given year than a certain percentage of the fund;
- Liability-based, to underperform the liabilities by no more than a certain percentage in any year;

These measures seek to limit short-term risk. It is fundamental, however, to long-term investing to regard short-term volatility not so much as a risk always to be avoided but as an opportunity for return. While it may not be appropriate to set minimum risk levels, monitoring such measures as deviation of the portfolio from an index (“tracking error”) or probability of loss (“Value at Risk”) may help to test the level of conviction of an investment manager in its investment choices.

Other types of risk indicators particularly appropriate to long-term investing, regardless of the return objective, include:

- Minimum (and possibly maximum) number of stocks
- Maximum size of any single position
- Portfolio turnover
- Gearing

The next step would be to test the compatibility of the fund’s aspirational goal for returns with its risk tolerance, to test whether the goal is practically achievable within these constraints. The less the constraint, the more aspirational the goal may be.

The end result should be a combination of objectives for long term return and management of risk which can be incorporated into a mandate.

Time Period

The final step is setting a reasonable time period over which the investment return objective should be measured. Investing for the long-term, trustees must recognise that, typically, investment returns from such an approach may come in waves rather than a straight line. We believe that return objectives for long-term investing should be set for, and judged over, the course of a whole business cycle – i.e. 5 to 7 years.

Setting a return objective for such a period inevitably raises questions about how manager performance should be measured in the interim. The Marathon

Club believes that the best approach is a more in-depth review at the time of manager selection, with ongoing monitoring concentrated more on the manager's investment process and portfolio construction. These issues are dealt with more fully in the sections on *Manager Selection* and *Relationship.* Questions around how performance against the benchmark is related to compensation are discussed in the section on *Alignment*

"A good marriage is at least 80 percent good luck in finding the right person at the right time. The rest is trust."

Nanette Newman

"Trust, but verify."

Ronald Reagan

Manager Selection

Introduction

Having set a mandate, the most important decision trustees make is selection of the manager. Choosing the right partner is critical to the success of a long-term relationship. Those with experience of a long-term investment approach stress that significant time and resources need to be committed to the manager selection process.

The Marathon Club believes that, under conventional mandates, trustees and managers often do not spend enough time together prior to appointment. The 'beauty parade' format has, in many cases, been too short and superficial, and trustees only really get to know managers, if at all, much later. A much higher mutual understanding of the beliefs of each party must be reached at the very outset to see if there is a fit.

We recognise that the available time and resources of the trustees themselves will often be limited. In addition, not all trustees will have the level of expertise required for in-depth review of a potential investment manager. It is therefore imperative that trustees make best use of the time and resources which are available. As the Myners Report mentions, it is good practice for trustee boards to have an investment panel to which all or a significant part of the selection process can be delegated. In addition, there will almost always be some level of in-house expertise on which the trustees can draw, whether staff dedicated to the fund itself or finance or treasury staff of the scheme sponsor. Finally, there are independent investment advisory resources available from large firms and an increasing number of specialist boutiques.

Process steps

A robust selection process requires clarity in setting out the steps in it, assigning responsibilities for each step, the criteria for decision making, and (where responsibilities have been delegated) reporting decisions and the reasons for them. We believe that a robust selection process should place emphasis on the establishment of mandate parameters and the criteria for manager selection, in the light of the trustees' formulations of beliefs and objectives, so that the candidates short-listed do indeed have the attributes needed for long term investment in line with those beliefs and objectives.

Establish mandate parameters

It is important to specify as clearly as possible the limits to be imposed on the mandate. For example, for an equity mandate this could include size of companies by market capitalisation, exposure to overseas markets, risk controls, use of derivatives and hedging, benchmarks and performance targets, and any social, ethical and environmental constraints on stock selection. A mandate requiring absolute returns or any specialist requirements outside normal mandate construction should be made clear at the outset of the manager selection process.

Do the candidates fit the requirement?

