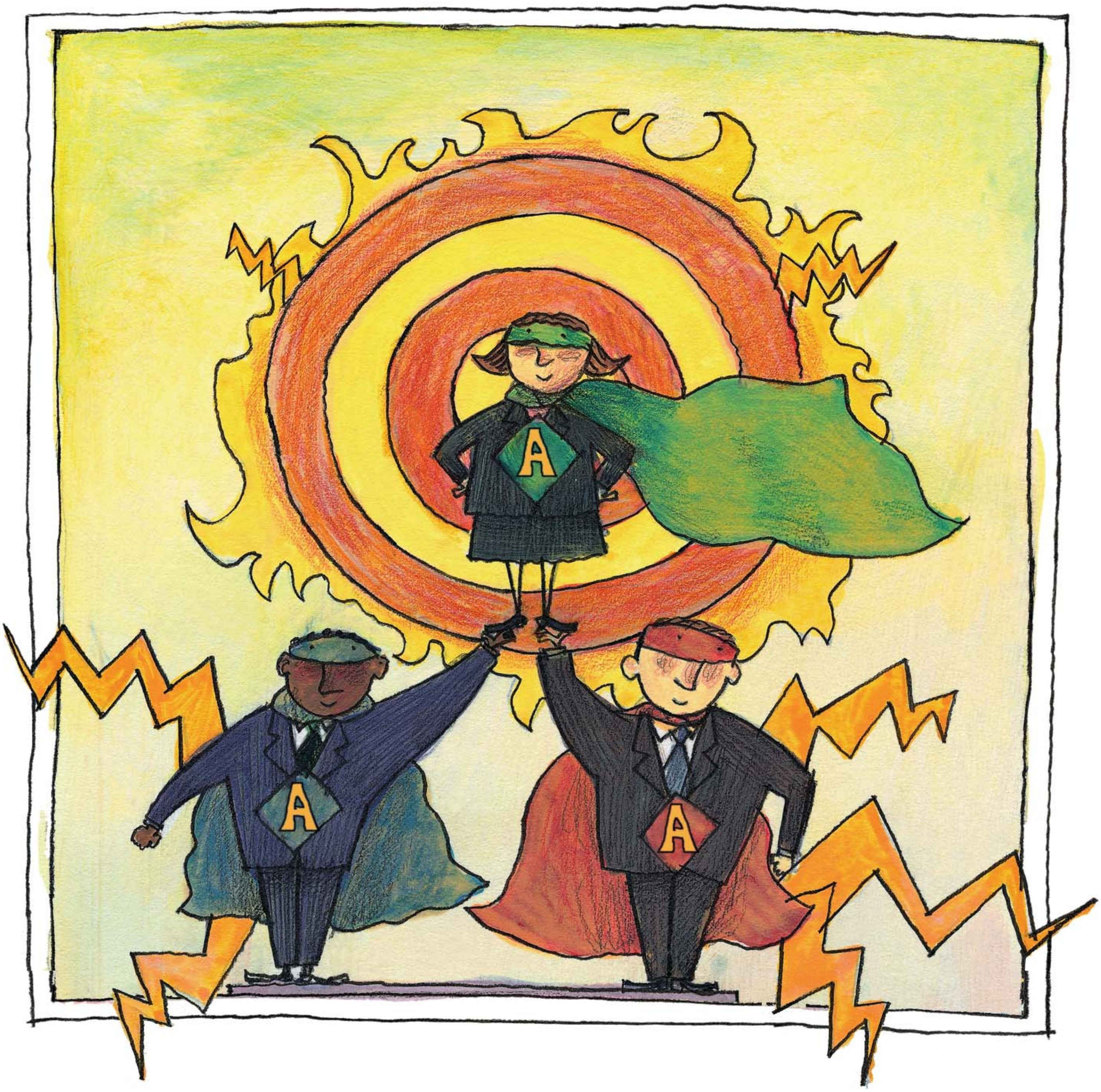
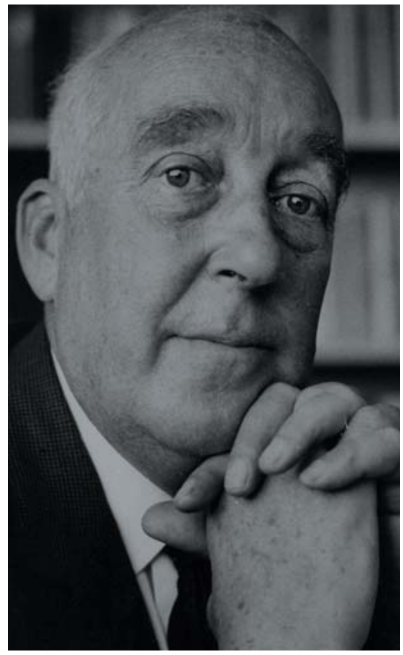
The Wincott Foundation Prize 2005



in association with PROFESSIONAL INVESTOR UKSIP The UK Society of Investment Professionals



Harold Wincott
1907 - 1969

About **Harold Wincott**

As well as editing the *Investor's Chronicle* for 21 years, Harold Wincott's regular column in the *Financial Times* attracted a substantial readership.

His writing went much wider than the traditional City Editor's concern with financial and fiscal policies. Championing the neglected cause of liberal capitalism, he was led to explore the contribution to national economic decline of trade unions, nationalised industries, monopolistic and restrictive practices, state welfare, and much other economic and political mischief.

Although lacking formal training in economics, he had an advantage over the pure academic. To the appraisal of all theories he brought the practical grasp of markets, competition and pricing gained as a young man studying the everyday operation of business whilst working in offices variously engaged in accountancy, insurance and stockbroking.

