

CapitalBridge's monthly newsletter focusing on institutional targeting and investor relations

## OnTarget – Trends

### Here it comes – Pension accounting changes and the IRO

On September 29th, the long-rumored announcement from the Financial Accounting Standards Board (FASB) finally hit the wires; rule changes, starting as soon as the end of 2006, that would change the reported financial position of nearly every company with either a defined benefit pension plan or Other Post-retirement Employee Benefit (OPEB) plan. The new rule (entitled SFAS 158), in a nutshell, puts the funded status of a company's plan on the balance sheet (either overfunded or underfunded), and requires measurements of pension plan status on the same schedule as company annual reports.

Industry watchers have seen this coming for a long time, and the announcement was fully expected; the FASB has been working on a project on pension accounting for quite a while, and the Pension Protection Act of 2006 also showed that Congress was actively looking at the topic. However, the effects of the change are about to hit the financial markets in short order, with all public companies with fiscal years ending after December 15, 2006 falling under the change; this year's 10-K reports, which will be prepared for many companies starting with calendar year fiscal years in January, will include these changes.

Here's how the effects hash out:

First, about 350 companies in the S&P 500 (or about 1,060 of the Russell 3000 companies) will need to place their plan funded status as a new line item on the balance sheet. Any negative balances resulting from underfunded situations will show a direct loss on the Stockholders' Equity line (in fact, in many prominent cases such as General Motors, Ford, and Goodyear Tire & Rubber, the Stockholders' Equity line will become a Stockholders' Deficit as all existing equity is "wiped out"). Merrill Lynch analyst Gordon Lattner and Credit Suisse analyst David Zion both estimate about 6% of overall equity in the S&P 500 will be removed, all other things being equal.

Companies with cash on their balance sheets may choose to use some of this cash to immediately improve the plan funded status, while other companies may choose to issue debt to cover the funded status of plans. While there is no FASB requirement that plans be funded, it's expected that the rules will lead toward higher funded status, and the recently signed Pension Protection Act of 2006 includes numerous measures designed to push companies towards full funding over the long term.

Traditional valuation and efficiency measures (in particular price/book and return on equity figures) will be immediately impacted – investors that screen investments based on these values may see securities drop off their "radar screens," as the impact of the equity change is not distributed evenly across most portfolios. CapitalBridge analyzed the equity adjustment for the Russell 3000 stocks using the most recently available defined-benefit pension data from CapitalIQ: **Sands Capital Management**, which manages about \$17 billion in equity in concentrated portfolios, sees its portfolio weighted average price/book jump from about 7.3x to about 8.9x (a 22% increase in valuation), while even more diversified equity investors like **Legg Mason Capital Management** and **Jennison Associates** see jumps in their portfolio price/book ratios of 18% and 13%, respectively.

Even more importantly, debt/equity ratios will increase for many companies, and this higher leverage could have secondary effects on many debt covenants in place. While most debt instruments issued in the last five to ten years have built-in "escape clauses" to covenants based on changes to accounting standards, there are some older instruments that do not specify how standards changes are handled in their agreements. Companies could be in violation of these debt covenants, or be forced to negotiate with debtholders. Some covenants even prevent companies from paying dividends, making

acquisitions, or issuing other new debt instruments if companies are too highly leveraged. Again, looking at the portfolios of investors that show large changes to debt/equity ratios from the new rules gives a hint as to which investors may have to adjust their portfolios. **Fifth Third Asset Management** stands out as showing one of the largest increases in its firm-wide weighted average debt/equity (an increase from 68.5% to 94.0%); **MFC Global Investment Management** (including the former **Sovereign Asset Management/John Hancock Funds**), no stranger to holding leveraged companies, sees an increase in its firm-wide portfolio debt/equity from 123% to 149%.