The Marathon Club believes that there is scope for significant improvement in the selection process. Over-reliance on investment consultants without sufficient critical evaluation may well lead to an inappropriately narrow range of candidates. The more the investment panel delegates the drawing up of the shortlist to the consultant, the more it should question the consultant to ensure that its evaluation criteria are consistent with those of the panel and that it has carried out the appropriate level of research. Merely asking the consultant to put forward its highest rated managers is likely to produce the same names every time. This may not necessarily include managers that are particularly suited to long-term investment.

In Appendix A we set out a list of characteristics we would expect to see in any candidate for a long-term investment mandate. Some of these might be considered a requirement for *any* mandate, but for long-term investment we place particular emphasis on an investment approach, consistently applied, with a focus on capital maintenance and fundamental research. This should be evidenced by portfolios which differ significantly from the index, with lower than normal turnover and the capacity to successfully hold views contrary to the market. Any candidate should be able to provide analysis of its track record, showing the sources of return, to support the viability and sustainability of its investment process.

Having drawn up the short list, many trustees might consider formal presentations to be the next step. However, the Marathon Club recommends that the investment panel or selected members should first make a site visit to each candidate investment manager's offices. Such a visit should help to give a more in-depth insight into each manager's investment philosophy and processes in action and it should enable the panel to better gauge the culture of the firm and its people. In advance of such a site visit, the panel should identify the key areas it wishes to explore. To assist it, the panel could draw up an appropriate list of questions designed to establish how well the candidate meets the required characteristics. Site visits by prospective clients are expected as a matter of course by US investment managers. This is a step we especially recommend trustees to adopt themselves, rather than delegate to external advisers. It's a great way of really finding out what makes the investment manager tick.

The Marathon Club recognises that its recommendations will likely require considerably more time and resource to be devoted to the selection process than trustees might currently take, but we believe that to be a good long-term investment.

Duration of contract

It is important that the trustees and the manager take time to agree at the outset what events would be used to review the contract. These are likely to include concerns about key people, ownership or process changes, regardless of what the results are. In other words, if the initial conditions that were considered essential for entering into a long-term relationship change, then the contract is reviewed.

Documenting the reasons, expectations and monitoring processes will serve to remind both parties of the beliefs and objectives.

Although the duration of the contract is not necessarily synonymous with long-term investment, the Marathon Club recognises that there may be extended periods of under-performance against market indices. Trustees will need to consider this as they consider long-term mandates.

J.M. Keynes said:

"An investor is aiming, or should be aiming primarily at long period results, and should be solely judged by these. The fact of holding shares which have fallen in a general decline of the market proves nothing and should not be a subject of reproach. It should certainly not be an argument for unloading when the market is least able to support such action".

At a minimum, trustees should accept that they may only obtain an objective appraisal of performance if they consider a full business cycle as the term of the appointment. Within this timescale trustees should consider what signals should be used for the early identification of potential problems.

How should managers be remunerated to align their behaviour with long term objectives?

The separation of interests of asset owners and their managers leads to an agency problem for owners. Though managers act as agents of owners, their objectives are not necessarily aligned with the owners. It could be argued that the *ad valorem* fee structure that is common in the industry encourages a long-term approach, because growth in fees comes from growth in asset values. However, the linkage is not sufficiently strong in itself. In addition, full alignment of interests requires alignment not only between investor and investment manager but also with the employees of the investment manager.

This may be why the best long-term investment performance is often found in boutique investment houses, where the investment manager has also invested its own money. The following excerpt from the third quarter newsletter of Eagle Capital Management Inc illustrates the point:

"In ancient Rome, when a bridge was completed, the architects and engineers who had initially designed it stood beneath the structure as the first carriages drove over. If the design was faulty, the bridge would collapse and they would be crushed. THAT is an incentive which aligns behaviour with client interest."

The Marathon Club strongly supports co-investment as probably the clearest and strongest mechanism for gaining alignment of interests.

The use of performance fees is more complex. There is an advantage to using performance fees only if it will change the investment manager's behaviour in the way intended.