About the **Wincott Prize**

The Wincott Foundation, perhaps best known for its Annual UK Press Awards, kindly sponsored a prize for the former IIMR's Association Examination. From 2003 the Foundation's trustees agreed to award a prize of £500 for the best unpaid article in *Professional Investor* submitted by a member of UKSIP. Now that the journal has developed into a pan European publication, in 2006 eligibility for the Wincott prize will be extended to any unpaid article printed in *Professional Investor* from a CFA Institute society member in the Europe.

About the **UK Society of Investment Professionals**

Originally established in 1955 as the Society of Investment Analysts, UKSIP was formed in 2000 by the amalgamation of the Institute for Investment Management & Research and the London Society of Investment Professionals.

Today UKSIP's growing membership encompasses a wide range of investment disciplines and its members are current and future industry leaders.

- Over 5,500 individual members
- Responsible for the Investment Management Certificate the industry's premier entry level qualification
- Publisher of *Professional Investor* throughout Europe
- Well recognised professional development programme
- Supports candidates seeking to attain the globally recognised CFA charter
- Supports the ASIP, CFA and IMC designations
- Advocates for the highest standards of practice in the UK's investment markets

UK SIP
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About the **Judging Panel**

The Panel comprised the following members of *Professional Investor*'s Editorial Board:

Richard Szwagrzak CFA Chairman
Virginia Blackburn (Editor)
Peter Gaston ASIP
Malcolm McIvor ASIP
Russell Sparkes ASIP
Brian Mairs IMC
John Rogers (Chief Executive, UKSIP)

PROFESSIONAL INVESTOR

I'm delighted to introduce the third annual award of the Wincott prize, sponsored by the Wincott Foundation, which was set up in memory of Harold Wincott, one of the most outstanding financial journalists of his generation. This year the entries were particularly strong and the judges needed some real deliberation to select which of the three short listed articles deserved to win outright. In the event we chose Stop The Activist Bandwagon by Arjuna Sittampalam, a cautionary tale of the dangers of institutional shareholder activism.

Professional Investor is also delighted to announce that the Wincott prize is spreading its wings. Until this year only UKSIP members have been eligible for entry, but as of next year the award will be European-wide. *Professional Investor* is now going out to all countries in Europe, a development that has been reflected in the recent editorial direction of the magazine, and we look forward to a fascinating and wide ranging variety of topics to be covered in the months ahead. All of these articles, provided they are unpaid, will be entered into next year's Wincott prize. We all look forward to a very exciting 12 months ahead.

Virginia Blackburn
Editor
Professional Investor

The prize **winning features**

WINNER
WINCOTT FOUNDATION PRIZE 2005

Stop the activist bandwagon

Arjuna Sittampalam warns of the dangers of institutional shareholder activism

This article appeared in July/August 2005 issue of Professional Investor

Buying and selling plays an important role in the efficient allocation of capital

Institutional shareholder activism is now widely regarded as a duty. This notion, while intuitively appealing, is misguided. Voluntary activism on a limited scale does have a useful role, particularly when cases of extreme abuse are targeted. Unfortunately, however, activists have now fallen prey to the classic misconception that, if a little of something is good, then more must be better. There are growing signs that activists are going too far and that corporate governance intervention has become a religion, with the addiction to dogma to which adherents of all religions are prone. A dispassionate analysis of the underlying principles is called for.

Under the principle of limited liability, shareholders have no obligation to devote any further resources beyond their original investment, be it money or effort. Yet advocates of activism assert that institutional shareholders have an obligation or responsibility to be activist. What is the basis of this assertion?

Fiduciary and social responsibilities

In assessing this, two different strands of thought can be identified. Activists believe that institutions, by intervening in companies with poor corporate governance records, will help to turn them into better-run companies. The value of their investments will thereby increase and thus profit their beneficiaries. This implies that institutions have a fiduciary responsibility to their underlying beneficiaries to undertake this activity.

The second strand of thought is encapsulated in the belief that if institutional investors show no interest in monitoring the behaviour of corporate management, there is no effective check on the power of the executive who are, therefore, effectively unaccountable to their shareholders. The danger is that companies will not be managed to enhance shareholder value, but in pursuit of other objectives, including the self-interest of managers. In this case, the impetus to intervene arises from the need to make corporate managers accountable to their shareholders. Institutions' acts of intervention provide a collective good to all shareholders and can be regarded as social in their consequence. This social duty to intervene is distinct from the fiduciary duty to beneficiaries.

The two strands of thought lead to two separate cases for activism, the fiduciary case and the social case. Corporate governance codes in general stress the fiduciary case, while many activists refer to both and believe that both responsibilities are discharged by the same action – intervention. This often leads to a confusion of the two separate issues. Differentiation between these two types of responsibility is integral to any analysis of whether any duty exists.

The first point that needs to be made is that, if there is a social case for intervention, it is not appropriate that fund management houses

Arjuna Sittampalam

As a fund manager, Arjuna Sittampalam has run global equity and global bond portfolios and has headed investment management subsidiaries of Swiss Bank and Sanwa Bank. In recent years he has advised leading global financial institutions particularly on the investment process and business strategy. He has written several articles and books on the industry, including the book *Coming Wars in Investment Management*. This article is based on his latest book, *Corporate Governance Activism - Desirable Doctrine or Dangerous Dogma?*, published by Sage & Hermes (www.sageandhermes.com). He can be contacted at as@sageandhermes.com.

be obliged to pursue society's needs. But, in any event, whether a social case can be made is arguable.

