ADDING VALUE

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Investment Review and Outlook: Restoring Trust to the Capital Markets

“The way we see it, ethics are as important as the analytics.” If this passage sounds familiar, it derives from the latest advertising campaign developed by the Association for Investment Management and Research (“AIMR®”), the grantor of the CFA designation. Certainly, the past three years have shown us that there is no shortage of companies that have been rebuked as “ethically-challenged.” World-renowned companies such as Adelphia, Tyco International, Enron, Global Crossing, Merrill Lynch, WorldCom, Xerox, Kmart, and Corning, among others, have demonstrated common traits of ethical collapse. One cannot help but recognize the signs of a systemic failure and ask what happened to our system of checks and balances. In other words,

- Where were the accountants?
- Where were the auditors?
- Where was the Board?
- Where was the media?
- Where were the investors?
- Where were the business analysts?

These questions are ongoing. Legislation, such as Sarbanes-Oxley, is attempting to remedy past failures. It is unclear, presently, if any permanent changes will come from the current solutions.

When does it start?

When do individuals first identify correct and incorrect ethical behavior? From the gut, we would say sometime in high school. In fact, a report released last fall by the Josephson Institute of Ethics in Los Angeles, based on a survey of 12,000 high school students, found that young people in general are less concerned about ethical behavior. Results of the study indicate that: the number of students who said they had stolen something rose to 38% in 2002, the number who had lied to their teachers and parents at least once rose to 93%, and those students that said they would lie to get a good job was up to 37%. In most cases, these numbers represent a significant increase from the results of the prior study in 1992.

SUMMARY:

Investing is a serious and potentially risky business. In the bull market, risk seemed to be a bad four-letter word. In the current bear market, understanding risk was the difference between preserving capital and losing large amounts of money. Individuals who don’t have the time, knowledge or interest should hire an experienced professional. With all the marketing strategies, highlighting the experience levels of their firms, how does the individual investor differentiate the messages?

Our advice would be to look at the adviser’s:

- People
- Performance
- Process
- Product
- Principles

Adding Value is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

Where does it go next?

Marianne Jennings, a professor of business ethics at University of Arizona, enlightened the audience at the recent 2002 annual AIMR conference that 47% of top executives, 41% of controllers, and 76% of graduate students in business have admitted that they would commit fraud by understating write-offs that cut into profits. In fact, she stated that nearly all MBA's believe shareholder value is more important than customer service. She further stated that convicts in 11 minimum-security prisons had higher scores on ethical dilemma exams than MBA's. These findings reveal that the prior high school students seem to become even more ethically challenged with additional education. Obviously, this is not a good trend line!

What is business ethics?

In our opinion, the study of business ethics is not the study of legality; rather it is the application of moral standards to business decisions. These moral standards are codes of personal conduct that are neither legislated nor changed by legislation. In the words of Peter Drucker, an octogenarian business consultant: "It is plain, everyday honesty. Businessmen should not cheat, lie, steal, bribe, or take bribes. But nor should anyone else. Men and women do not acquire exemption from ordinary rules of personal behavior because of their work or job."

An executive of a major health care institution once said to me: "Your problem is that your definition of right and wrong is too narrowly defined." I have had many years to ponder that statement; in retrospect, it became a defining moment of my career. Subsequently, the aforesaid institution declared bankruptcy and any other institutions that had similar tendencies also ultimately declared bankruptcy as we have seen in the corporate debacles of the last several years. So the good news is that, in the final analysis, the collective ethical consciousness of our economic system works in the long run. In the short-run, these are some serious fatalities that affect many innocent employees, shareholders, and other individuals.

What are some tips for judging corporate behavior?

From our perspective, when you buy shares of a company, you are making a conscious decision to go into business with the management. Surprisingly, people are willing to buy shares of companies managed by executives they know little about. One reason may be that it is very difficult to assess the corporate decision making process as an outsider. Furthermore, an executive is frequently torn between a decision based on business considerations and one based on his private ethical code. He may straddle the boundary between the two codes of conduct until finally stepping over to the "dark side." There is usually then a rationalization for this decision based on business competition. Phrases such as "no one will know the difference," " everyone else does it," "it has always been done this way," "let's wait until the accountants/lawyers tell us it is wrong," abound in the business world.