If the investment manager does not have, at the outset, beliefs about the advantages of long-term investing which are already embedded in its investment management style and processes, what assurance is there that performance fees will change those beliefs and processes? The danger of an inappropriate performance fee structure is that it may encourage excessive short term risk taking, for example to meet an impending three or five year goal. In addition, many investment managers say that performance fee structures will not change their behaviour, and only a relatively small proportion of their mandates have such structures. Only a minority of trustees appear to be encouraging them.

The Marathon Club supports the wider use of performance fee structures, suitably tailored to each case.

The likely components of any performance fee structure might be:

1. A base fee, which might most appropriately be calculated to cover the manager's basic costs (excluding any performance related costs within the manager) plus a small margin.
2. Performance related fees, designed initially to bring total manager remuneration towards the level of a "normal" basis point fee for the asset class on the achievement of an agreed return.
3. A ratcheting effect, so that reward might progressively increase with out-performance of various "hurdles", subject to a ceiling or absolute cap.

Design of the fee structure will require negotiation with the investment manager and must be consistent with the levels of risk the trustees wishes the manager to take. The better the performance – not simply the higher the market – the higher will be the performance fee.

One feature that has been used to discourage trustees' change of managers for reasons solely to do with short-term performance is a sliding scale redemption charge. The redemption fees progressively reduce over the term of the mandate and may be fully withdrawn after some specified period. However, exemptions to the sliding scale redemption fees need to be built in and to include trigger events for review of the mandate which are non-performance related.

Relationship with the investment manager and monitoring

What is measured and monitored will have an influence on the relationship between trustees and investment managers. The quarterly monitoring process, with a focus on performance relative to an index has become the norm in the investment industry and has been blamed for promoting short-term behaviour by investment managers.

The Myners Review recommended that *"pension funds should provide fund managers with clarity about the period over which their performance will be judged"*, so as to reduce uncertainty for managers.

The Marathon Club considers that it is the focus and content of the review meeting that has greater bearing on manager–trustee behaviour, than either the frequency of review or the lack of clarity around the term of the contract.

The content and conduct of review meetings can help build mutual trust between trustees and their managers. When trustees simply focus on performance without intimate knowledge of the process they are likely to encourage short-term behaviour. If the ongoing reviews inform the trustees of the investment manager's decision making process, so that they can assure themselves that the philosophy and process they bought into initially is intact, this will engender a relationship of trust. In long-term investing, the purpose of the ongoing review should be to help the trustees determine that they are still on track to achieve their long-term objectives.

Frequency of review meetings

In the early stages of a mandate, trustees and the investment manager may feel that it is necessary to meet frequently, e.g. quarterly. The regular pattern of meetings is best determined only when a good dialogue and understanding of the investment strategy and approach has built up between trustees and the manager. The depth of preparation and discussion for a formal review of a long-term investment mandate is likely to require a commitment of time such that an annual review cycle may be more appropriate, once the relationship is established.

Regardless of the cycle of formal review meetings, trustees can obtain quarterly reports from their in-house staff or investment consultant on the manager's performance and organisation.

Agenda and preparation

Trustees should set the agenda for the review meeting and agree the format of reports from the manager. Trustees need to be sufficiently briefed in order that they can ask pertinent questions. Investment advisors and internal staff have an important role in helping to set the agenda and prepare trustees for the review meetings.

Trustees also need to decide who they wish to see in the review meeting. Ultimately the portfolio manager is best placed to give an understanding of the investment portfolio. Yet, this practice can distract portfolio managers and therefore must be considered when deciding the frequency and location of the manager review meetings.

Contents of a review meeting

The Marathon Club recommends that a review meeting covers the following:

1. Changes to investment philosophy, process and systems. Trustees should encourage the manager's skills, allowing subtle adjustments to keep pace with evolving markets. In contrast, reactive changes to an investment process following a period of underperformance would be grounds for concern.