As an IRO of a company with a defined benefit plan, the knee-jerk response is always to downplay pension questions as a “non-operating issue” – however, as of the end of 2006, pension funded status becomes just as important to a company’s decision-making as many other operating issues. SFAS 158 is just Phase I of the overall review of pension accounting that the FASB is undergoing – Phase II may lead to more sweeping changes, including collars or set limits on return assumptions and discount rates, placing the full pension plan (assets and liabilities) on the balance sheet, or additional disclosures beyond the current plan footnotes. While you’ll always want to focus your approach to any investor on your company’s operations, it’s a good idea to take the time now to prepare yourself and your management for any questions about the current or future status of your plans. If you’re not running a defined-benefit plan, make sure you’re aware of the impact that the changes will have on your investors’ portfolios – positioning your company as a lower-risk investment when compared to other peers that may face “pension risk” in the future may help your shareholders justify increasing their holdings in your company.

*As usual, just scratching the surface of pension accounting here – for more on the expected effects of FASB 158 on your company and/or your investor base, send us a quick email at [targeting@cap-bridge.com](mailto:targeting@cap-bridge.com).*

## OnTarget – Best Practices

### Calling on Capital? Knock Three Times...

Capital Research & Management, currently the world’s largest equity mutual fund manager, is in a class of its own when it comes to the views of investor relations professionals. IRO’s hope to attract its massive amounts of capital to their investment stories, but dread its selectivity when it comes to equity investments. While other large managers like Fidelity will hold diversified portfolios over a much wider range of investment styles, Capital Research tends to hold more focused portfolios within a smaller style base. For example, Capital Research has \$453 billion overall invested in US stocks in the form of only 740 total positions, while Fidelity’s similar-sized \$490 billion portfolio of US equity is spread across 2,673 holdings.

The firm’s large and concentrated portfolios may have become victims of their own success, with the mutual fund products being a prime example of this. Capital Research’s American Funds make up six of the ten largest stock funds in the US, with the largest of the group, Growth Fund of America, having current assets of around \$150 billion. While scale helps lower costs, it can also bring large funds up against tough trading situations. Imagine being a trader for the fund and having to unload a position of 8.2 million shares (\$3.1 billion) in GOOG, without driving the price against you, or a position of 106.6 million shares (\$2.4 billion) in MSFT for that matter. It’s no surprise, therefore, that Capital Research’s overall turnover in its equity portfolio is just 24% per year (with an average holding period over 4 years).

Obviously, rapidly growing cash pools and larger investments made in fewer companies (when compared to other large managers) then means tougher competition for mindshare with Capital’s analysts – and often harder work prior to an initial investment. And, with its internal structural reorganization, you’ll have twice the work to do to keep the lines of communication open.

#### About the new Capital Research structure

Capital Research has divided its research staff into two organizations internally – Capital Research Global Investors (about 50 investment professionals) and Capital World Investors (about 40 investment professionals). These two research teams operate independent of each other, conducting separate research and pursuing separate investment ideas. Even though these divisions do not share fund management or research activities, they report their holdings under the legal name of Capital Research and Management Company; this means for the time being you won’t be able to tell which of the two groups is managing your position based strictly on the 13F filing.

Capital Research has always approached its decision-making by carving its portfolios into slices, then assigning them to a team of portfolio managers and analysts. Portfolio managers have free rein to invest as they see fit, within the mandate of the fund. Analysts invest in the sectors they cover. The accountability and diversity produced by this "multiple portfolio counselor" system "is believed to have provided the Group with a sustainable method of achieving the funds' objectives," says Capital's Chuck Freadhoff, Director of Investor and Media Relations. Nevertheless, under the new system, instead of having all analysts and portfolio managers who cover a particular industry listen to a call with a particular sell-side analyst, now the new system will have two separate calls with the analyst. (Yes, even the sell-side will have more work to do to keep the firm in its good graces.)

These two new organizations also operate alongside the other managers in the Capital Group Companies – Capital International (which runs global portfolios under its own distinct investment approach) and its subsidiary Capital Guardian Trust Company (which manages non-mutual fund portfolios for private pension funds, insurance companies, endowments, and trusts) also operate independently; this means you may have even three or four different decision-makers to impress.

All in all, any time you spend with Capital Group analysts or portfolio managers is time well spent. You'll want to make the rest of your team aware that the multiple managers will increase your workload, however; you may need to set off a larger block of time for either face-to-face or phone contact for any outreach you do.

