Management of UK equity portfolios

In January and February this year, interviews were carried out, on behalf of the City Capital Markets Committee, with eighteen of the largest fund managers in the United Kingdom, in an attempt to examine how large UK equity portfolios are managed and to assess the implications for quoted companies. The survey was carried out in response to the concerns expressed by a number of industrial and commercial companies that fund managers' attitudes are too short term, leading to a tendency for the stock market to undervalue some companies, especially those investing heavily in research and development, therefore making such companies vulnerable to takeover. The survey included independent managers, insurance companies, pension funds, and merchant banks. The managers in the survey group handled UK equities totalling £63.7 billion—around 20% of the UK equity market (see Table A). This article[1] sets out the main findings. Among the main points are:

- *Pressures on fund managers to achieve good performance have increased in recent years, particularly regarding unit and investment trusts and the outside management of pension funds. This has led to more intensive management of portfolios.*
- *But it is not clear that fund managers are necessarily taking a more short-term view of the prospects for companies. A number of managers try to beat the index by looking for shares which are undervalued relative to the fundamental strengths of the company.*
- *There seems to be a strong predisposition on the part of a number of fund managers to support the incumbent management of a target company in a contested bid.*

Pressures on fund managers

Performance reviews

It was clear from most of the interviews that pressures on fund managers regarding their performance had increased markedly in recent years, but the pressures were not the same for all managers. The two types of activity where the perceived pressure for performance is greatest are the management of unit or investment trusts, and the outside management of pension funds. For unit and investment trusts the pressure stems from the monthly assessment, in the financial press, of the comparative performance of various trusts, which in turn is reflected in very frequent reviews of performance in-house. Unit trust managers found that sales of new units via independent intermediaries were adversely affected by poor performance after only a quarter or so. However, direct sales to the public are much less vulnerable and managers more reliant on such sales are therefore able to take a longer-term view of their performance.

There seemed to be a general view among the external managers of pension funds that pension fund trustees were more aware of performance than had been the case five years ago. They thought that this reflected the greater availability of statistics on comparative performance and also the greater use by the trustees of consultants to assess the relative performance of a fund and to advise on

Table A
Fund managers included in the survey

Type of manager	Number of managers interviewed	Total UK equities under management (£ billions)
Independent managers	4	8.7
Merchant banks	5	23.2
Insurance companies	5	20.1
In-house pension funds	4	11.7
Total	**18**	**63.7**

investment strategy. The trustees generally looked at performance in detail annually—although some were given quarterly as well as annual performance figures, and some of the smaller pension funds did pay particular attention to quarterly figures.

It was rare for an external pension fund manager to be appointed for a fixed term, but there was usually felt to be a tacit agreement that the appointment would be for a minimum of three years. Most of the merchant banks and independent fund managers thought that performance was viewed over a rolling three-year period. This did put them under pressure, because poor performance over one year would be commented on, poor performance over two years would put them under notice and, after a third year's poor performance, they might lose their client.

There was some indication that a few pension fund trustees, particularly those for smaller funds, reacted to

(1) This article was written by Mrs P D Jackson of the Bank's Financial Supervision—General Division.

poor performance over an even shorter period. One case was cited where the manager had achieved top quartile performance over two years and then had been sacked because of below-average performance over the succeeding nine months. Several of the fund managers stressed that it was in the interests of the outside consultants to encourage the trustees to change the fund manager because they would be involved in the selection process for the new managers and this would generate extra fee income. Good quarterly performance seemed to be particularly important for gaining new clients, especially if a firm wished to attract US pension fund business.

Some pension fund trustees also seem to lay down unrealistic targets for the performance of the funds in the hands of outside managers (eg consistent top quartile performance) without considering the risks that would be entailed in trying to achieve them—although a few consultants are beginning to look at risk as well as return when assessing pension fund strategies.

The in-house pension fund managers seemed to be under considerably less pressure than the outside managers. As in the case of the outside managers, their performance was reviewed in detail annually but it tended to be considered over a rolling five-year period rather than the rolling three years faced by most of the outside managers. There also seemed to be much less pressure on them to produce consistent above-average performance.

Insurance companies were under the same pressure as other managers to achieve good performance on unit-linked funds, unit trusts and outside pension funds. They did not, however, seem to be under anything like as much pressure on their life and general funds. This was in part because it was felt that the different tax treatment (life assurance funds are subject to capital gains tax whereas pension funds are not) meant that their performance could not readily be compared with the performance of other types of fund. There is little comparative information on the short-term performance of different life funds but, even if it were available, the different spread of liabilities would make it difficult to assess the relative returns.

