CFA UK is a member society of

Alistair Cowie,
Kay UK Equity Market Review
Department for Business, Innovation and Skills
1 Victoria Street
London
SW1H 0ET

27th April 2012

CFA UK response to the Kay Review's interim report

Dear Alistair,

CFA UK welcomes the opportunity to share its views about the Interim Report for the Kay Review. This response has been prepared by the CFA UK's Professional Standards and Market Practices Committee.

The society has a number of comments to make about the interim report. These are summarised below and then addressed in greater detail

- Adherence to the terms of reference
- Alignment between value generation by companies and returns to savers
- The role of asset managers
- The report's scope and clarity

Terms of reference

As per Annex C, the terms of reference for the review are: 'To examine the mechanisms of corporate control and accountability provided by UK equity markets and their impact on the long term competitive performance of UK businesses, and to make recommendations.'

The interim report reviews accountability mechanisms in depth, but spends little time examining mechanisms for corporate control. In addition, despite the Advisory Board's emphasis on the need for evidence, CFA UK also observes that, while the report provides interesting and extensive anecdote that describes respondents' views, it contains little hard data relating to the review's terms of reference. In his own article in the Financial Times of March 14, Professor Kay noted that the ascendancy of science over assertion was hard won and valuable. We hope that the review's final report will emphasise data over opinion.

The role of asset managers

The responsibility of an asset manager is to generate return for his client. While value generation by companies held within a portfolio may improve return generation, enhancing that value generation is not the asset manager's primary objective.

Return generation will usually be maximised by identifying and exploiting market mispricings. The premise that managers are able to enhance return generation by being long term, engaged shareholder has not been evidenced in the report.

The report states (in 2.17) that asset managers are the stewards of the funds entrusted to them by investors. That is absolutely correct and all of our members – and candidates in our educational programmes for investment professionals – agree to adhere to a code requiring them to act in their clients' interests at all times. However, the interim report goes on to suggest that asset managers 'discharge that function most effectively by acting as stewards of the corporate assets they control by virtue of their management of these funds.' This statement is flawed.

The asset manager's primary responsibility is to the client – the investor. The client's interests may be best served by active engagement with the companies in which the fund is invested. However, the report provides little evidence to suggest that investors achieve the outcomes that they seek (their risk-adjusted return objectives over their expected time horizons) more often as a consequence of active engagement.
CFA UK recognises the value that engagement can provide, but also recognises that other investment strategies can be followed by investment professionals intent on acting in their clients' best interests. For instance, the client's interests might best be served by an asset manager selling the client's holding in a poorly managed company, rather than by engaging with the company on the client's behalf.

<u>Alignment between value generation by companies and returns to savers</u>

The interim report states 'There is a fundamental alignment between the success of companies and the returns to savers'. There is a binding relationship between aggregate value generation by the market and aggregate return generation, but they are not necessarily aligned in terms of the time periods over which they are realised. The two factors can be aligned, but do not have to be.

As we explained in our initial response, publicly listed companies generate value when they generate economic profits - returns that meet or exceed the cost of capital. To ensure company managers focus on value generation, they are exposed to other market participants that are focused on generating returns for themselves or their investors. Return generation is about identifying opportunities to generate investment performance for the ultimate beneficiary by anticipating share price movements. These share price movements may closely parallel the timing of value creation, but might just as easily pre-empt that or come at a delay.

Summary results of a survey of the society's membership are attached again below:

86% of respondents agreed (or strongly agreed) that the Board and senior executives of UK listed companies should focus on economic profits ahead of accounting profits. However, only 9% of respondents agreed that the Boards and senior executives of UK listed companies actually do focus on economic profits.

88% of respondents agreed (or strongly agreed) that to generate economic value a publicly listed company should at least cover its weighted cost of capital (equity and non-equity). 56% of respondents disagreed (or strongly disagreed) that remuneration structures at UK listed companies were focused on delivering economic value.

63% of respondents felt that the Board and senior executives of UK listed companies paid too much attention to short term share price movements.

The top five factors that are cited when developing a forecast or recommendation are (share price momentum is the least popular factor) –

- Cashflows
- Current share price relative to fundamental value
- Competitive advantage/position
- Balance Sheet strength
- Management quality/earnings outlook.

93% of respondents agreed (or strongly agreed) that fundamental analysis is necessary to estimate share value. While 53% agreed (or strongly agreed) they would invest in a company if its share price undervalued its cashflows irrespective of whether the market came to the same conclusion over the course of a year.

68% of respondents agreed (or strongly agreed) that the role of the investment manager is to generate returns to investors by investing in the equities of those companies likely to deliver the greatest economic value (cashflow that meets or exceeds the weighted average cost of capital) over their investors' anticipated holding period.

<u>Differential voting rights</u>

The interim report comments on the potential to introduce differential rights for shareholders based on the term of their engagement with a company. This appears attractive because it suggests that investors with a long-term interest in a company might have greater influence on that company's management. However, we are unsure that there would be benefits to value creation and also are concerned about the impact of differential voting rights on market integrity.