The perceived social case for activism stems from the classic principal-agent problem. How can top management of corporations, the agents, be made to manage solely in the interests of the shareholders, their principals? Institutional investors are regarded as obvious candidates to play the role of principals, given that private shareholders are too weak

But the flaw in this reasoning is that the intervening executives of fund management institutions are just as much agents as company management and therefore the principal-agent problem is not solved through their intervention. This is particularly so because some fund managers suffer from conflicts of interest themselves. Furthermore, there are clear measures for which top management of corporations can be held accountable: turnover, profits, assets etc. But the only mechanism for holding fund management executives to account is the investment performance of their assets. If they embrace activism and focus on influencing companies for the longer term instead, there is no methodology currently in place to hold them to account. There are some well-publicised cases of activists improving companies and making money for their clients, but this is selective evidence emanating from a small minority of successful activists who have a particular talent and enthusiasm for the task. Unless there is a process for recording and measuring all cases of intervention and their results, accountability of intervening fund managers will remain an elusive concept. Especially, given the increased danger of insider trading, the public interest demands this recording. So, from society's viewpoint, the accountability gap can actually widen when fund managers intervene *en masse*.

Fund managers not qualified

While the management of corporations are agents, not principals, they are highly qualified agents for the job assigned to them. For the most part they are trained and experienced in management and concerning the industry in which they are operating. Generally replacing this set of agents with another set of agents, the fund managers, who are much less equipped to cope with the complexities of running a corporation, cannot make sense. Their qualifications are insufficient. The problem is made worse if reluctant investing institutions are coerced into activism by peer group pressure or official nudging, rather than acting of their own volition with deep conviction.

Buying and selling

Another argument frequently put forward by the proponents of activism is that buying and selling

by institutional investors is a wasteful zero-sum activity and that they are better off being long-term relationship investors instead. It is also stated that companies and the economy would also do better in the long run. Yet another well-known activist statement is that selling merely passes the buck to somebody else. There are weaknesses in this train of thought.

Firstly, this could predispose the UK-US approach to corporate governance to degenerate into the old-style, much attacked model of German-Japanese capitalism, whereby, except for a few favoured institutions, shareholders were left out in the cold.

Secondly, collective condemnation of all buying and selling is misplaced. Some of it is undoubtedly fruitless, but some of it is profitable, and the value proposition of much of the fund management industry includes striving for the latter. Furthermore, from the social viewpoint, such buying and selling plays an important role in the efficient allocation of capital, by providing liquidity to the stock market. Liquidity levels in many smaller stocks already leave much to be desired. Eschewing buying and selling can only make this worse.

Only a small minority of investors... are likely to enhance their performance through activism

There is now the danger that companies, beset by large numbers of institutional investors seeking to intervene, will play the safety-first game. Already there are reports of considerable seepage of management talent and quoted companies into the private equity sector. Even the most diehard proponents of corporate governance activism should accept that an unregulated and non-transparent private equity sector gaining at the expense of quoted companies cannot be good for enterprise and the economy in general.

Dangers for companies from widespread activism include the increased cost of devoting management resources to dealing with disputes, distraction from other objectives, the stifling of entrepreneurialism and possible paralysis of decision-making. From a social perspective, there are threats to liquidity, stock market efficiency, savers' trust in institutions, industrial efficiency and the future of the stock market. There are also the dangers of undue concentration of industrial power and increased insider dealing.

Far from elevating intervention by fund managers to the status of a highly desirable social principle, there are grounds for asserting that the balance of the social arguments is against obligatory activism.

The fiduciary case for intervention rests on the premise that fund managers will improve their performance through intervention. A detailed analysis of a number of different situations leads to the conclusion that this premise is seriously flawed, and that only a small minority of investors of particular types are likely to enhance their performance through activism. In many cases it can even be demonstrated that beneficiaries' financial interests can suffer if their fund managers undertake intervention, and that there is, therefore, actually a fiduciary obligation to avoid intervening.

It can, therefore, be concluded that fund managers in general have neither a social duty nor a fiduciary duty to be activist.

Other flaws in activist assumptions

An implicit assumption, on the way to becoming a paradigm amongst corporate governance activists, is that management is on one side of the fence and that shareholders are on the other side as a monolithic entity having a uniform and composite view on how matters should be handled. This is not so. In a well-managed company with disparate shareholders who change over time, good company management plays an essential role as a referee. Here, it is not an adversarial situation of a company versus its shareholders. If some shareholders succeed in influencing management, it will not necessarily be in the interests of the majority.

Moreover, it is wrong to implicitly assume that most companies are poorly managed, and account should be taken of the large number of well-managed companies who might be affected adversely by the dangers posed by activism.

Yet another assumption is that institutional investors, if they attempt to intervene, will do so for positive reasons. It is true that some institutional investors who carry out corporate governance intervention have commendable motives. However, the chances are that, if a much greater number of institutions get involved, prodded by a blanket encouragement to be activist, some will intervene for the wrong motives. In fact, there are indications that this has already started to happen. The *Financial Times* of 19 May 2005 reported on boardroom fears of activist investors induced not by investors committed to the long-term health of the company, but by short-term arbitrageurs. The same report suggests that many chief executives are being forced into short-term thinking.

The way forward

Many owners, including hedge funds and derivatives players, have no commitment to any form of long-term ownership. The problem is that they have a legal right to intervention and the question is whether this situation should continue. With the structural complexities of modern financial markets, the time has probably come for a full-scale review of the concept of joint-stock ownership introduced in the mid 19th century for different needs and circumstances.

Given that investment institutions should not be made to feel responsible for controlling the management of companies, the problem of how to make company management effectively accountable to shareholders remains. It is unlikely that that there will ever be a perfect solution, given the many different considerations that come into play. The best approach is already at work – the market solution.