*For more on the effects of Capital Research's restructuring on your company, contact us at [targeting@cap-bridge.com](mailto:targeting@cap-bridge.com).*

## OnTarget – Firms

### Target Firm: Harris Associates

#### Targeting Profile

Harris Associates recently became the largest active institutional equity manager in the Chicago area (passing UBS Asset Management/Brinson Partners), with over \$60 billion under management as of mid-2006. The firm's six Oakmark Funds make up about \$26 billion of the total equities under management, but it has also seen growth in its separate accounts business and IXIS-branded portfolios (it is a division of global asset manager CDC IXIS). Value investing is the goal here – finding stocks that are trading at discounts to either private market value ("takeout" value) or other demonstrable value has made the firm good returns.

#### How to Approach

The firm will start with traditional valuation characteristics to narrow down its potential investments; emphasize any mispricings you see in the market (possibly a division or product that other investors aren't "getting" yet). After that, the firm's estimates of intrinsic value or private market value become the best way to tailor your approach – preparing valuations given to industry acquisitions or other M&A activity related to your sector may save your analysts some work and allow you to add some influence. In particular, the firm has been increasing its weightings in small-to-mid-cap issues over the last six months, looking at smaller companies with reasonable valuations such as Hong Kong retailer Giordano International and American retailer Zale Corp. Companies with global exposure have attracted attention (make sure to show your company's international story), and pure cheap valuations in sectors such as homebuilding have produced investments; Harris may make a good stop in a period of trading weakness for your company.

**Average equity holding period:** 3.4 years

#### How Not to Approach

The firm has an inordinately large weighting in the broadcast/cable TV space, possibly owing to the large number of transactions involved in the space, attractive pure valuation, and the "sum of the parts" analysis necessary to look at companies like DirecTV and Disney – it has recently cut back on holdings of both issues (DIS after a YTD move from \$25 to \$31 and DTV after a YTD advance from \$14 to \$18 per share) while rotating into Liberty Media (L) and Viacom (VIA), the cheaper companies in the same space on valuation. Its portfolio of materials stocks consists of mostly overseas issues, and it has pulled away from purely domestic financial exposure; wait for better looking valuations before aggressively pushing these investment stories to Harris.

#### Largest Portfolios Managed

Oakmark Fund – \$6.5b equity – Bill Nygren/Kevin Grant  
Oakmark Select Fund – \$5.7b equity – Bill Nygren/Henry Berghoef  
Oakmark Equity & Income Fund – \$5.2b equity – Clyde MacGregor / Ed Studzinski  
Oakmark International Fund – \$5.0b equity – David Herro/Robert Taylor

#### Investment Potential

Average holdings for the firm at each market cap range:  
Giant-cap: ~\$280 mm  
Large-cap: ~\$190 mm  
Mid-cap: ~\$70 mm  
Small-cap: ~\$20 mm

## OnTarget – Funds

### Target Fund: Oakmark Global Fund

**Managing Firm:** Harris Associates – Robert Taylor (312-621-0200, rtaylor@harrisassoc.com), Clyde McGregor (312-621-0200, mcgregor@oakmark.com).

#### Targeting Profile

This fund is a rarity in the mutual fund market – a fund that not only has a *true* global, all-cap focus (from an investor’s standpoint), but also a fund that takes large concentrated positions and has a fairly long holding period (attractive from a targeting perspective). No matter where your security is listed, this fund’s managers are worth talking to, *as long as* you’ve got an attractive valuation.

#### How to Approach

Clyde McGregor handles the U.S. side of the portfolio, which has dug in deeply into companies in just about every sector that look cheap. Retailer TJX Companies and medical equipment maker Laboratory Corporation of America represent the lower end of valuations in their respective sectors and received new investments recently; the firm also jumped into the financial transaction processing space with buys of Ceridian Corp. and eFunds, while selling Equifax in a similar business line – as with the parent company, “trading down” in valuation appears to be a popular move. Robert Taylor runs the global side, which has made fewer new purchases but has increased holdings in some of its other favorite value stories (like Credit Suisse and Julius Baer, both of which have solid private banking operations in Europe). Present your valuation story as both relative to your peer group as well as on an absolute basis to maximize your time here.

