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Asian Corporate Governance Association (ACGA)

"The Pros and Cons of Corporate Governance Funds in Emerging Markets"

Presentation by
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Agenda

1. Concept of the “focus fund”
2. Opportunities in Asia
3. Why aren’t there more focus funds?
4. Questions of strategy
5. Competition
6. Conclusion

1. Concept of the "focus fund"

- Premise: Every market has undervalued and underperforming companies. If they are small or medium-sized, it is unlikely that analysts follow them or major investors pay much attention.
- Hence , an investment opportunity: work actively with these companies to improve strategy, finance and governance, then reap above-average returns over the medium-term. Investors should be able to exert more influence over smaller companies (vs large ones) and there is less information in the market.
- Early examples:
  - LENS, US (Formed 1991 by Robert Monks and Nell Minnow)
  - Relational Investors, San Diego (First fund launched June 1996)
  - Hermes Focus Asset Management, London (First fund launched October 1998)
- These are not "good governance" funds (ie, bad companies screened out). In fact, the opposite.

Hermes Focus Asset Management (HFAM)

HFAM has four sets of "shareholder engagement" funds:

1a. **UK Focus Fund**, managed by HFAM, launched Oct 1998. Focuses on the FTSE 350. Holds 12-20 stocks.

1b. **UK Small Companies Focus Fund**, managed by HFAM and launched in March 2002. Invests in listed firms outside the FTSE 350 and AIM. Holds 10-30 stocks.

2. **European Focus Fund**, managed by HFAM Europe and launched Feb 2002. Universe is 500 non-UK European stocks over Euro 100m in market cap. Holds 5-20 stocks.

3. **Nissay Hermes Stewardship Fund**, managed jointly by Nissay Asset Management, Japan and HFAM. Universe is all listed Japanese firms, but mostly above ¥100 billion in market cap. Holds 12-20 stocks.

4. **Relational Hermes Fund**, managed by Relational Investors and launched in May 2001. Universe of 10,000 US and Canadian listed firms. Holds 8-12 stocks. (Note: Relational is an entirely separate company.)

Performance

- "Returns to Shareholder Activism"—Becht, Franks, Mayer and Rossi (December 2006). An analysis of performance data from the Hermes UK Focus Fund (HUKFF) for 1998-2004.
  - Previous studies of activism (in the US) found "little or no link between activism and performance". (Note: CalPERS would probably disagree with this statement!)
  - But the HUKFF "substantially outperforms benchmarks" and its high returns are "largely associated with engagements rather than stock picking".
  - "Engagement" = seeking changes to company strategy (eg, sales of non-core assets), higher payout policies, replacement of chairman or CEO.
  - Stronger shareholder rights in the UK vs US (eg, an ability to vote against directors and call EGMs) forces management to listen.
  - Abnormal returns net of fees of 4.9% a year against the FTSE all-shares index over 1998-2004. And 90% of such returns was due to "activist outcomes".

2. Opportunities in Asia

- Asia, like other parts of the world, has hundreds of small and neglected listed companies. For example:

- **Hong Kong**:
  - 670 of 1,146 listed companies at end-2005 were "penny stocks" (ie, share price of less than HK$1.00).
  - Top 50 of 952 main-board issuers as of July 2006 made up 78% of market cap. Hence, the other 902 = 22% of market cap.
  - Top 50 of 198 issuers on the smaller GEM market as of August 2006 made up 88% of total market cap. Hence, 148 = 12%.

- **Singapore:**
  - 403 of 576 listed companies in late 2004 were "penny stocks" (defined there as below S$0.50).
  - Top 15 of 516 main-board issuers in July 2006 made up 52% of market cap. Hence , the other 501 = 48% of market cap.

Questions

- A lot of poorly managed companies that could be bigger and better?
- A lot of companies that came to market badly prepared by their sponsors?
- A lot of companies with weak governance whose controlling shareholders, directors and managers are not trusted by the market?
  - Surely this points to numerous companies with upside potential if they can get the right assistance and advice from outside and independent investors.
  - If long-established small companies are a lost cause, look at new IPOs with good business models but young management and fragile CG structures (eg, PRC private firms in HK).

Where are the focus funds in Asia?