2. Changes to organisation ownership, general management and key staff compensation, particularly co-investment;

3. Continuity in key personnel;

4. Major client acquisitions and losses;

5. Regulatory issues;

6. Adherence to process and performance

It is, perhaps, inevitable that trustees will continue to look at the return and compare this to an index or the performance of comparable managers in order to get some sense of the context of their manager's performance. The Marathon Club advocates that the emphasis of the review ought to be on testing that the process and the development of assets within the portfolio conforms to the underlying philosophy or investment beliefs. The focus must not be on price-based, short-term performance measures. Such measures are an inappropriate way to decide whether to retain or change managers under a long-term approach.

> **"Compared with their predecessors, modern investors concentrate too much on annual, quarterly, or even monthly valuation of what they hold, and on capital appreciation and depreciation generally; and too little either on immediate yield or on future prospects and intrinsic worth."**
>
> **Keynes 1938**

The indicators for the portfolio review would be most helpful if they are based on the way the manager manages money and should be developed with input from the manager, at the final stage of manager selection.

Trustees should check whether the individual characteristics of the portfolio are consistent with the overall investment process, e.g. in terms of the number of holdings, concentration, type of holdings (small, large, growth or value oriented), turnover, themes, valuation characteristics (price-to-earnings, yield, manager's valuation, etc.) or fundamental characteristics (return on equity, operating margins, sales/earnings growth rates, etc.). Trustees should be able to test how new purchases conform with the investment philosophy and security selection process and how sales conform to the sell discipline.

From a snapshot of the portfolio, trustees should identify a very small number of holdings, possibly new purchases or holdings that are out of favour with the market, for a more detailed discussion. A case-by-case analysis, as shown in Appendix C, can be the most insightful part of the monitoring process as it will help the trustees understand how the process is being applied, the depth of research and see the output of the investment philosophy.

As already described above, trustees should agree the metrics with the investment manager which will be used for evaluating the portfolio at the final stage of the manager selection.

The type of metrics agreed upon will vary according to the preferences of the trustees and the way the investment manager is managing the money. Some examples of the types of measures that could be relevant for monitoring long term mandates are provided in Appendix D.

Termination of a Manager

A mandate should be terminated if, based on a review process described above, the trustees conclude that the portfolio does not reflect the investment philosophy and process or that changes to the organisation or key individuals are such that the philosophy and process will not be deliverable in the future.

Trustees will generally need to be more tolerant of managers appointed for a long term mandate who may encounter occasional bumps in the road (experiencing periodic performance decrements in anticipation of a major pay-off).

> *"Effective executives concentrate on the few major areas where superior performance will produce outstanding results."*
>
> **Peter Drucker**

Governance, Leadership and the role of Internal Executives and Advisers

Given that trustees' actions will vary from fund to fund, depending upon the total resources available, there is no clear standard definition of roles and/or trustees' relationships with internal executives and advisers. The National Association of Pension Funds has explored this area in more detail in its March 2005 publication, and we refer readers to this source for additional information.

The long-term approach is more demanding and onerous for trustees than the traditional approach to investing. As outlined in this guidance note, long-term investing requires trustees to articulate their investment beliefs, set overall investment strategy, select managers through a more intensive manager selection process, negotiate arrangements that are aligned to their funds' financial interest and thoroughly test the portfolio implementation for conformity with the underlying process.

Successful long-term investing will place a strain on governance arrangements and will require leadership, particularly in resisting short-term pressures. This leadership has to come from within the trustee board and from independent advisors. Leadership is important to help withstand pain when the long-term approach lags the market, when patience and adherence to belief are needed to hold the course. Strong leadership will also hold the trustees firm to their beliefs as over the course of time inevitable changes take place in the make up of the sponsor's board.

Besides leadership, the long-term approach requires trustees to take greater control over strategic direction, which in turn needs them to develop a deeper understanding of investment issues and to be up to date with investment trends. It is incumbent upon trustee boards seeking to apply the principles of long-term investment to review whether they have the necessary skills, access to expert independent advice and organisational structure to successfully manage a long-term investment programme.

