OnTarget

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

OnTarget – Trends

SRI ownership analysis

There's a lot of talk these days about Socially Responsible Investing (SRI) and its impact on institutional investment. In recent years, there has been increased engagement and other activity surrounding corporate governance. SRI is a separate, somewhat new in significance, emphasis on environmental issues such as carbon emissions of public companies, as well as social issues like community relations. CapitalBridge has endeavored to stay at the forefront of this issue, as we anticipate growing investor interest in this area. European investors and public companies are already taking a keen interest in the issue, with European Carbon Markets (an emissions credits trading system) now burgeoning, and many firms such as those PRI Investor Group signatories (www.unpri.org, representing $5 *trillion* in assets) have now pledged to engage public companies in their behavior and factor SRI into their investment strategies. We've taken a closer look for this issue of the newsletter to see if US-based firms are starting to move in this direction as well.

Looking at a myriad of factors, including SRI Index membership, independent SRI company ratings, and SRI fund ownership, an SRI Investor Score, scaled from 0-10, was derived for all US money managers of size. A score of 10 indicates a firm investing *only* in more Socially Responsible companies. Winslow Management Company, a successful SRI investment firm in Boston, has a score of 9.24, for example. A score of 5 is the median score, in effect, of firms not factoring SRI into their investments - Index firms on average scored 4.997, for example, which is what one would expect.

Findings from the analysis:

The straight average score of all US Firms was 4.5, indicating that many firms do not factor SRI into their investments (unless they are engaging with their less-socially-responsive invested companies, hoping to help change behavior).

Barclays Global Investors, the largest US investor and primarily an index investor, scored 4.95. Capital Research & Management, however, at #2 by asset size, scored 4.35, or Underweight Socially Responsible companies, in general. Dodge & Cox, a rapidly growing firm in recent years, scored a surprising 3.4, or Significantly Underweight Socially Responsible equity.

Berkshire Hathaway, right on the heels of the news of Warren Buffett's giving away his fortune to beneficial organizations such as The Gates Foundation, scored a hefty 6.39, the highest score of the 100 largest US firms, indicating possible additional long term thinking by the 'Oracle of Omaha.'

Overall, though, it would appear that most managers of size are not factoring in SRI, with the same top 100 US firms averaging a score of 4.6. So, while some investors are engaging with companies they invest in, and some firms buy SRI research, it appears that the dawn of the significance of SRI to US investors lays ahead.

You may well see your first engagement on the issue coming from overseas investors. The largest 10 European firms are leaning more towards SRI positive companies than their US counterparts. Six of the top 10 UK institutions are above average, and likewise five of the top 10 on the European continent (mainly in Germany), yet only one of the largest 10 US firms is above average. In addition, UK firms like Hermes, Insight Investment, Henderson Global, and others, are well schooled at engaging corporates for a result.

On the US side, in addition to the usual public pension fund suspects (such as CalPERS), we are seeing a number of long term value investors moving towards SRI-positive companies. One such firm is Oppenheimer Capital, which has a history of involvement with SRI. Oppenheimer has won allocations in recent years from the Unitarian Universalist Association among others. Other large value investors, such as Pzena Investment Management and Kayne Anderson Rudnick, are also skewing towards more Socially Responsible companies. It's interesting to see some research intensive valuation firms moving in this direction. Whether they see long-term valuation upside for socially responsible companies, or just happen to be investing in such companies, is a separate question, of course.

So far as determining the true nature of a firm's intent is concerned, CapitalBridge is now handling a growing number of SRI Perception Studies and related Ownership Analyses to assist those companies interested in staying ahead of this issue with regard to their current and prospective shareholder base.

For additional information about SRI, drop us a line at: targeting@cap-bridge.com

OnTarget – Best Practices

Back in May, the *Wall Street Journal* highlighted the disparity of institutional ownership between two head-to-head competitors, XM Satellite Radio and Sirius Satellite Radio. XM had seemingly won the battle for the professional investor's dollar with 95% institutional ownership, versus less than 20% for Sirius. For most companies, however, institutional ownership lies somewhere in between the Sirius number and the XM number. But is there an ideal level of institutional ownership?

Not really. Let's be clear – institutional demand is typically the most significant long-term value driver for a stock. But, the level of institutional ownership at a particular company has a lot to do with its history and capital structure. For instance, AT&T in its prior incarnations and the Baby Bells had a higher than normal percentage of retail ownership that was fostered through the original IPO and the hundreds of thousands of employees and retirees that owned shares. Companies that have offered shares more recently tend to have profiles that are skewed more toward institutions. So, while an ideal level of institutional ownership is a bit elusive, it is worthwhile to benchmark the level of your company's institutional ownership to a peer group or companies with similar market caps. We've provided some tables below to help you along with this assessment.