It has been suggested that corporate governance activism should be embedded in the investment process. This would be in general misplaced, because it should be a matter of choice for fund managers whether or not they want to be involved in activism. On the other hand, the assessment of corporate governance, as opposed to activism per se, is already part of the investment process, as indicated by fund managers' influence on ratings.

There is evidence that companies with good governance enjoy better ratings in the market. These ratings come about through the process of trading shares, with investors putting a premium on the factors they value. If the claim that good corporate governance enhances share price ratings is substantiated, then, rather than supporting the case for intervention, this would actually do the opposite, as it would constitute evidence that the fund management industry is carrying out its function effectively. Notwithstanding the strictures against selling, the market is effectively exerting pressure on companies for good corporate governance. Reliance on the market solution would seem a sensible way forward.

Several intermediary organisations have established indices and ratings which differentiate between companies with 'good' and 'bad' governance. These help the investing community to implement the market solution by assigning the appropriate premium in their valuation of shares.

Other company attributes, such as the quality of accounting standards and credit ratings, do not provoke calls for institutional intervention. The market solution is relied upon, with investors punishing the companies with poor attributes in these respects and rewarding the good ones through the buying and selling process. Corporate governance attributes can well be handled in the same way.

There are additional mechanisms which can be combined with the market solution to foster a greater degree of control over corporate management. These include collective policing by authorities such as stock exchanges and the activities of specialist funds and intermediaries. The role of the private shareholder also needs to be strengthened. They have a direct ownership interest and many keenly follow the companies they invest in.

What then is the place for activism? As stated before, activism is useful if exercised sparingly. These include situations where there is obviously extreme abuse, neglect or incompetence on the part of management and immediate action is called for. It is unfortunate, however, if a climate is established where institutions at large feel under pressure to display activist colours. It should be remembered that in many cases of company underperformance it is not easy to identify whether it is a temporary blip, a case of unfortunate external circumstances with management doing a good job, or poor management. A knee-jerk reaction by activists is not any better than knee-jerk selling.

Activism is intuitively thought of as a neat solution to the problem of company management accountability. But a tidy approach is not feasible in a complex fund management industry with many facets, of which corporate governance is just one. If focus is directed at any one facet, the complexities can be overlooked. The market solution, though less direct in its workings, should remain the centrepiece of bringing management to account, as activism unchecked can do much damage. ■

Arjuna Sittampalam ASIP, has run global equity and global bond portfolios and has headed investment management subsidiaries of Swiss Bank and Sanwa Bank. In recent years he has advised leading global financial institutions. He has written several books on the industry, including Coming Wars in Investment Management. *This article is based on his latest book,* Corporate Governance Activism – Desirable Doctrine or Dangerous Dogma?, *published by Sage & Hermes. Email: as@sageandhermes.com*

On file...

CFA Body of Knowledge V
Professional Investor

- **Dec/Jan 2004/05** What makes an effective board? *Lorraine Young* and *Julia Casson*
- **Dec/Jan 2004/05** A question of leadership *John Mellor*
- **November 2004** Serving the new shareholder *Patt Scott*

HIGHLY COMMENDED
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How IFRS 3 is changing how companies account for mergers

This article appeared in November 2004 issue of Professional Investor

Jeremy Cranford and Ben Moore explain that although the new standard looks like it creates just another non-cash charge to the P&L, in fact, the effects are more far-reaching

Jeremy Cranford, CFA
Jeremy is a Senior Manager in the valuation practice in the Washington D.C. office of Deloitte. Jeremy has provided valuation advisory services for both US and international, public and private businesses for the purposes of mergers and acquisitions, financial reporting, shareholder disputes, restructuring, privatisations, and tax restructuring. Jeremy was a secondee to the London office of Deloitte for 18 months over 2003 and 2005 where he concentrated on business and intangible valuations and interpretation of IFRS.

Ben Moore
Ben Moore is a Director in the valuation group within the corporate finance at Deloitte & Touche LLP in London. Ben qualified as a Chartered Accountant with Deloitte in 1996 and since then he has undertaken numerous valuations in the context of commercial transactions and disputes. Ben co-ordinates Deloitte's global valuation effort with respect IFRS 3 has also built up significant experience of dealing with valuations for financial reporting purposes under US GAAP and UK GAAP.

The new International Financial Reporting Standards (IFRS) have introduced a new rule (IFRS 3) on accounting for business combinations that has far reaching effects on both published accounts and the valuation of equities. In this article, we focus on the factors within IFRS 3 such as reported earnings volatility, transparency and cash taxes that may well affect company valuation and share prices. The changes are anything but just another non-cash charge to the profit and loss account.

The new standard, IFRS 3 – Business Combinations, was issued by the International Accounting Standards Board (IASB) in March 2004. IFRS 3 requires companies to estimate the fair value of all assets acquired, tangible and intangible, and liabilities assumed in transactions, a process referred to as a purchase price allocation. The European Union has made it mandatory for all listed companies to adopt IFRS by 2005. We estimate that almost 7000 companies will be affected by this mandate. It will no longer be acceptable to allocate the excess value over acquired net assets purely to goodwill. Instead, companies must identify and value the intangible assets acquired and amortise the fair value of these assets over their estimated useful life.

Another departure from UK Generally Accepted Accounting Principles (GAAP) is that residual goodwill purchased in an acquisition will no longer be amortised over 20 years, but will remain on the balance sheet and be subjected to annual impairment tests. Both changes are similar to those adopted by Statement of Financial Accounting Standards (SFAS) 141 and 142 under US GAAP in June 2001.