Rewards linked to returns

For the majority of managers, rewards were not linked to returns either individually or corporately. However, there were indications that in the more competitive conditions in the industry this practice could be increasing. Several managers had started to take on a few clients on performance-related fees. One organisation had a few accounts with performance related fees set in such a way that it would only cover its costs if it achieved a return in excess of the WM average for pension funds. Even among organisations which did not link salaries explicitly to performance, some gave the impression that their staff were under a significant amount of pressure to achieve desired performance levels. Some managers who at present did not link bonuses explicitly to performance were considering doing so.

Approaches to fund management

The approaches and objectives of the various fund managers regarding their UK equity portfolios differed substantially. The organisations had in every case almost complete freedom to decide the asset allocation of this part of their portfolios. Guidelines agreed with their clients, and in the case of the in-house pension fund managers their trustees, tended to be limited to, for example, the broad split between gilts, UK equities and foreign securities. One of the in-house pension funds discusses the risk profile of the fund in some detail with the trustees and limits are set on the proportion of the portfolio which can be invested in any instrument and the percentage deviation in the weight of a share away from the index. Another in-house pension fund has similar limits. But in general the other managers do not discuss the risk profile with trustees in specific terms.

Pension funds

Even within the group of in-house pension fund managers there are quite different approaches and objectives. In one fund, the managers kept around 80% of the fund index-matched. For the remainder, they hoped to identify shares that would give income and growth over the long term. They were not looking to make a quick turn and would usually hold on to a share as long as the prospects looked good. Another fund was around 75% index-matched. The non-matched element was managed in part by outside managers and in part in-house. The in-house element was managed aggressively, with each holding being reviewed and justified according to expected gains in the share price over a relatively short horizon, and the turnover of these funds was high. Another, with no index-matched element, looked for sectors likely to outperform the index over a five or ten-year horizon. The fourth fund, also with no index-matched element, chose to hold overweight or underweight positions in companies according to their expectations for the share price over a two-year period. If the investment did not look encouraging in that period, they would reduce the weight.

Insurance companies

The approaches of the insurance companies in the survey differed according to the type of fund managed. One insurance company's policy for its life and general funds, and its own pension fund, was to invest for long-term growth in dividend income. Capital appreciation was a secondary consideration. For their unit trusts, however, the reverse was the case—capital appreciation over a short period was the main objective. The extent to which tax was perceived as a major constraint on changes in the life fund's portfolio was highlighted by the fact that fund managers had to refer all sales of holdings involving tax implications to senior management. The substantial increase in share prices in recent years had made them reluctant to realise their capital gains and pay the tax. Another company also felt that its life funds were dominated by tax considerations, but in its performance funds it looked for short-term gains where possible.

In contrast, the other three insurance companies in the survey felt that decisions on the profile of their life funds should not be dominated by tax considerations, although they might avoid marginal switches for tax reasons. One of the companies outlined its strategy for its UK equity portfolio in the following way. If they thought that the shares of a growth company were undervalued (by perhaps 10%–15% for the life and general funds), fund managers would increase their weighting in the stock, and would reduce their holding back towards an index weighting when the shares looked 15%–20% overvalued. For companies which offered less growth potential and for which they would usually have a below-average weighting, they would buy when they looked 15%–20% undervalued and sell when they looked 5%–10% overvalued. For relatively small companies which they did not want to hold on a long-term basis, fund managers would buy when they were 25%–30% undervalued, and then take a gain at an early opportunity. For the performance funds, the managers would buy and sell on lower percentage movements.

One of the companies used index-matching for a significant part of its funds—holdings of alpha stocks were expected to be virtually index-matched. For beta and gamma stocks, for which the markets were thought to be less efficient, managers were expected to take positions by observing the fundamentals. Shares were bought on the basis that they represented good value at the time of purchase. Sales would be made at the point where the share price was regarded as higher than was warranted by future prospects.