#### How Not to Approach

Given the global concentrated approach, currency effects and liquidity will be on the minds of the managers as any individual stock in a tough currency environment could hurt returns. This may be why exposure in Latin America has been limited; Kimberly Clark de Mexico represents the firm’s lone holding in the region. Just about every major sector is represented in some way, but in this kind of portfolio you’re not as likely to see the managers digging deeply into your competitive structure and operational advantages – you may want to replace your presentation slide that shows the advantages of your products versus a competitor’s products and instead add focus to justifying a higher valuation than your company is seeing today. No matter what, concentrated portfolios always look for more responsive IR efforts; don’t neglect offering rapid response times to help build the comfort level of managers like these that may have an “itchier trigger finger” than those managing broader portfolios.

#### Investment Potential

Average holdings for the firm at each market cap range:

Giant-cap: ~\$51 mm

Large-cap: ~\$43 mm

Mid-cap: ~\$35 mm

Small-cap: ~\$33 mm

**Average equity holding period:** 1.6 years

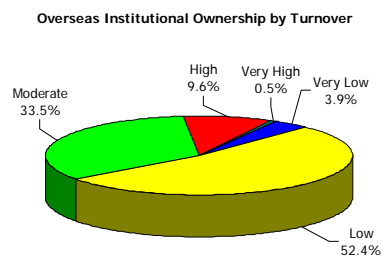
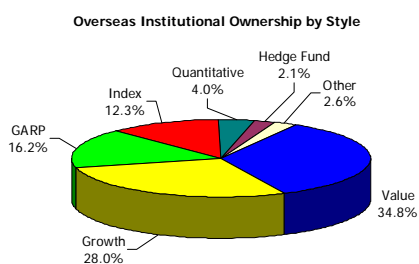
## OnTarget – Weightings

### Ownership in Japan – Long-term Money Likes the Long-term Culture

The long-awaited rebound in the Japanese equity markets and the Japanese economy in general has been well documented and clearly a positive for the stability of global markets. Over the past 52 weeks, the Nikkei 225 is up more than 20%, as overseas institutional investors have continued to increase their allocation to Japanese equities.

Similar to companies in the U.S. and Europe, Japanese companies had found themselves operating under the specter of increased shareholder activism. Long-time activist hedge funds, such as Steel Partners, were being joined by Japanese companies like Oji Paper, which launched an unsuccessful takeover bid for competitor Hokuetsu Paper. What was happening in Japan? Were speculative hedge funds and aggressive corporate predators re-shaping the typically staid equity markets?

CapitalBridge reviewed the most recent overseas ownership data on Japanese equities and the answer is clearly no. Not only have traditional investment managers significantly increased their exposure to Japan, but a good portion of these investors are long-term oriented value- or GARP-style investors. Take a look at the charts that follow:



As seen above, close to 90% of the overseas ownership of Japanese equities is controlled by firms with portfolio turnover rates of very low, low, or moderate (<66%/year). Also shown are the predominant investment styles of the overseas firms owning Japanese equities. The typically patient capital of value investors and GARP investors manage a majority of shares.

So, what's this mean for the IRO at a Japanese company? First, the good news is that the rebound in Japanese equities should have some staying power, as a high percentage of overseas ownership is in the hands of stable lower-turnover investors. Second, when pitching your company to the investment community, stick to your long-term strategy. Clearly, there are a large number of firms with billions dedicated to Japan that make ideal shareholders. While you can't keep hedge funds from buying your shares, there is plenty of traditional money that would effectively dilute their influence. Outreach to North American and European institutional investors is far easier in the current investment climate than at any time in the last decade – taking advantage of this market can strengthen your shareholder base and guard against management's fears of shareholder activism.

*If you would like a complimentary copy of our Japanese Equity Ownership Analysis, just send an e-mail to [targeting@cap-bridge.com](mailto:targeting@cap-bridge.com).*

## OnTarget – Contacts

Recent notable contact moves:

Adrian Hickey (Senior Portfolio Manager) joined Pictet Asset Management in October 2006. He was formerly a director of Japanese equities and a portfolio manager at F&C Asset Management PLC.