Opponents of the changes argue that the valuation and amortisation of intangibles provides little additional information to investors, and instead makes net reported earnings figures less reliable and more volatile. The valuation and amortisation of intangibles is not a purely scientific process and subjectivity is involved in both the interpretation and application of the standard.

This will most likely result in varying applications of IFRS 3 and consequently, varying proportions of amortisation passing through the acquirers profit and loss account. In addition, the initial adoption of IFRS 3 may lead to increased volatility in reported earnings when compared to periods prior to the adoption.

Earnings volatility

We tested this theory by examining the volatility of reported earnings of companies in the S&P 500 index prior to and after the adoption of SFAS 141 and 142, which are comparable standards in the US. We analysed the annual reported earnings before interest, taxes, depreciation and amortisation (EBITDA) and earnings before interest and taxes (EBIT) for the 500 companies in the index between 1990 and 2003, and removed companies that had insufficient detail or negative reported earnings throughout the sample period.

A relative variance analysis was constructed to compare the variance in EBITDA to EBIT. We made a simplifying assumption that depreciation was not materially different in relation to the reported earnings level of the companies since there was insufficient detail available on amortisation expense for the population of companies over the sample period. We constructed a coefficient of variation for the relative volatility in EBITDA and EBIT for the pre- and post-SFAS 141 and 142 periods, and compared the statistics to determine if reported earnings volatility increased after the adoption of the standards. The coefficient of variation is standard deviation divided by the average.

Our simple test revealed that approximately 70% of the companies experienced more volatility in reported earnings caused by

Table 1: Hypothetical example of goodwill

	(£)
Purchase price	90,000
Non-financial liabilities	10,000
Fair value of assets	**100,000**
Less:	
Tangible assets	30,000
Intangible assets	20,000
Goodwill	50,000
Fair value of synergies	30,000
Workforce (25% of salaries)	5,000
Strategic premium	**15,000**
Premium (% of purchase price) 17%	

amortisation in the period following the adoption of the standards in 2001 in the US. Assuming that the experience in the US is a reasonable approximation of the effects of IFRS 3, might therefore expect increases in volatility in reported earnings starting in 2005 and beyond. All else equal, increased volatility introduces more risk to projected reported earnings and could have a negative effect on value.

Greater transparency

Proponents of the standard believe that IFRS 3 provides greater transparency by disclosing the details of acquisitions including all the assets acquired and liabilities assumed, including contingent liabilities, to the companies shareholders. Prior to the adoption of IFRS, investors knew little about the value of intangible assets that were acquired since excess purchase price was simply booked as goodwill. This practice made it difficult to assess the relative value of acquisitions made by companies, or whether or not companies may have overpaid in certain transactions.

Since investors are not necessarily privy to the projections and other analyses relied upon by management in evaluating potential transactions they are often forced to examine evidence after the fact. Purchase price allocations prepared after the closing date of transactions assist shareholders in appraisingthe intrinsic value of the acquisition and evaluate the merit of any strategic premium paid for the target. For these purposes, the strategic premium paid for acquisitions is defined as the amount over the intrinsic value including cash flow effects of any reasonably quantifiable hard synergies, such as revenue or cost synergies.

Potential purchasers that rely on discounted net-cash-flow models as well as market-based approaches will capture the changes in tax amortisation

Table 2: Typical amortisation lives for common intangibles

Intangible Asset	Life (yrs)
Technology	3-6
Customers	5-12
Trade name	Indefinite
Goodwill	Indefinite

Amortisation could vary widely between companies since some acquisitions result in a much higher percentage of definite-lived intangibles relative to goodwill

This is of particular interest because it enables investors to understand any difference in what management has paid in an acquisition and what is reasonably expected from the risk-adjusted cash flow return from the target. In cases where the purchase price allocation information is available we often use the intangible asset valuation and managements synergy estimation as tools to analyse transactions as described below.

After a transaction has closed, management will be required to allocate the purchase price to the tangible and intangible assets acquired in the transaction. Any excess purchase price will then be allocated to goodwill, the only residual allowed under IFRS 3. Classic financial theory suggests most of the purchased goodwill can be attributed first to synergies and second, to going concern value (approximated by workforce in place value that is not booked for reporting purposes) leaving in theory the true strategic premium as the residual. A quick hypothetical example in Table 1 illustrates this.

Following our previous discussion, let us assume the purchase price of £90,000 is added to the non-interest bearing liabilities of £10,000 to estimate the fair value of assets. The value of the tangible and intangible assets is subtracted to leave the residual goodwill, which is booked in the financial statements under IFRS 3. We take that a step further and estimate the value of the synergies in the transaction by capitalising the annual expected run rate. We do this by multiplying the annual expected synergy run rate by the EBITDA multiple of the transaction.

Justifying strategic premiums

Another way to estimate the fair value of synergies is to capitalise the run rate by the return required by debt and equity holders, since banks will lend to a degree on the back of synergies. We also consider a quick estimate of the additional going concern value and workforce using an assumption that the value is approximately 25% of the fully burdened salary expense of the employee base. The assumption of 25% was derived from experience in valuing intangible assets and synergy analyses prepared for clients. The residual amount of £15,000 is attributed to a pure strategic premium paid for the target.

The strategic premium is often justified by reference to certain soft synergies that are difficult to quantify and are not necessarily required to be valued under IFRS. Some examples of soft synergies include systems improvement, best practice migration, acquiring first mover advantage in a market and overall extension of product lines to fit with the organisations strategy. It is in the soft synergy area where shortfalls are more likely to occur and where companies may struggle to reach financial targets set pre-deal. The purchase price allocation can be a useful tool in comparing the strategic premium with managements justification of the purchase price, and the hard and soft synergies expected in the transaction. This analysis would have been a useful tool during the internet bubble in the late 1990s and early 2000, but history tells us that many of the strategic premiums that were paid did not come to fruition.