Merchant banks

The approach of the merchant banks was to assess trends in markets and sectors and to look for undervalued stocks—particularly among the betas and gammas. One merchant bank had radically changed its approach to UK equities in recent years. Five years ago fund managers had selected stocks on their view of the quality of a company's management and its technical edge. They now look more to value than quality and look for stocks which are likely to gain in price over a twelve to eighteen-month period. Once a stock was seen as 15% overvalued (undervalued) it would be put on a sell (buy) list and at 30% overvalued (undervalued) would be actively sold (bought). The change in their approach reflected the reduction in transactions costs. Five years ago the cost of switching a sizable holding (say 2% of a company's equity) from one company to another was around 10%, now it is around 5% (these figures include the spread on such a deal as well as commission and stamp duty). Another merchant bank looked for shares to show an expected return (in terms of capital growth and income) over two, three or five years. Its research department concentrated on finding undervalued stocks. Yet another looked for shares likely to outperform the index over a three, four or five-year period. But fund managers would take their profits if shares appreciated more quickly than expected, and were prepared to trade their smaller stakes actively.

Independent managers

Several of the independent managers had a philosophy similar to that of the merchant banks. One looked for shares to increase in value over a two to three-year period. If the increase was achieved within, say, a month, the fund managers would tend to take the profit for their unit trusts and overseas funds (which were more intensively managed) but would not necessarily do so for their pension funds. A second managed its funds in a similar way. Another took long-term views about particular companies, concentrating on finding smaller companies which were relatively undervalued. The fourth concentrated on income flow because this was a feature of many of its unit trusts. If a share had a falling yield, perhaps because of recovery and an increase in the share price, then the managers would sell slowly.

Research on individual companies

The in-house pension fund managers and a number of the insurance companies relied on the detailed research on individual companies produced by brokers. The other fund management organisations also tended to rely on brokers' research on alpha stocks, but those which were looking for relatively undervalued stocks put some effort into researching betas and gammas. Most of these managers thought that contact with companies was important for assessing their strengths and in particular the quality of the management. They were looking for shares which would outperform the index over, in many cases, a two to three-year period, and were therefore looking for companies which had greater long-term strength than was recognised by the market. One organisation which used a dividend discount model was assessing the current value of the earnings projected over a seven-year period (discounted using the yield on seven-year gilts) to assess whether a share was overvalued or undervalued. If the fund managers thought that a share was substantially undervalued they would then take a view on whether they expected the price to increase within two years. If they did they would buy it, if not they would wait and buy it later.

Autonomy of individual fund managers

In most organisations, individual fund managers had autonomy over the selection of individual stocks, although there were usually limits or checks on substantial changes in significant holdings. The degree of autonomy over selection of sectors of the UK equity market varied considerably between fund managers. Fund managers in the merchant banks tended to have the least autonomy, as there was usually a house view regarding sector allocations and also in some cases regarding holdings in major stocks (even as far as setting a house weighting on the top forty or fifty stocks).

The effect of pressure for performance

Most fund managers did think that the pressure for performance affected their investment decisions to a degree. Some felt that the pressure for good short-term performance meant that they were reluctant to invest in some assets such as property which they expected to be extremely profitable in the long run but which were likely to register poor performance in the short run. Since they did not know exactly when the price would start to pick up, by waiting they could miss a good opportunity to buy at a low point.

Pressures for performance also seemed to be reflected in higher turnover because funds tended to be managed more intensively—although this was not the only explanation for the higher turnover (see below).

Turnover

There are marked differences in the rate at which the UK equities held by various types of institution are turned over—although for all types of institution the turnover has increased significantly in recent years. UK equities in pension fund and insurance fund portfolios, which amounted to £79 billion and £48 billion respectively at end-1985, are on average traded once every five years. The turnover of UK equities in investment trust and unit trust portfolios (amounting to £8 billion and £11 billion at end-1985) is much higher—on average each stock is traded once every three years for investment trusts and around once every two years for unit trusts. Table B shows the turnover for the UK equity market as a whole and for the shares held by each type of institution—the turnover includes purchases and sales and therefore double counts transactions per share.

Table B
Turnover of UK equities held by institutions

	1981	1982	1983	1984	1985	1986(a)
Pension funds(b)	25	27	35	33	37	41
Investment trusts(b)	46	69	67	71	80	69
Unit trusts(b)	83	88	98	95	107	116
Insurance funds:(b)						
Long-term	20	23	27	30	30	39
General	26	32	28	34	33	35
All UK listed equities(c)	*35*	*34*	*40*	*41*	*47*	*61*

(a) First three quarters at an annual rate.

(b) $\left| \frac{\text{Purchases plus sales less new money}}{\text{Average value of fund}} \right| \times 100$. Source: *Financial Statistics*.

