

Evaluation of the Manager:

A paper for Non-Executive Directors of Investment Trust Companies on meeting the requirements of the listing rules



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Evaluation of the Manager

At the outset to this paper it should be emphasised that assessing the management's performance in running an investment trust company

- is an ongoing duty, responsibility and process of a board of directors, carried out in whole or in part at every board meeting;
- involves monitoring the management of a company, not just a fund;
- is a core and necessary skill of the board of directors of an investment trust company; and
- requires the setting of a clear objective, including the time scale over which it is reasonable to achieve it.

In its annual evaluation of its manager, the board of directors of an investment trust company is seeking to determine whether or not the manager should continue in situ. It is therefore a forward looking exercise and it should not be based solely on an analysis of past investment performance. Whilst this will form an important aspect of any evaluation, consideration should also be given to factors such as the experience, skills and commitment of the specific individuals who are assigned to the investment company, the resources and reputation of the management house and the level of skill and care which those individuals bring to bear in executing both the management of the portfolio and the overall management of the investment trust company. Only through inclusion of such considerations can the evaluation seek to be ***forward looking***.

The factors that Directors may wish to consider can be grouped under four main headings;

- Operational Considerations
- Results and Investment Performance
- Other Investment-related Considerations
- Other Services Provided by the Manager

The main operational issues to be considered are likely to include the reputation and resources of the management house, the level of importance which the house places on its investment trust clients in general and on the company concerned in particular, and the scale of operations of the management house in the investment markets with which the company is involved. Directors will also wish to consider the quality of the individual or team that is assigned by the management house to look after its affairs. In particular the quality of advice given to the Board, on both investment matters and other operational issues such as gearing, hedging, or the implementation of share buyback programmes, should be considered. The nature of the manager's relationship with major shareholders, and the ability of the individuals involved to articulate their investment process to them, may well also feature in this context.

In attempting to assess past performance, boards should first of all consider whether or not the objectives of the investment trust have been achieved. Thereafter they may wish to consider how the results have been achieved starting with a study of the 'headline' figures - such as the change in gross and net assets over various review periods. These numbers should be considered in their own right but also compared to appropriate benchmarks and the performance of others in the peer group. Directors should gain an understanding of how that performance has come about through the use of techniques such as attribution and contribution analyses.

The following general principles should be borne in mind in any performance analysis exercise:

- Consideration should be given to the performance against the objective and the time scale involved, to the absolute returns and to the peer group and benchmark relative returns;
- A variety of review periods should be studied with a greater emphasis placed on longer term trends than shorter term outcomes;
- Capital-only or total return figures may be most relevant depending on the aims, objectives and policy of the trust concerned;
- Discrete periods should be analysed as well as cumulative numbers as the former give a better indication of how consistent the manager has been;
- Great care is needed to ensure that any benchmark selected is relevant to the investment policy of the company and the constraints within which it operates. If there is no relevant benchmark available, consideration should be given to commissioning an independent organisation to produce a meaningful benchmark, possibly in conjunction with their peer group trusts;
- Similarly, the choice of the constituents for the peer group against which performance is compared is critical if meaningful results are to be obtained.

In addition to analysing investment performance, Boards may wish to take account of other investment considerations and in particular seek to gain an appreciation of the level of risk being taken in the management of the company's assets. This may be achieved through a study of the characteristics of the portfolio (spread, size composition etc.) and the major positions taken in absolute terms and relative to any benchmark adopted. Alternatively some Boards may wish to make use of statistical measures of volatility or to evaluate the 'anatomy of the portfolio'.

Managers usually manage the company as well as the portfolio, therefore providing additional services over and above the investment management role (for example accounting, company secretarial, investor relations or marketing functions, etc); the level of achievement in these areas should also be taken into account as part of the evaluation process.

When reviewing the contents of management agreements, or any other documents which define the basis on which the manager is engaged, attention should be paid to the basic management fee, any performance fee arrangements, and the notice periods required to be given by each party to the other in the event that either the Board or the manager decides to terminate the relationship. Particular attention should be paid to the level of compensation payable, if any, in the event of termination. Any additional fees payable to the manager in respect of services other than investment management, for example company secretarial services or marketing activity, should also be considered as part of the review.

The recent amendments to the Listing Rules specifically require that a Board satisfy itself as to whether the continuing appointment of the manager **on the terms agreed** is in the interests of shareholders as a whole. In reviewing the ongoing suitability of the existing terms, Directors will wish to make use of relevant peer group comparisons but at the same time recognise any unique or distinguishing features that set the manager or the mandate apart from those of their peers.

Directors are required to make a statement on the form and outcome of their deliberations in the annual report to shareholders and the Listing Rules require this statement to be **in a prominent place**. The content of the statement must make reference to **the reasons for** the view that has been reached and will typically refer to factors such as the resources of the management group and the past performance achieved for the company in this connection.