The introduction of IFRS 3 also creates possible tax implications for companies and therefore, the valuation of shares. The overriding theme has usually been for tax treatment to follow the accounting treatment, at least for asset acquisitions. However, in contrast to UK GAAP, IFRS 3 may result in a large portion of intangible value being amortised over very short periods, and goodwill that may not be amortised at all. This would be a big departure from the current state of policy under which all intangibles and goodwill can be amortised over 20 years.

Will the tax treatment follow the accounting treatment under IFRS 3 and will there be different standards for companies under UK GAAP as opposed to IFRS or International Accounting Standards?

Competitive disadvantage?

The Inland Revenue is reportedly considering the implications of IFRS 3 in relation to UK GAAP and the level of amortisation of intangibles for companies allowable for tax. The aim of the new legislation introduced in 2002 was to address the perception that the UK tax system had until then created a competitive disadvantage for UK businesses in the global market place that might lead multinational companies to acquire and own their intangible assets and goodwill outside the UK. Presumably the Inland Revenue had in mind the tax regulations in the US where purchasers can choose how to amortise intangible assets even in share acquisitions. However the UK rules currently have less flexibility and apply only in the case of asset acquisitions. There is no tax relief for intangible assets and goodwill generated only on consolidation.

Real cash flow impact

Nevertheless the changes imposed by IFRS 3 could have real cash flow impact if the rate of amortisation is allowed to follow this accounting convention. Definite-lived intangible assets, such as technology and customer contracts, would be amortised over their useful life. Indefinite-lived intangible assets, such as trade names, and goodwill would not be amortised, but instead tested annually for impairment. Amortisation could vary widely between companies and industries since some acquisitions result in a much higher percentage of definite-lived intangibles relative to goodwill. A table of typical amortisation lives for common intangibles is set out in Table 2 to demonstrate the variability in the range of amortisation periods that companies might encounter.

Companies that allocate a large amount of the purchase price to definite-lived intangibles rather than goodwill will derive cash benefit from the shorter amortisation periods. Conversely, companies that have purchased large balances of goodwill, which typically includes synergies and future growth opportunities under financial reporting standards, could be at a disadvantage in terms of tax amortisation. Companies with relatively high balances of goodwill and indefinite-lived intangible assets may elect to amortise such goodwill over 25 years. However, this choice does come with risks. The company could forfeit future tax deductions from impairments that may occur on the assets or associated goodwill.

The example in Table 3 helps illustrate the impact. Assume that two similar companies are acquired, Company A and Company B. Company A has proprietary technology, but has a customer base with high turnover. Company B has no proprietary technology, but has long-lived contracts with its customers, low turnover, and a long history with them. Assume that both companies derive similar profits because of their relative advantages.

Table 3: Impact of electing to amortise goodwill over 25 years

	Company A	Company B
Tangible assets	100	100
Technology	500	-
Customers	100	600
Goodwill	300	300
Purchase price	1,000	1,000

Table 4: Impact of electing to amortise goodwill over shorter periods

	Company A	Company B
Technology	100	0
Customers	10	60
Goodwill	0	0
Amortisation	110	60

Short versus long amortisation

Assuming amortisation lives of five years for the technology and 10 years for customers, the amortisation profile of each company, if acquired, is shown in Table 4. Company A would benefit from amortising the technology over the short economic life whereas Company B would have a much lower amortisation because of the long customer life. Even though the companies may have overall similar business models and valuations, the tax implications of purchasing one business over the other could be very different. Potential purchasers that rely on discounted net-cash-flow models as well as market-based approaches will capture the changes in tax amortisation that may be allowed by the Inland Revenue under IFRS 3.

Will the change be reflected in market multiples as well? Proponents of the semi-strong or strong form of efficient market hypotheses would argue that if the change is allowed by the Inland Revenue share prices would fully and immediately reflect the cash flow benefit of accelerated amortisation on future business combinations. The result would be multiples that also reflect the tax advantages, or disadvantages, of comparable companies or companies acquired in specific transactions. Either commonly accepted method of valuation, the income or market approach should result in changes in valuation due to potential tax amortisation changes brought on by IFRS 3 and the valuation of intangible assets.

On file...

CFA Body of Knowledge IV

Professional Investor

- **September 2003**
  Reporting financial performance
  Richard Barker
- **June 2002**
  Putting a firm figure on brands
  Jonathan Knowles
- **May 2001**
  Pension Fund Management: The economic problems of asset valuations
  David Blake

More scrutiny

Regardless of where the Inland Revenue ends up on the topic of acquired intangibles and tax, it is evident that intangibles will come under more scrutiny in both accounting and tax environments. As discussed, purchase price allocations will be important in assessing potential cash tax impacts in acquisitions and could result in tangible changes in valuation depending on the tax law and deal structure.

We have examined a number of effects that IFRS 3 may have on reported financials and valuation of shares. Evidence from the US markets suggests that we can expect an increase in reported earnings volatility from the different amortisation profile, while at the same time providing investors with more transparency in transactions. IFRS 3 enables investors to better analyse the assets obtained and liabilities assumed by the company in transactions, and to better evaluate the merit of any strategic premium paid in relation to hard and soft synergies identified by management. Finally, we note that IFRS 3 may result in changes in amortisation profiles and cash taxes, depending on the views of the Inland Revenue going forward. All of these factors have a potential real impact on the valuation of shares and are certainly not just another non-cash expense. ■

Jeremy Cranford, CFA is a manager in the valuation group within corporate finance at Deloitte & Touche LLP in London and is a secondee from the Atlanta office in the US. Jeremy has over seven years of experience in valuing equities and intangible assets in the context of financial reporting, tax, disputes, reorganisations and transactions. Jeremy earned the right to use the CFA Charter in 2001 and is member of UKSIP and the CFA Institute.