<u>Average Institutional Ownership by Market Cap - All U.S. Companies; Percentage of Outstanding</u>

Micro (<$250M):	26.9%
Small ($250M-$2B):	66.0%
Mid ($2B-10B):	76.9%
Large ($10B-$50B):	76.1%
Mega ($50B+):	67.9%

Institutional ownership generally increases as you move up the capitalization scale. Micro-caps, the smallest of small companies, get little institutional attention, as speculators (primarily some risk-taking individuals) dominate the ownership of these companies. There's a huge jump in institutional ownership as you move to companies in the small-cap range. Small-caps have been the sweet spot of the equity markets over the last five years as the Russell 2000 index has outperformed every broad U.S. index. Clearly, institutional ownership had a lot to do with this performance. Institutional ownership peaks in the mid-cap range and then ebbs slightly with large caps and drops down below 70% for mega caps. More on that next.

<u>Institutional Ownership - 10 Largest U.S. Companies; Percentage of Outstanding</u>

ExxonMobil:	53.6%	Bank of America Corp.:	72.9%
General Electric:	58.3%	Johnson & Johnson:	66.1%
Citigroup:	66.5%	Procter & Gamble:	61.0%
Microsoft:	66.5%	Pfizer:	67.4%
Wal-Mart Stores:	37.6%	AIG:	66.7%

As you can see, several of the largest companies by market cap in the U.S. have below average institutional ownership. There are a variety of reasons for the relatively low level of ownership; some of these are classic "widows and orphans" stocks, others have significant insider ownership. Regardless of the reason, ownership levels within this group illustrate that while it's difficult to come up with an ideal level of institutional ownership, if ownership is below the 60%-65% range you're stock is probably in "underowned" territory.

Of course, it would be our pleasure to analyze your company's ownership distribution to highlight its strengths, weaknesses and more importantly opportunities to grow institutional ownership. Feel free to drop us a line at targeting@cap-bridge.com.

OnTarget – Firms

Target Firm: Loomis Sayles & Co.

Targeting Profile

The firm has recently increased asset size to $22.8 billion in equities under management from $13.2 billion a year ago (a 73% increase over the period), based both on cash inflows and some solid investment performance. The firm manages both growth-oriented and value-oriented products at all cap ranges, with the growth-oriented portfolios having a slightly higher average turnover. Its "home-branded" mutual funds have produced decent performance, but its external mandates comprise the majority of assets ($55 billion in institutional assets versus $24 billion in mutual funds).

How to Approach

This firm is prone to "top-down" sector rotation activity that takes place over a fairly long period of time (somewhat based on the broad valuation characteristics of the sectors), allowing companies in the "sweet spot" of its rotation to take advantage. However, it will tend to sell the more expensive issues in each sector while adding assets to the cheaper issues. Financials are in its focus over the last quarter, with the firm piling into cheaply valued investment banks such as Goldman Sachs (GS) and Lehman Brothers (LEH) at multiples near 10x earnings with rapid expected growth. Home Depot (HD) and Nordstrom (JWN) represent the firm's interest in larger consumer stocks, both coming in at the lower ends of valuation while more expensive issues like Target (TGT) are aggressively sold. Bring your best picture of your valuation versus comparables and tell your best GARP story; the firm's traders are known to be less price-sensitive than others when accumulating, meaning a boost to your stock price.

Average equity holding period: 1.3 years

How Not to Approach

Largest sales for the last quarter include Yahoo! (YHOO), Microsoft (MSFT), Intel (INTC), Adobe (ADBE), and Google (GOOG), which may say as much about their valuation as the firm's sector rotation choices. Needless to say, telling the firm a software growth story may be a tougher sell now than a year ago. The firm sets a floor of a $2 billion market cap, though it will occasionally gather information on smaller companies. Before any discussions with the firm, check peer and industry holdings, and if you're up against a sector or valuation concern, change your presentation to a longer-term focus.

Largest Portfolios Managed

USAA Growth Fund – $790 mm equity – Mark Baribeau
Loomis Sayles Small Cap Value Fund – $560 mm equity – Joseph Gatz
Delaware Trend Fund – $1.2 b equity – Stephen Lampe
IXIS Loomis Sayles US Large Cap Growth Fund – $520 mm equity – Mark Baribeau

Investment Potential

Average holdings for the firm at each market cap range:

Giant-cap: ~$82 mm
Large-cap: ~$42 mm
Mid-cap: ~$15 mm
Small-cap: ~$5 mm
Micro-cap: ~$2 mm

OnTarget – Funds

Target Fund: Hotchkis & Wiley Large Cap Value Fund

Managing Firm: Hotchkis & Wiley Capital Management -- George Davis (213-430-1838, george.davis@hwcm.com)

Targeting Profile

Despite the name, this fund stretches its cap focus down to just $1 billion in market cap, nearly rendering it an "all-cap" name. Indeed, the firm's mid-cap allocation has jumped from $1.3 billion to $1.6 billion in the last quarter. Its impressive purchasing power and low turnover make it worth a look for any investor relations effort; however, the fund will not make a large number of new investments given the holding period.

How to Approach

Run your dividend discount model in advance and see how it matches up with your competition and investments in general. In addition to a 2.6% average dividend yield, many of the firm's larger-cap investments show impressive dividend growth rates. Its largest buy this year, Eastman Chemical (EMN), boasts a 3.3% yield. If a yield isn't a part of your story, focus on free cash flow that's being pushed into high-return businesses.