Based on our understanding of this behavior, here are some of the issues that are important to us in our evaluation of stock purchases and that place companies in high ethical risk categories:

- Monotonously smooth earnings
- High ROE and abnormal, unsustainable, double-digit growth rates
- Liberal interpretation of accounting standards
- Fervent pledges to continue performance
- Financial wizardry
- Young and inexperienced senior management
- Charismatic CEO's
- Serial acquisitors

- Investment in low-return projects that require lots of capital
- Autocratic CEO's
- Excessive incentives/options
- Repeated "one-time" charges
- Weak Boards
- Conflicts of interest within and among auditors and management
- High employee turnover
- Incentive systems based on an executive's short-term tenure in a position
- Companies who repurchase shares when their stock price is high

As stated earlier, it is much easier to identify high-risk companies when you work for one than it is as an outsider, because you can apply your private ethical standards to the quality of the business decisions. If you do have the misfortune of working for one of these companies at some time during your career, you definitely become more experienced in detecting the clues hidden in the financial statements as you analyze other situations.

Standards of Professional Conduct

The first responsibility of a professional was spelled out clearly 2500 years ago in the Hippocratic oath of the Greek physician. In English, it reads: "Above all, not knowingly to do harm." Today, we can apply this oath to all professionals. This doesn't mean that we are not human and will never make a mistake; it does mean that any professional counseling a client or patient must have a core understanding of the subject matter developed through independent thought, analysis, and experience.

The first thing that comes to mind when promising to do no harm is to educate ourselves into the nuances of the capital markets. Education takes the form of advanced degrees, independent study and experience. At a minimum, as holders of the CFA designation, we have taken 18 hours of examinations in three consecutive levels over at least three years, requiring a minimum of 750 hours of self-study in the areas of financial statement analysis, portfolio management, analysis of debt, equities, alternative investments, etc.

Each of the partners in our firm have on-the-job training of over 30 years. We have analyzed on a monthly basis the performance results of over 450 investment managers, trying to understand what works and what doesn't work in the investment markets. We read voraciously.

As CFA charterholders, we also annually sign a statement declaring our allegiance to AIMR's *Code of Ethics* and *Standards of Professional Conduct.* Briefly summarized, we are required to:

1. Act with integrity;
2. Practice in a professional and ethical manner;
3. Exercise independent professional judgment; and
4. Put client interests before our own.

The fact that CFA charterholders have not been involved (thankfully) in any of the capital market controversies is small comfort to us. As AIMR states: "The actions of any unethical and inexperienced practitioner can cause investors to question the trustworthiness of all of us." As we build our business, we see quite clearly the cynicism and skepticism of our prospects that simply wasn't there in the early 1990's at our prior firm. We haven't changed our core fundamental investment processes, but people's reaction to the delivery of our investment message is much more jaded.

Finally, we have developed a set of standards and core beliefs that govern the management of every portfolio (and we allow no wiggle room):

- Make all investment decisions with a thorough understanding of downside risk
- Risk and losses will be governed by the understanding of the underlying business, not the external price fluctuations of the stock

- Keep current and ask thoughtful questions on all aspects of the investments in each client's portfolio
- Invest our clients' money in the same manner and with the same diligence as is done with our own investments
- Craft each portfolio to meet each individual client's goals and objectives
- Manage client expectations

Few individuals have the time, skills, or technology to make the selection of stocks, bonds, and cash for their portfolios. Yet we are all obliged to make far-reaching personal investment decisions. Traditionally, advisers have counseled clients to look at the three P's: people, performance, and process. In the world of the 21st century, we may need to add two more criteria: product and principle. The latter may be the most important for most people. In assessing who will make the investment decisions in your portfolio look to the adviser's fundamental guides—intellectual proficiency, passion for the investment business, selflessness, competency, and belief system.

As Dean LeBaron, a famed money manager, writes: "So in selecting an investment manager, examine the principles. If you find they do not exist, flee. If you find they do exist but you do not like them, walk away slowly. But if you find them consistent with your belief system, and if enough of the other P's are present to satisfy you, stop searching. You are home."

As always, we welcome your comments and questions.

Sincerely,

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