Debate has generally regarded this as a resourcing issue and concentrated on governance, as opposed to leadership. In our view, whatever beliefs trustees espouse, they need to ensure that:

- The strategic framework for implementing investment policy is consistent with those beliefs;
- The beliefs, strategy and framework are clearly understood by all involved; and
- There is transparency in implementing the strategy and in monitoring outcomes.

This is the reason why the Marathon Club lays such emphasis not only on the initial formulation of beliefs and objectives, but also on the processes by which investment managers are selected and monitored. We consider these to be important in the context of any mandate, but particularly so for long-term investing. Experience suggests that, in the absence of clear emphasis by trustees on long-term value creation, investment managers and trustees will become too concerned with short-term comparisons to the detriment of long term performance.

The Myners Report and other publications have all highlighted the problems caused by trustees having limited time or experience. In these circumstances, trustees need to determine what matters should be delegated to internal executives or to external service providers. Delegation of investment issues to an investment committee or a small group of trustees along with internal executives and independent advisers can be an effective vehicle for dealing with the complexity of investment issues.

The format of investment committee meetings can adapt to a long-term approach by placing greater emphasis on less frequent but more in-depth reviews of investment issues, instead of the typical quarterly cycle. The investment committee can still keep track of developments in the portfolio and investment trends through quarterly reports from the investment manager and the independent advisor. An effective structure would promote ongoing training and encourage the manager or independent advisor to notify the trustees of any critical developments, outside of the quarterly reporting and annual review cycle.

While these may all be considered aspects of good investment process in a more traditional approach, they are fundamental to the good governance of long-term investment.

A number of commentators, including Myners, have lamented the reduction in numbers of in-house investment managers. We understand that, for those funds or sponsors who can sustain and manage an in-house team may be easier to obtain alignment between the fund's objectives and the manager's investment strategy. Leaving aside the counter-arguments on conflicts of interest, many funds will simply find it impossible to attract and retain investment professionals of sufficient quality or will be too small to justify an effective in-house arrangement. For them the only choice is between different external advisers. These business realities reinforce the need for clearly stated beliefs and policies and, equally importantly, manager selection and monitoring processes which are consistent with the trustees' stated aims.

The way forward

The Marathon Club believes that trustees of endowments and pension funds must fundamentally re-consider the way they invest.

This paper argues that a long-term approach is ideally suited to investors who have a long time horizon. A change of mindset is needed for investors to think of success in investing as participation in the growth of enterprises within the economy at various stages of their life-cycle. This is different from the widely followed approach of perceiving success as outperforming market indices over short periods of time.

The Marathon Club recognises that the change in mindset needed is significant. It cannot be achieved without the cooperation of all participants in the investment chain – trustees, investment managers and investment advisors. The role for each is clear:

- **Trustees must devote time to establish their investment beliefs and express their need for long-term investment in seeking advice;**
- **Investment advisors must raise trustees' awareness of a long-term approach through advice, discussion with and training of trustees.**
- **Investment managers must be prepared to offer investment products with a long-term approach, which includes appropriate pricing structures and reporting.**

Some might argue that there is insufficient supply of long-term investment products. We believe that the supply will follow demand. If trustees, supported by their consultants, ask for long-term approaches to investment and question managers on their approach, the products available will expand. This Guidance Note should help trustees to specify their need for long-term investment and create such a demand.