How Not to Approach

With a long-term investment horizon, sustainable growth is the key message the fund appears to look for; this may be a good opportunity to pull the "next four quarters growth" slides out of your presentation and lead with the long-term approach that so many other investors "say" they want when they're planning on speculating, not investing. Healthcare stocks are surprisingly underweight in the portfolio, with just two hospital managers, Tenet Health (THC) and HCA Inc. (HCA) showing up in smaller allocations.

Investment Potential

Average holdings for the firm at each market cap range:
Giant-cap: ~$130 mm
Large-cap: ~$115 mm
Mid-cap: ~$90 mm
Small-cap: ~$45 mm

Average equity holding period: 5.6 years

OnTarget – Weightings

Ever get the feeling the "aggressive growth" manager sitting across the desk from you isn't really an aggressive growth manager (as he/she keeps asking what your enterprise multiple is versus your peer group instead of what your growth prospects are)? You may actually be right about this, and there may be even more at stake than just what the manager hangs out on his/her shingle.

In the endless quest to outperform a benchmark, every once in a while a manager may undertake a truly different strategy than what they claim to follow. Most portfolio management agreements will allow managers a pretty wide discretion in the investments that they make, with respect to asset classes, sub-classes, and diversification requirements. However, public pension funds are starting to lead the way in terms of oversight on where their equity allocations are headed, and, more importantly, whether they're choosing appropriate cap and style benchmarks for reporting.

For example, take a look at a few of these mutual fund portfolios that in some sense may be saying one thing and doing another with their allocations. CapitalBridge used a methodology similar to that of BARRA, using book-to-market ratios in order to split securities into growth and value investments, while separating out "aggressive growth" (companies aggressively priced at >27x forward EPS) and "yield" (generally >4% yield) stocks based on their different investment stories. Lower-turnover funds were filtered out to analyze just investors that are not constrained by turnover limits when rebalancing their portfolios.

The resulting allocations for some of the portfolios are interesting, to say the least. Just as a small example, here are some of the "value" funds that don't seem to have much of a pure "value" focus in their holdings. This is not to say that their decision-making is inaccurate in any way, but if you're an investor looking to have one of these funds cover the "value" portion of your diversification scheme you may not be getting what you think you are.

Fund	Manager	Turnover	Benchmark	Aggr. Gr. Weight (%)	Growth Weight (%)	Value Weight (%)	Yield Weight (%)
Lord Abbett All Value Fund	Lord Abbett & Co.	Moderate	Russell 3000 Value	7.0	67.3	22.0	3.7
Lord Abbett Small Cap Value Fund	Lord Abbett & Co.	Moderate	Russell 2000 Value	5.1	62.5	29.1	3.3
Oppenheimer Quest Opportunity Value Fund	OppenheimerFunds	Moderate	S&P 500	20.5	46.0	26.9	6.7
DWS Large Cap Value Fund	DWS Scudder Investments	Moderate	Russell 1000 Value	0.0	61.6	27.7	10.7
Oppenheimer Value Fund	OppenheimerFunds	Very High	S&P 500	10.2	49.1	30.7	10.0
STI Classic Large Cap Relative Value Fund	Suntrust/Trusco Capital	Moderate	Russell 1000 Value	1.8	56.2	32.1	9.9

Take a look at the portfolio of any investor you're talking to – if you fall pretty far outside their typical investment discipline, you may be speaking to an investor looking for a shorter-than-average-term holding (needing some quick returns instead of someone looking to make you a "core" investment).

OnTarget – Contacts

Recent notable contact moves:

Neil Wagner (Portfolio Manager) joined Merrill Lynch Investment Managers, Inc. (US) in June 2006. He was formerly a managing director and portfolio manager at BlackRock, Inc.

Michael White (Portfolio Manager) joined Hovan Capital Management, LLC in April 2006, covering the healthcare sector. He was formerly a portfolio manager at Seneca Capital Management, LLC.

Megan Kulick (Director and Equity Analyst) joined Merrill Lynch Investment Managers, Inc. (US) in May 2006, covering the broadcasting and media industries. She was formerly a vice president and an equity analyst at JPMorgan.

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.

Just a few conferences this month as vacation season kicks in. We hope your conference schedule includes a few days on a beach and plenty of time with the family. If you're not stuck in the middle of earnings season/quiet period, make sure to conduct your investor outreach in a target-rich environment – your local golf course. Conferences for the month:

Conferences – July 2006

Mon	Tues	Wed	Thurs	Fri
3	4	5	6	7
10 SEMICON West 2006 – San Francisco, CA	11 CIBC World Markets Annual Consumer Growth Conference – Boston, MA Unterberg Emerging Growth Opportunities Conference – New York, NY	12	13	14
17 SRI's 8th Annual Anti-Cancer Drug Discovery & Development Summit – Philadelphia, PA	18 SRI Energy Technology Investors' Conference – San Francisco, CA	19	20	21
24	25	26	27	28
31				

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