Ben Moore is a Director in the valuation group within the corporate finance at Deloitte & Touche LLP in London. Ben qualified as a Chartered Accountant with Deloitte in 1996 and since then he has undertaken numerous valuations in the context of commercial transactions and disputes. Ben co-ordinates Deloittes global valuation effort with respect IFRS 3 has also built up significant experience of dealing with valuations for financial reporting purposes under US GAAP and UK GAAP.

Scott Donald
Scott Donald was Director, Marketing and Product Development for Russell Investment Group from 2001 to the summer of 2005, when he returned to Australia. He had previously spent 6 years as Director of Research in Russell's Sydney and London offices. Prior to that he spent eight years advising corporate, public sector and private clients on investment strategies for leading Australian firm, IPAC Securities.

Alexandra de Zwart
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It's risk Jim, but not as we know it

Scott Donald and Alexandra de Zwart appeal to investors to understand the risks they are taking in their portfolios before pushing into the unknown

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In episode after episode of Star Trek, the intrepid crew of the USS Enterprise boldly went where no man had gone before pushing back the frontiers of space. Many investors are now on a similar journey. Some may be looking to more exotic types of investments, such as hedge funds or forms of structured products, whereas others may simply be wondering why their investment strategies seem to be lost in a black hole they didn't see coming.

Exploring new frontiers, or even re-considering more familiar investment territory means coming to terms with new types of risk. Investors should consider three different types of risk, each of which needs to be managed in a different way:

1. Ignorance;
2. Uncertainties where common probability-type notions apply; and
3. Those special uncertainties that defy neat characterisations and hence are impossible to model precisely.

Ignorance

The first type of uncertainty is the simplest type. It occurs in situations where the investor does not currently know the answer, but the information is available. Unsurprisingly, investors do not get rewarded much for taking on this type of risk. This is a basic feature of efficient markets – the effects of this type of information are already priced into in the market.

Fortunately it is easy to deal with. Good research should remove the uncertainty. So long as the benefit of the research in addressing the risks outweighs the costs of undertaking the research, it is worth doing.

However, there are some types of uncertainty that no amount of research can eliminate. These risks fall into the second and third categories.

Unfortunately many people assume that all types of risk can be avoided by cleverer people doing more research.

The most obvious example is the effect of market pundits. Whether managing hedge funds, trading currencies or simply writing books, they ride a wave of public acclaim, making a series of ever more heroic forecasts and acquiring an almost mythical status before the inevitable fall from grace. The investing public fuels this cycle because they want to believe there is someone out there who can see what will happen next. However, the research shows that sooner or later the forecaster loses the magic touch and fades back into obscurity, all too often leaving behind investors to sift disillusioned through the debris of their shattered portfolios.

This is not an apology for the failures of those in the investment industry to predict stock market collapses. It is rather an appeal for people to recognise whether what they seek is knowable, or whether the knowledge is of a type that falls more properly in one of the next two categories of uncertainty.

In complex environments, prediction is a risky business. In some cases, even the distribution of outcomes cannot be predicted

Roulette wheel

Investment is often likened to gambling. The association is sometimes unfavourable, implying that the investor is being reckless. Such references may make investment professionals recoil in horror. However there is one sense in which the simile is appropriate.

Roulette and similar games work on the basis that simple, identifiable rules give rise to reliable probabilities that can be exploited to one's advantage, if one plays often enough and with enough patience. But you have to be the House. A small advantage (about 2% in the case of roulette) can create large fortunes very consistently if the wheel is spun often enough.

Similarly there is a small set of factors in the investment market that are immutable. They would be called laws except for the fact that they are being broken at every instant of the day. Investment markets are far more complex than spinning a roulette wheel. Movements in interest rates, consumer behaviour, weather patterns, trade policies and new technologies merely start what would be a very long list of things that drive markets. In fact, in the short term, markets suffer a continuous barrage of news about these influences. Their movements are a result of these inputs.

This means that the laws only hold over long periods, periods longer than human patience. Longer even than human memory (in some cases). Nevertheless these laws provide a gravitational point around which markets oscillate.

So what does this have to do with roulette? Well, no one knows for certain whether equities will outperform bonds or property in the coming month or year. No one even knows whether any of them will beat inflation. But if you play long enough, you have the laws working in your favour. Also, by spreading the investment bets across different assets (domestic equities, international equities, bonds etc.) you stand a better chance of this risk working in your favour.

The trick is to align how long you can wait (your time horizon, a critical determinant of your risk tolerance) to the mix of different types of assets. This is often called the Strategic Asset Allocation. It is the biggest 'bet' an investor makes. It is impossible to be absolutely certain about the outcome, but taking this bet is both reasonable and rational. So this type of risk is managed by taking as long a perspective as possible, given all of the investor's other circumstances.

New risk frontier

In complex environments, prediction is a tricky business. Chaos theory was popular in the early 1990s. It provided many eye-catching examples of capriciousness in the world of forecasting. However people were mostly disappointed when they tried to apply the techniques to the world of investment – it seems the investment markets are too chaotic even for chaos theory!

The reason is simple: in some cases the environment is so complex that even the distribution of outcomes cannot be predicted. The interaction of all the different factors defies computation. Extreme results may be too frequent. Alternatively, they may be less frequent than you expect or may appear to be skewed towards particular outcomes. Or they may appear to follow no pattern at all.