Appendix A: Investment beliefs

Underlying beliefs	Practical evidence
Strength of a sponsors' covenant can allow a longer term deficit recovery period, say 20 years.	• Reasoned funding strategy statement • Long term volatility features in risk assessment both to funding levels and contributions
Equities will outperform bonds and therefore should dictate the asset allocation.	• Heavy weighting of equity type assets in relation to bonds
Diversification across all asset classes, asset types and management structures will reduce volatility of deficit.	• Specific mandates to asset classes • Allocations to alternatives and to quoted equities with long-term expectations • Mix of styles and approaches
Passive management of equities provides low cost exposure to equities.	• Use of index tracker mandates for equities with clear benchmark performance targets
Active managers can add value over the long-term with clearly expressed objectives.	• Objectives expressed in terms of periodic out-performance • Careful manager selection process and due diligence
Different management styles can reduce volatility but can cancel out performance.	• Choice of different approaches • Manager freedom to hedge out short-term market impact
Benchmarks and risk parameters constrain active managers.	• Absence of benchmark constraints on asset allocation • No tracking errors imposed • Benchmarks used only to define a performance target
Market indices should be used to set performance targets but should not define security selection.	
Alternatives to publicly quoted equities provide additional return, but carry additional solvency risk.	• Portfolio performance targets set in relation to liabilities and relative to equity risk premium
Any allocation to bonds should be for cash flow matching purposes.	• Bonds allowed within multi-asset mandates • No specific mandates for bonds • Structured mandates for cash flow matching
Important to avoid being a forced seller in short term markets.	• Cash or liquid assets held linked directly to fund short-term cash flow requirements • Clear strategy agreed for cash
Performance of active managers should be assessed to confirm that the original investment process on appointment is being delivered.	• Criteria evidenced at time of appointment • Monitoring focuses on action in relation to criteria • Investment decisions evaluated against strategic criteria

<table>
<tr><td>Short-term performance reviews detract from long-term strategy.</td><td>Manager performance reviews operate annually
Emphasis on forward strategy rather than past actions</td></tr>
<tr><td>Active management performance should be monitored over annual rolling cycles.</td><td>Performance targets linked to actuarial valuations and targets
Forward targets set on rolling three years</td></tr>
<tr><td>Active managers cost more money.</td><td rowspan="2">Investment management costs rise as a percentage of fund value
Fee levels structured to reflect performance
Fee scales combine flat fees with shares of out-performance
High performance increases fees rather than market increases</td></tr>
<tr><td>Fees should be aligned to the interests of the Trustees rather than the performance of the market.</td></tr>
<tr><td>Investment consultants are a source of expertise and research to inform trustee decisions, which should be based on independent advice.</td><td>Trustees use independent advisers to guide selection and mandate construction
Trustees use consultants to advise on manager long lists and provide research
Independent advise is used to determine monitoring and performance evaluation
Process in place to assess trustees, advisers and consultants</td></tr>
</table>

Appendix B: Attributes of a Long-Term Investment Manager

- *stability of ownership, financing and staffing the investment management business. This may come from its ownership by the current generation of managers, or at least by their having a very significant minority holding*
- *manager remuneration based on alignment of financial interests, e.g. co-investment in the same strategy or fund*
- *investment processes with a focus on capital maintenance and a distinctive investment philosophy, typically based on fundamentals, for researching investment opportunities*
- *the ability to monitor and control risks from poor corporate governance and to exercise ownership rights*
- *the ability to assess long-term risk factors from damage to environment, poor human capital management and damage to reputation*
- *wherever possible, a track record over several business and market cycles*
- *analysis of the track record which references the source of return to the investment process, to support its validity and sustainability*
- *evidence of being able to hold a successful contrary view to the market*
- *portfolios (often but not necessarily concentrated in a smaller number of stocks) which differ significantly from the index and sector weightings of the broader markets*
- *low portfolio turnover (typically 10-30% per annum, rather than the 50-200% recorded among conventional managers)*
- *internal absolute return targets. NB: trustees need to ask themselves and their advisers whether long-term managers who are prepared to accept targets such as RPI plus 5% per annum or more, or whose internal benchmark is cash plus or gilts plus, are adequate in relation to their investment policy*
- *the discipline to invest money only as opportunities arise, rather than vesting immediately into an existing portfolio, (sometimes on a commitment/drawdown basis like private equity, or being prepared to hold cash or bonds until sufficient real asset opportunities present themselves)*
- *avoidance of growth in assets under management at the expense of investment performance, evidenced by a policy of closure of funds to new inflows whenever necessary*