(c) $\left| \frac{\text{Purchases plus sales}}{\text{Average market value}} \right| \times 100$. The figures include a small amount of turnover in foreign equities. Source: *Stock Exchange Quarterly*.

Most of the fund managers included in the survey thought that the turnover of the shares they manage had increased in the past five years, although this was not true of all. One organisation said that it had taken a conscious decision to reduce the rate of turnover in the last year because the extra return did not cover the costs. Several thought that the deeper markets and lower transactions costs post-Big Bang would enable them to increase their turnover further.

The higher turnover in part reflected the change in market conditions, with more takeovers, and the reduction in transactions costs—in particular, stamp duty, charged on each purchase, was halved to 1% in the 1984 Budget and then was further reduced to ½% in October 1986. But it was also a response to the greater pressures on managers for good short-term performance.

The highest turnover was in unit and investment trust portfolios (which for most managers seemed to be the funds under the most pressure for performance). However, the turnover varied substantially according to the objectives of the particular trusts—for example, a long-term growth fund, looking for an improvement in the performance of the companies in its portfolio over a long period, would tend to have a low rate of turnover, whereas an income fund would have a higher rate of turnover because shares which moved from a high to a low yield would have to be sold. Turnover of shares in individual trusts seemed to range between 34% and 200% or more.

The very high turnover of the UK equities in unit trust portfolios is made possible by the relatively small size of the individual holdings. It is possible to trade an entire holding at far less cost (in terms of the spread between the bid and offer prices quoted by market makers) than is the case for the larger institutional funds.

The turnover of pension funds managed by outside managers was significantly higher (at between 28% and 48%—see Table C) than the turnover of funds managed by in-house managers (between 10% and 35%). This again probably in part reflects the greater pressure on the outside managers and possibly also the fact that the average size of the individual portfolios under their control was smaller than that of the in-house managers, who had very large single portfolios. One of the merchant banks said that the average turnover of their pension funds was around 50% but on a small (£10 million) fund it might be closer to 100%. It probably also reflects the fact that several of the in-house pension funds index-matched a significant part of their portfolio. Outside managers did not do so because they were being employed to beat the index. In general, pension fund managers do not have the same necessity to switch their existing holdings as some other fund managers because the substantial inflows can be used to reshape the portfolios.

The turnover of general and life insurance funds varied markedly between companies at anywhere between 5% and 30%. A key factor for some of the managers was the tax constraint on a particular fund—transactions which

Table C
Turnover of UK equities

Range of figures provided for latest year

Type of manager	Type of fund	Turnover(b) (per cent)
Independent managers	Pension funds	50(a)
	Investment/unit trusts	34–150
Merchant banks	Pension funds	28–48
Insurance companies	Life funds	10–30
	Unit linked funds/ unit trusts	30–227
In-house pension fund managers		10–35

(a) Only one manager supplied figures for this category.
(b) Turnover calculated as in footnote (b) to Table B.

would have substantial capital gains tax considerations were considered very carefully. The bull market had exacerbated the problem for some funds.

The link between turnover and return

Although there seemed to be a link between the pressures on fund managers and the rate of turnover of their portfolios, it was not clear whether the higher turnover was in general reflected in a higher return. A number of the managers had started to look at this but the results differed. One insurance company had found that the dealing costs negated the benefits of high turnover on unit trusts and had decided to keep turnover low in future. Another insurance company, which had very high turnover for its developing unit trust business and on its other performance funds, had looked to see whether there was a correlation between turnover and return but had found that the results were inconclusive. Another insurance company had found that its high-turnover unitised funds normally outperformed its life and general funds by one or two points—it thought that this reflected their smaller size and therefore the ease of making transactions that were sizable in relation to the total size of the fund. Another insurance company felt that the market was efficient, reducing the benefits from turning over a portfolio actively, and managers were encouraged to use new money to reshape their portfolios.

The results for the independent managers and merchant banks were also mixed. One of the independent firms had looked closely at the success rate of its various managers, in relation to the activity levels of their portfolios, and had found that the more active managers generally performed better by a point or two. It attributed this to the view that the managers of the less active portfolios tended to hold on to shares, yesterday's winners, too long, and did not adapt to changes in fashions sufficiently quickly. One of the merchant banks had found no link between turnover and performance for its funds, and another, which had also not found a significant link, thought that the most important reason for differences in performance was cash flow.