Most Boards that have reported since the amendments to the Listing Rules became effective have elected to include a statement within the Chairman's Review, though some have opted to include it within the Directors' Report or a separate 'Corporate Governance Report' where one is included. The summary of the principal contents of

any agreement with the manager is generally included within the Directors' Report and should include (as a minimum) details of management fees payable under normal circumstances and any compensation payable in the event of termination of the agreement. The key factors of an evaluation can be broken down into a menu of considerations as follows:

- **Quality of team** – the skills and particularly the experience of the team involved in managing all aspects of the company's business;
- **Investment management** – portfolio management skills, experience and track record and other investment related considerations, including gearing, currencies, hedging, buybacks etc;
- **Commitment of Manager** – the commitment of the manager to the investment trust business generally and to the trust in question in particular;
- **Managing the company** – in running and controlling the administration, accounting, and secretarial side of the company;
- **Promotion** – Commitment to and execution of activities designed to secure sustainable demand from prospective long-term shareholders;
- **Shareholders** – shareholder consciousness and relations, discount management and commitment to the stated goal of the trust;
- **Management agreement** – consideration of fees, notice periods, duties;
- **Annual report** – consideration on how to report on the annual assessment.

Final thought - boards should be aware that it is possible to get bogged down in the detail of any analysis and thus fail to see the woods from the trees. Ultimately, continuing in situ with the manager is a matter of judgement. Common sense and the bigger picture are what are important to that decision.

Example of Possible Wording for the Summary and Statement

1. Summary of the Principal Contents of the Agreement with the Manager

'Manco', a wholly owned subsidiary of 'Mangroup', manages the Company's assets. Other subsidiaries of 'Mangroup' provide company secretarial and administration services and undertake certain promotional activities for the Company. Either party can terminate the provision of these services at any time by giving twelve months notice. Under certain circumstances, the Company may be required to pay up to one year's management charges if the Company gives less than twelve months notice.

Under the terms of the management agreement dated 1 November 1996, Manco receives a management fee at a rate equivalent to 0.70 % per annum plus VAT. This fee is calculated and payable monthly in arrears based on the Total Assets less Current Liabilities at each month end. Any investments made in funds managed by companies within the Mangroup Group are excluded from Total Assets for the purposes of calculating the level of management fee payable. For the year ended 30th April 2004, £1.2 million plus VAT was paid.

In addition, Manco are entitled to a performance fee of up to 0.5% of net assets under management based on the level of outperformance versus the Company's benchmark, during the relevant performance period. However Manco is only entitled to receive a performance fee under these arrangements if the Company's net assets at the year-end are greater than the level at the end of the last financial year in respect of which a performance fee was paid. In addition, the total level of fees payable to Manco in respect of any financial year is capped at 1.00 % of net assets as at the year-end (the performance fee shall be reduced to the extent necessary to comply with this limit.) For the year to 30th April 2004, no performance fee was paid.

In respect of the year ended 30 April 2004, a fee of £56,254 plus VAT was paid for the provision of administrative and secretarial services.

This fee is adjusted annually in line with the Retail Prices Index.

Subsidiaries of Mangroup also operate a Savings Scheme and Individual Savings Accounts for the Company. A sum of £42,000 was paid for the provision of these services during the year ended 30 April 2004. This fee is calculated by reference to usage rates and promotional costs incurred.

During the year ended 30 April 2004, the Company incurred irrecoverable VAT totalling £ 114,256 in connection with fees paid under the arrangements described above.

2. Statement Regarding the Continued Appointment of the Manager

The continued appointment of Manco as investment manager to the Company on the existing terms was approved by the Board on 20 May 2004. The Board considers the arrangements for the provision of investment management and other services to the Company on an ongoing basis and a formal review is conducted annually.

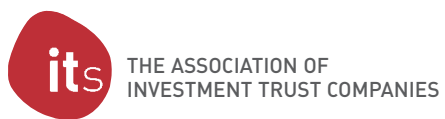
As part of this review the Board considered the quality and continuity of the personnel assigned to handle the Company's affairs, the investment process and the results achieved to date. As noted in the Chairman's and Investment Manager's report, the performance of the company over the last two year's has been disappointing and this remains an area of concern. However, in line with the company's objective, the Board places greater importance on the manager's ability to deliver long-term performance and notes that the company has outperformed its benchmark over 5 and 10 year periods.

The Board has considered the manager's proposals to deal with recent underperformance, which are discussed in detail in the Investment Manager's report. The Board supports these proposals. The Board also believes that the appointment of James Smith to manage the private equity portfolio will help strengthen the management team.

In addition, the Board considered Mangroup's ongoing commitment to the promotion of investment and savings products linked to the Company's shares. The Board believes that increasing the proportion of the Company's shares held by private investors over the medium term is important for ensuring a healthy future for the Company and to tackle discount volatility. The Board notes that holdings by private investors through Mangroup's savings plans increased by 4% over the last year, and by 15% over the past 3 years. The Board has considered the Mangroup's plans for the promotion of these plans in the coming year and believes that they will benefit shareholders by helping to create sustained demand for the Company's shares from retail investors.

The principal contents of the agreement with the manager have been set out in the previous section. Having considered the terms of this agreement, and where relevant those of companies in the same peer group, the Board considers that the terms of these agreement represent an appropriate balance between cost and incentivisation of the manager.

The one area of concern highlighted by our review was the potential impact of the recent acquisition of Mangroup by Holdingco. The Board intends to carefully monitor the impact of this development on the services provided by Mangroup to the Company.



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