Fundamentally, providing differential voting rights to some investors is likely to lead to an increase in a company's cost of capital as investors suffering the reduced rights mark down the value of that equity to compensate for the loss of control rights. Increasing a company's cost of capital makes it more difficult for a company to generate economic profits (returns that meet or exceed the cost of capital).

There may also be other disadvantages of such an approach. For instance, many long-term investors are passive investors. Providing passive investors – who by definition have not made an active decision to invest in a specific company – with enhanced voting rights over other investors (such as small activist investors) might be an unintended outcome of a move to introduce differential rights. Also, the accretion of voting rights to long-term shareholders might make those shareholders less willing to sell stock as the value of the enhanced voting rights could not be transferred (and, therefore, realised) by a sale. That means that the shareholder register would become increasingly static (and, over time, increasingly likely to identify with management).

Under the present 'one share, one vote' structure, Boards and management can be regularly challenged by a shareholder base that is dynamic and can respond to different investors' interest in particular sectors. Challenge is good for discipline which is good for market integrity. While we support the need for greater research in this area, we are inclined to believe that differential shareholder rights would, on balance, not support long-term value creation and would damage market integrity.

<u>Scope and clarity</u>

We remain concerned at the report's narrow scope. The report deals exclusively with the UK equity market. If the review is concerned with UK plc's long-term competitiveness, it should also have considered the corporate sector's engagement with the bond markets and the market for commercial bank loans (by far the biggest provider of capital).

We share the review team's surprise at the absence of comment about the role of the sell-side in UK equity markets. In addition the Review does not take into account the resources expended by listed companies to engage with investors via Investor Relations. The review has focussed on the asset manager, but the manager is just one of four parties to consider, the others being the saver, the issuer and the sell side. The Interim Report does not sufficiently consider the interaction between the sell side and publicly listed companies. The lack of emphasis on the sell side may be deliberate or accidental although it is noticeable no major sell side firm or its representatives have responded to the review. It is the sell side that has corporate broking relationships, makes markets in secondary equities, raises funds via primary equity offerings, forms market expectations, facilitates non-equity funding and influences the market for corporate control. The prime source of revenue for this market is transaction driven, whereas asset managers have a disinclination to trade. The review should actively seek input from the sell side.

The interim report frequently mentions 'high performing companies', but does not define these or suggest how these companies would be identified. CFA UK welcomes the report's reference to our suggestion of economic profit as a possible metric to identify value generation. Perhaps a high performing company is one that generates value in excess of its cost of capital. Not every company is high performing. The review's final report might develop its recommendations in this area so that more resources are diverted to companies that meet or exceed their cost of capital.

Last, as mentioned at our meeting, the interim report describes CFA UK as CFA Institute. CFA UK – the body that responded to the review's call for evidence – is a member society of CFA Institute, but is a separate legal entity and we would be grateful if the references in 4.20 and 6.12 could be appropriately amended.

Despite these comments, CFA UK welcomes the publication of the interim report as a valuable opportunity for a discussion on the themes of value generation, return generation, market discipline and integrity, and the interaction between them.

<u>Additional suggestions for the review team's consideration</u>

1) The review might usefully focus on understanding the relationship between value generation and compensation structures at publicly listed companies. The current structure of executive remuneration is based on metrics that are not robust and are open to manipulation. By encouraging publicly listed companies to generate economic value, the review will have a direct impact on UK productivity, thereby enhancing equity market returns to the ultimate beneficiary.

2) The review should make it clear that the link between return generation and value generation can be weak. The review might look at ways to enhance market integrity through an improved market for corporate control so that companies unable to generate value are exposed more quickly and resources transferred to more productive uses.

3) The review might consider examining the interaction between the issuer, sell-side, buy-side and ultimate beneficiary in greater depth.

4) The final report's credibility and influence would be increased if it contained a greater degree of hard data than was present in the interim report. CFA UK can understand the Interim Reports emphasis of anecdotal evidence and opinion, especially from prominent market participants. However, even though anecdotal evidence can be vivid and appear to be more representative; the Review should be aware of the risk it faces when overweighting this type of evidence in relation to rigorous empirical evidence. Recommendations to reform market practices should be based on reliable, repeatable information.

We remain keen to assist the Kay Review team and invite you to contact us at any point for assistance in collecting additional evidence and providing input. We would also welcome the opportunity to discuss our feedback on the interim report.

Yours,

Natalie WinterFrost, CFA FIA
Chair Professional Standards & Market Practices Committee, CFA UK

Will Goodhart
Chief Executive, CFA UK

Sheetal Radia, CFA
Policy Adviser CFA UK

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of close to 10,000 leading members of the UK investment profession most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance reporting standards for the investment industry. CFA Institute has more than 106,000 members in 135 countries, of whom more than 97,000 hold the Chartered Financial Analyst® (CFA®) designation.