Links with companies

Regular contact with companies

In general, managers seemed to be becoming more interested in developing close contacts with the companies in which they invested, although practice did vary between the various fund managers. A number of the managers saw it as a way of reaching a different view from that of the market on the prospects for a particular company, especially smaller companies which were less heavily researched by the stockbrokers. A number of the fund managers thought, however, that this increased contact was not always welcomed by the companies.

Managers were asked how they viewed a sudden change in direction by a company in which they were a significant shareholder, for example substantial investment in new plant or R&D which might depress reported earnings over the short term. The general view seemed to be that, ideally, they should have been kept sufficiently closely in touch with the plans of the company to ensure that it was not a complete surprise. The effect that it would have on their willingness to maintain the weight of the particular share in their portfolios would depend upon their confidence in the management. If the management had been successful in the past they would have more confidence that their future strategy would be successful as well. However, there was a feeling that investors would be justified in questioning very radical changes in direction by a company. The uncertainties surrounding the outcome of such a change could well lead them to take a rather conservative view of the future earnings stream.

Action taken if a company underperforms

When a company started to underperform relative to the market's expectations, some managers would tend to reduce its weighting in their portfolios, which would tend to depress the share price and reduce the price/earnings ratio. Other managers who were interested in income rather than growth might increase the weight in their portfolios at this point. If it was clear that a company was severely off track and the performance was likely to remain very sluggish, some fund managers—though generally only the very largest, holding 2% or more of the share capital—might consider taking some steps to nudge the company towards a different course. In the case of one large institution the stake might even be increased to give greater leverage. Other managers might speak to the company's brokers, to express their dissatisfaction, and might join a shareholders' group if another institution was leading it. However, many were concerned that the rewards from such action, in terms of the added value given to the portfolio if it succeeded, did not warrant the time spent. Another factor might be the knowledge that the improvement in the performance of a company whose shares were widely held by the fund management community would do little to affect any one manager's relative performance. But there was also a general view that it was extremely difficult to shake up management which was off track.

Exercise of voting rights

Rather disappointingly, the majority of fund managers did not exercise their votes as a matter of course—although most would do so in exceptional circumstances or if asked by the company's broker to make up a quorum. Only one of the independent managers usually exercised its voting rights—and then only if it held 5% or more of the shares. One of the in-house pension fund managers always voted and two of the insurance companies always did so—a third would if it had a significant holding. None of the merchant banks voted as a matter of course on all issues. The managers who did not do so said that it would be too time-consuming unless they had an automatic procedure, particularly as many of them used nominees. They also said that if they were content with the incumbent management they would always cast their votes in their favour.

Takeovers

General attitude towards takeovers

The way in which the decision on takeovers was taken varied significantly between the fund managers; but most seemed to put a considerable amount of effort into reaching a house view, with senior management usually involved in the decision, and in several cases the decision was put to the manager's board.

There seemed to be a distinct bias on the part of a number of fund managers in favour of the incumbent management of a target company. However, although a few of these managers almost never supported bids, others would do so if the price offered was extremely attractive. Other managers simply reached a view of the benefits of a bid to their clients and supported or rejected the bid accordingly. One organisation provided some statistics on the number of contested takeovers which succeed. Over the period end-1983 to end-1985 there were 106 bids for UK companies in its portfolio, of which 29 were contested, and of these only 7 were successful. In 1986 there were 125 bids of which 29 were contested and of these only 10 succeeded. A success rate of 29% for these 58 contested bids does not indicate strong support, in general, for bids opposed by a target company's management.

Most managers would agree to underwrite the offeror's shares even if they did not support the bid. They saw it as two quite separate decisions and were prepared to underwrite the shares if the price was not excessive. A few saw a conflict between the two decisions but felt that, although it might be possible in theory to affect the outcome of a bid by refusing to underwrite the offeror's paper, in practice other institutions would step in to fill the gap and the net result would simply be that they lost the fees.

Fund managers' attitudes towards dealing during a takeover also varied. A few had a house rule that no dealings should take place and others were reluctant to deal. However, some seemed to deal quite actively —selling at least part of their holdings. If the offeror's or offeree's share price had been inflated to levels which seemed unsustainable they might sell both sides just before the acceptance date and then might buy back later when prices had reverted to more reasonable levels.

The section below sets out the responses to these questions by type of fund manager.