David Ishibashi (Portfolio Manager) joined Matthews International Capital Management, LLC in October 2006. He was formerly a vice president and equity analyst at Lazard Asset Management, LLC.

Joanne Egrovich (Portfolio Manager) co-founded Kacela Capital, LLC in September 2006, covering the technology and consumer discretionary sectors. She was formerly a co-founder, managing director and a portfolio manager at Heirloom Capital Management, LLC.

Simon Melliush (Equity Analyst) rejoined Gartmore Investment Management PLC in September 2006. He was previously a senior portfolio manager there until 2004.

Kathy O'Connor (Portfolio Manager) joined Morgan Stanley Investment Management, Inc. in September 2006. She was formerly a managing director and portfolio manager at New York Life Investment Management, LLC.

*To keep an eye on other major contact moves, subscribe to CapitalBridge's IRxtras monthly newsletter containing research updates on movements from contacts, firms, and funds. There is no charge for this newsletter. To subscribe, simply email [IRxHelp@cap-bridge.com](mailto:IRxHelp@cap-bridge.com).*

## OnTarget – Conferences

Post-earnings season, the conference schedule gets heavier in mid-November and will continue into early December.

### Conferences – November 2006

Mon	Tues	Wed	Thurs	Fri
		<b>1</b> Goldman Sachs Global Capital Goods Conference – NYC	<b>2</b> Oppenheimer & Co. Digital Media Conference – NYC  Stephens Logistics & Transportation Services Conference – NYC	<b>3</b>
<b>6</b> CIBC World Markets 17 <sup>th</sup> Annual Healthcare Conference – NYC  Goldman Sachs Software & IT Services Conference – NYC  Rodman & Renshaw/Techvest 8 <sup>th</sup> Annual Healthcare Conference – NYC	<b>7</b> Raymond James Boston Fall Investors Conference – Boston  Robert W. Baird Industrial Conference – Chicago  Cowen & Co. Global Health Care Conference – London	<b>8</b> Credit Suisse Large Cap Pharmaceuticals Conference – London  Merrill Lynch Renewable Energy Conference #2 – London  Fox-Pitt, Kelton Financial Services Conference – Orlando  NAREIT REIT Week 2006 – San Francisco	<b>9</b> Standard & Poor's Global Bank Conference – NYC	<b>10</b>
<b>13</b> JPMorgan Small Cap Conference – Boston	<b>14</b> Citigroup 21 <sup>st</sup> Annual Transportation Conference – NYC  Merrill Lynch Banking & Financial Services Conference – NYC  Prudential Equity Group Healthcare Conference – Washington	<b>15</b> Deutsche Bank European Paper Seminar – London  Lehman Brothers 3 <sup>rd</sup> Annual Small Cap Conference – Dana Point  Bank of America Energy Conference – Key Biscayne  Credit Suisse Annual Healthcare Conference – Phoenix	<b>16</b> Oppenheimer & Co. 4 <sup>th</sup> Annual Restaurant Conference – Las Vegas  Credit Suisse Annual Insurance Conference – NYC	<b>17</b>
<b>20</b>	<b>21</b> Goldman Sachs Shipping Conference – NYC	<b>22</b>	<b>23</b>	<b>24</b>
<b>27</b> Deutsche Boerse Group German Equity Forum – Frankfurt  ING Central & Eastern European Conference – Prague	<b>28</b> Merrill Lynch Health Services Investor Conference – NYC  Credit Suisse Annual Technology Conference – Phoenix	<b>29</b> Keefe, Bruyette & Woods European Insurance Mid/Small Cap Conference – London  Merrill Lynch European Chemicals Conference – London  Piper Jaffray Health Care Conference – NYC	<b>30</b> UBS Global Real Estate Conference – London  Calyon Securities European & US Oil Services Conference – Paris	

Produced by CapitalBridge, copyright 2006

targeting@cap-bridge.com