- **China:** None, but a few private equity* funds playing a similar role (though in the unlisted sector).
- **HK:** None, but some private equity and hedge funds fill this niche. Also some long-only funds with a CG angle and David Webb.
- **India:** None, but again private equity.
- **Indonesia:** Private equity.
- **Japan:** Nissay Hermes Stewardship Fund, Taiyo Fund, SPARX Asset Management, Ichigo Asset Management + various hedge funds.
- **Korea:** Korea Corporate Governance Fund, Allianz Global Investors Value Creation Fund, also private equity
- **Malaysia:** Private equity
- **Philippines:** Private equity
- **Singapore:** Similar to HK.
- **Taiwan:** Private equity + hedge funds.
- **Thailand:** Private equity + boutique funds with a CG angle.

*"Traditional" private equity, not leveraged buyout funds.

3. Why aren't there more focus funds in Asia?

- Corporate governance reform is still relatively new (ie, less than a decade old). But this is a weak excuse…
- Lack of corporate governance expertise & commitment in the long-only investment industry.
- Many fund managers are "growth oriented" and follow cyclical trends. Focus funds need to be "value oriented". But market boom of recent years has meant fewer undervalued companies and an ability to make money in a rising market. Hence, less incentive to look for deep value.
- Majority of fund managers are judged and compensated on a short-term basis (ie, 3 months, 12 months). Focus funds need to take a longer term view.
- Diversification: Many fund managers manage risk by diversifying across 50-150 companies. Holding only 10-20 stocks could hugely increase their potential downside.

Questions of character

- Focus funds are established by people or firms with a sound understanding of corporate governance, clear views on how to invest and a willingness to use the tools of shareholder rights to engage with management—both privately and publicly (if necessary). There are few investors in Asia right now who meet this criteria.

- Focus funds need the support of institutional-investor clients (eg, pension funds) that are willing to take a risk on this approach. There seem to be few buyers at present in Asia—possibly in part because there are few "sellers" with an established track record.

Questions of culture

- Focus funds in Asia face the immediate obstacle of listed firms controlled by large blockholders (families or the state) who are not used to taking outside advice. Hence, the strategy may not work with many of the more opaque listed companies in this region.

- In contrast, because of dispersed ownership in the UK, minority shareholders there are better able to exert influence with only a few % of the shares of a company.

  - But at the same time, formal shareholder rights in Asia are closer to those in the UK than US. This suggests that shareholders could use these tools to overcome some of the obstacles posed by concentrated ownership.

4. Questions of strategy

- If an active focus on corporate governance is the right investment approach, why limit it to a focus fund? Why not incorporate CG elements and engagement across your investment process?
  - Some fund managers in Asia do, up to a point, although active engagement is virtually impossible if your fund has 50+ companies.
- Investing in "good, but undervalued" vs "bad and undervalued": Trying to fix bad companies, especially ones with entrenched and uncooperative family owners, is a tough job. Arguably tougher than attempting the same with a US/UK firm that has dispersed owners and hired managers.
  - Some fund managers in Asia have, therefore, adopted the former approach: invest in undervalued companies whose managers you trust, then engage through voting of shares & one-on-one meetings.

5. Competition

- As noted earlier, some private equity and hedge funds have arguably moved into the "focus fund space".
  - Private equity funds in Asia also began investing in publicly listed companies after the financial crisis of 1997-98, when valuations fell to attractive levels.
  - In the past three years, some hedge funds in Asia have started to act like private equity funds: 3-year investment horizons, substantial stakes of 10+%, engagement with management on strategy and finance.
- Has this crowded out focus funds from the Asia market?
  - Perhaps to an extent, but the bigger issue is the lack of leadership, expertise and the willingness to take the risk.

6. Conclusion

- There is clearly scope for many more targetted focus funds in Asia, holding a small number of stocks and where the investor actively engages with management.
- Private equity and hedge funds have mostly filled this space to date, but this need not be an obstacle.
- The paucity of focus funds is more a function of the limited number of people in Asia who have both the investment experience and CG expertise to run such funds, plus the incentive to do so.
- Concentrated family ownership may be an obstacle to engagement, but this has not stopped other investors from succeeding. Not all families are closed-minded on CG and shareholder rights in Asia could prove a useful tool.

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