Appendix C: Example of Individual Stock Analysis

Company	Date	Buy/Sell	Shares	Local Price	% of Portfolio
MITSUBISHI	17 October 2005	SELL	145500	2131.14	2.93
The company is a hybrid. It is part bank, part middleman, part manufacturer, part investment company. Prospects depend to a great degree on domestic Japan but Mitsubishi is also geared to China in particular. It's very difficult to analyse given the business mix and a structure which is overlaid with gearing. Margin improvement has occurred and the share price has responded.					
KOOKMIN BANK	14 October 2005	SELL	38500	55.22	2.29
In the last eight years there has been the Asian crisis, the chaebol insolvency crisis, the LG Card insolvency with related massive fraud and the credit card lending crises are a way of life. As Korea's largest bank Kookmin has had and will continue to have its share of exposure to these highs and lows. At the moment the country is working through a credit crunch which is the aftermath of the overlending of 1999-2002. Trying to look through these emerging economy growing pains is not easy but amongst the structural positives the country offers a higher growth and positive demographics.					
ITOCHU	17 October 2005	BUY	350000	739.90	2.44
Itochu is a diversified trading/financial manufacturing/resources company. Until recently this had produced an abysmal ROA which, combined with a geared balance sheet, had left an unappealing investment proposition. The operating leverage is enormous and with costs under control a sub 10 PE is possible next year. This will be facilitated by a domestic cyclical recovery. It's geared by cheap enough.					
PETROBRAS PN SPN.ADR 1:1	11 November 2005	SELL	35000	56.33	2.06
Rising production volumes and healthy refining margins no longer underpin the share price against any future oil price decline. The valuation now over discounts a sustained high oil price.					
DELL INC	17 November 2005	BUY	95000	29.84	2.98
There are still plenty of computer market segments for Dell to address, such as servers, printers and peripherals. Its concentration on the direct selling channel gives it a huge cost advantage over traditional vendors. The stockmarket has become overly-concerned with the maturity of the US consumer pc market, which provides a buying opportunity.					
DEUTSCHE POST	18 November 2005	BUY	107000	18.98	2.49
The FYI dividend yield will be at least 3.5%. In addition, the absence of large acquisitions could permit a rise in the payout ratio to well above the stated 35% target. There remains a small risk that profits might suffer from higher than forecast pensions and restructuring costs.					
COLLINS STEWART TULLET	14 December 2005	SELL	207290	5.91	2.05
The shares had been under a cloud since the Splits scandal but its fortunes are now as an IDB, rather than a broker. Reported bid discussions then pushed the shares higher, to a level where we felt the recovery was fully discounted by the price.					
MERCK & CO.	15 December 2005	SELL	86800	29.90	2.46
Merck is currently facing a wave of litigation following the withdrawal of its Vioxx drug and is a company in crisis mode. The fundamental outlook is poor due to 35% of revenues facing generic competition. The stock now yields 5.5% with a very strong commitment to this payout. Merck is seen as a takeover candidate. However, it is unlikely Merck can be taken over until litigation fears recede. The stock could be reacting to the whims of the US legal system for a number of years.					
HONG KONG ELECTRIC	16 December 2005	SELL	442720	38.54	2.08
Hong Kong Electric is a vertically integrated electric utility. It also has JV interests in three states in Australia and in the UK. The crux of the recommendation revolves around two factors: the current SOC replacement scheduled for 2008 and the possibility of competition. We remain concerned about the former as the market has not really factored it in.					
ROYAL BANK	14 December 2005	BUY	80000	17.27	2.33
RBS is a UK based bank with a diversified earning stream, both by geography and by product. The company's long standing guidance on capital use is intact. This says that the closer the Tier 1 ratio gets to 8%, the higher is the likelihood of buybacks. The market continues to be sceptical of the group's capital allocation record and awards RBS a low valuation. The scepticism is not warranted.					
PFIZER	15 December 2005	BUY	110000	23.02	2.41
Pfizer has rarely been this cheap in recent times, with good reason. Huge patent expires up to2007 and current operating margins leave earnings growth for the next five years made up almost entirely of Pharmacia cost synergies and share buybacks. Pfizer nevertheless now looks oversold based on short term sentiment.					
PORTUGAL TELECOM SGPS	14 December 2005	BUY	250000	8.26	2.34
PT incorporates a declining cash-generative domestic fixed line business, a slow growth and almost saturated domestic wireless business, a rapidly growing but competitive Brazilian wireless interest and a domestic broadband/multimedia business. None of this is inspiring, but IFRS goodwill changes and a drop in restructuring charges conspire to produce a reasonable multiple. Combined with compelling cash generation and accompanying dividend yield this makes for a reasonably attractive investment.					
BANCO POPULAR	15 December 2005	BUY	205000	10.09	2.37
Banco popular has a 5% share of the Spanish banking market. Moody's reported of Banco Popular: "Excellent financial fundamentals, very high earnings power, high earnings predictability, low risk profile and strong capitalization". There are similarities between Spain and the UK in housing market development in recent years with Spain currently trying to achieve what the UK seems to be doing viz. a soft landing for the housing market. With strong economic fundamentals and Popular continuing to take market share the next five years are likely to be as successful as the last ten. With takeover potential in the background, this has the potential to be a core holding.					