This does not necessarily mean that the outcomes are more volatile. Instead, it means that it is not possible to predict with any confidence how likely different outcomes actually are, which makes precise mathematical modelling difficult. This is a situation where additional research will not necessarily yield any more precision in your estimates. It is therefore a different type of uncertainty from either of the two previous types.

The first thing to note is that this notion of uncertainty is not new, just forgotten. A certain Professor Frank H Knight of the University of Chicago devoted considerable ink to the subject over many years in the 1920s. He didn't win a Nobel Prize or work for a big hedge fund, but his point was valid. There are some situations where the interaction of different contingencies is so complex that it is hard to predict even the distribution of possible outcomes, never mind the outcome itself.

Why this attention now, after approximately eighty years? Simply that some of the new investment alternatives being considered by investors demonstrate this third type of uncertainty par excellence. Moreover, even familiar types of investment carry this risk, albeit to a lesser extent.

A striking example of the third type of uncertainty is the way that trustees and other investors are approaching hedge funds. Hedge funds offer a variety of challenges. They are not a homogeneous group, for a start. Also, because they can go short and invest in complicated derivatives strategies, they do not necessarily perform the way the overall market does. Many employ leverage, and some invest in securities whose prices are not re-priced regularly. And, as a final nail in the coffin (as it were), the performance histories of the hedge fund industry are riddled with holes and inconsistencies. So getting to grips with the range of possible performance outcomes from an investment in hedge funds can be quite tough.

Table 1: Do funds in the real world comply with normal distribution rules? Not always

	Statistically different from normal *(at 5% confidence)*		Statistically different from normal *(at 1% confidence)*		Size of Universe
	No.	**%**	**No.**	**%**	**No.**
UK equities	48	49	38	39	98
US equities	56	43	52	37	131
Japanese equities	78	61	72	56	128
European equities	40	69	31	53	58
Global equities	174	45	114	36	319

The results of the spring and summer of 2004 surprised some investors. The numbers put about by many hedge fund managers sounded compelling. Low volatilities and high historical returns generate impressive Sharpe ratios. That's the way the equation for the Sharpe ratio works.

Illusion of rigour

What many investors missed was that the Sharpe ratio was never meant to be used on hedge funds. Neither were the traditional measures of risk, such as volatility. The measures have been applied to hedge funds because the instinctive reaction of many trustees when they hear the word 'risk' is to look for statistical support. They seek comfort from correlation coefficients, tracking errors and efficient frontiers. This is, after all, established best practice across other parts of their portfolios. However the distribution of possible outcomes for many hedge funds is not known, so these apparently precise mathematical measures actually rest on shaky foundations. Many trustees intuitively know this and are wary as a result. The problem is that the illusion of rigour inspired by the numbers can overwhelm their caution.

The same problem arises when you try to forecast the distribution of outcomes from active management of any fund, not just hedge funds. But the problem is smaller. The constraints on leverage and short selling greatly reduce the complexity. So does the influence of the benchmark index. So while the range of returns earned by hedge funds is very wide and extremely hard to predict, things are a little better behaved in traditional funds.

We tested this intuition by analysing the

performance of five different universes of active equity funds. The analysis questioned whether the index-relative returns of each manager conformed to the normal distribution that is so beloved of statisticians. The results are shown in the table below.

The table clearly shows that the normal distribution, while not a bad approximation, is not always appropriate. Around half the managers in each universe did not satisfy the test for normality.

We do not believe this result is peculiar to the past five years. It matches our anecdotal experience, which extends over a much longer period. Some investment managers seem error prone, with far more performance catastrophes than you might expect. Others seem to introduce an unnatural skew into their performance. For another set of managers, the level of active risk they introduce into their portfolios varies with market conditions, which would mean risk measures are not stationary through time. All these real world phenomena are inconsistent with the mathematical assumptions underlying standard performance measures such as tracking error.

Fortunately, qualitative research can often uncover reasons for these anomalies, such as the use of options or particular trading strategies. This is one reason to be very wary of relying too heavily on quantitative analysis for building portfolios of managers. Quantitative analysis, bereft of real-world understanding, could give misleading results.

So how should investors manage this type of risk? For a start, one of the things that insiders to the industry often forget is that diversification works even if you cannot calculate a correlation coefficient or estimate the standard deviation of returns. You need those statistics if you want a simple way to calculate a single number for portfolio risk. You also need them to conduct mean/variance optimisation, the basis of many asset allocation strategies today. You don't need them to benefit from diversification. So long as the strategy does not perform in the same way as other investments in the portfolio, it will provide diversification. This very basic insight applies to both of the examples described in this article – hedged funds and active management.

Identifying event risks

Other considerations can be applied to so-called alternative investments. An important safeguard is to ensure that any potential draw-downs will not unduly injure the investor's ability to meet their investment objectives. That probably means allocating only a small amount of a portfolio to any one strategy, perhaps 5% to 10%. Investors should also identify the likelihood of any singularities, event risks that might de-rail the investment, and understand what drives the returns from the fund, such as the people, their strategies and tactics. Investors should understand the level of liquidity offered by the fund, and so on. Similar considerations might apply to private equity investment or some forms of structured products.

Getting better acquainted with the risk in your own portfolio is a big step towards steering a smooth path through the investment universe, whether you decide to re-evaluate the path you're already on or whether you decide its time to venture into new territory. No one doubts the courage of the team on the USS Enterprise in venturing away from the known world. The same courage is required in the investment world, and the frontiers may not be suitable for many out there. After all, investors cannot rely on Scotty to be there to 'beam them up' if it all begins to go pear-shaped. ■

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