Appendix D: Metrics for monitoring a long term mandate

The Assessment of Upside/Downside Potential

An interesting question for trustees is to assess how much upside potential or downside risk exists within the portfolio with respect to the value placed on the individual holdings by the investment manager. This assessment can provide a sense of the risk-reward balance in the portfolio and insights into the valuation process of the investment manager. It should usefully lead to areas that trustees can probe further to understand how the process is being applied.

For example, if a manager believes that the market value of the portfolio vs. his/her assessment of the value is 60%, it will give trustees a sense of the potential upside. Obviously, trustees will then need to be comfortable with the basics of the valuations and gain insight into the process through investigation of specific holdings. Below we have outlined a form of reporting that trustees may wish to request from their managers that can form a basis for the assessment of upside/downside potential.

Realised Returns Assessment: This is a particularly meaningful measure for long-term mandates since it uses the entry and exit prices as selected by the manager and hence avoids performance measurement based on volatile short term pricing which can suffer from noise. An assessment of the return achieved on investments sold would provide a true picture of performance for investments which had reached their full potential and therefore tests the manager's ability to add value. The analysis looks at the difference between the price paid for a stock and the price at which it was sold and calculates the annualised return over the holding period taking account of the dividend income received, i.e. the Internal Rate of Return (IRR).

An example of a possible monitoring report based on realised investments is shown below:

Realised Investments

Company	Date of investment	Investment amount	Realised proceeds	Realised +Unrealised value	Dividend income	Gross IRR
XYZ Inc	July 03	£90,500	180,000	180,000		49.4%

The remaining unsold holdings within the portfolio could be considered as 'work in progress' investments which still need time to mature. It would be possible to calculate an IRR for the unsold holdings based on quarter end or year end market prices although such metrics should not receive the same level of significance as the IRR metric based on sale price.

This report would naturally lead to a discussion on stock purchases and sales and analysis of stocks out of favour with the market.

The sample format of a report on the return on unrealised investments is shown below:

Unrealised Investments

Company	Date of investment	Investment amount	Realised proceeds	Market Value	Realised +Unrealised value	Dividend income	Gross IRR
ABC plc	Jan 01	£25,000	-	48,000	48,000		21.8%

With special thanks to Claire Maloney and the team at Capital MS&L for their help in the formulation of this guidance note.

Printing provided by First Colour Limited

The Marathon Club
6 More London Place
London SE1 2DA
Tel: 020 7939 4363

enquiries@marathonclub.co.uk