Pension funds

In the case of one pension fund there was a formal system in which analysts would assess the benefits of a particular takeover and submit this to the chief executive who would, if necessary, consult the trustees in controversial cases. The decision was taken according to whether the takeover appeared to be in the long-term interests of the companies concerned but the fund manager did have a strong bias in favour of supporting the incumbent management. Another pension fund went through a similar analytical process but would not necessarily inform their trustees. They would try to support good management even at the expense of forgoing a short-term gain. They had found that a bid could sometimes spur management into action, and therefore the company's results would improve. They could recall only two cases in the last three years in which they had not backed the incumbent management.

Another fund again went through a similar analytical process and would visit or would be visited by both sides in the takeover. The takeover would be considered very carefully and, although the trustees would not be consulted, the fund managers had to be able to demonstrate that they had taken the right course of action. They would accept a bid if they felt that it would improve the potential for the company. They might also sell in the market if the price was very attractive. In some cases they might sell and buy back after the failure of a takeover if they thought it worthwhile. The fourth fund reached a conclusion on the basis of the documents and their own analysis. The trustees would not be consulted unless the outcome might lead them to breach their guidelines on particular holdings. They were inclined to sit bids out until the final stages but were prepared to trade in the market if the paper offered was unattractive or if they thought that post-bid prospects were poor.

Insurance companies

In the case of one of the insurance companies, the analysts would review the prospects for the companies involved in a contested takeover and brief the investment management committee, which would come to a conclusion and make a recommendation to the board—the board would rarely disagree with the recommendations. The committee would usually defend a company whose management was refusing to recommend a bid. They would only support a contested bid on the rare occasions where the price offered was so high it was totally out of line with their assessment of the worth of the company. As a house rule they would not deal in the market in any of the companies involved in a contested takeover—on the basis of experience (analysis over many years) they felt this was to their advantage. During 1986 there was only one case in which they acted against the recommendations of the offeree's board.

In another, the analysts would consider the proposal and report to senior management. If the takeover were particularly controversial it might be referred to the general managers of the company but this would be rare. In principle they were not keen on takeover bids although they accepted that they could be a solution to poor management. They were particularly sceptical about bids from conglomerates. Bids were evaluated in terms of their investment philosophy, which was to look for rising income more than capital appreciation. They could think of only one recent instance when they had supported a contested bid and that was because they regarded the offeree as badly managed. Occasionally their performance funds took a different line and sold in the market.

The fund managers of another company would form a view after discussion with the managements of the companies concerned. They would tend automatically to support the incumbent management if they thought that they had a good record, unless they thought that the price offered was more than fair. In the latter case they would discuss this with the management of the offeree company but would usually finally support them unless the terms offered were extraordinarily attractive. However, their unitised funds were sometimes treated differently—in the case of these, they would sometimes sell both sides in the market if it was felt to be worthwhile. The managers of the conventional funds would not usually trade during a bid.

The other two companies tended to review each takeover on its merits, after a careful assessment by their analysts. In one case, the performance fund might trade during the bid and in the other, although they might trade, they regarded themselves as not easy sellers.

Independent managers

One of the managers would usually hold discussions with the management on both sides of a takeover and would try to reach an in-house view (although the decision would not be imposed on all managers). Usually they did not support a bid until 50% of the shares were in the hands of the offeror. They would refuse a bid even if they thought that the price of the offeree company would fall if the bid failed, as long as they thought that it would recover in the long term. They said that this would have little effect on their short-term performance because of the widespread nature of their portfolios. They felt strongly that those who sell the shares of the offeree company in the market were letting the company down. Another manager had a rigorous procedure for assessing the benefits of a bid for any company in which they had a holding of 5% or more. The manager responsible for the holding would ensure liaison within the organisation, and presentations from both sides would be arranged and attended by all the investment managers. The board, which included four non-executive directors, would be fully involved in the process. They generally supported the incumbent management if they had confidence in them. Even where they thought a takeover would provide necessary change, they were unlikely to assent their shares to a bidder if they had not already made their opinion of management known to the company. For minor shareholdings their approach was sometimes less rigorous. They were unlikely to sell shares during a bid.

The other two organisations showed less of a bias towards the incumbent management. In one, the managers discussed the takeover centrally and both sides were seen. They reached a view but did not impose it on all of their funds. They had sometimes forgone a short-term gain because of long-term expectations about a higher price. They sometimes sold in the market (perhaps both sides) but with their large holdings (5% or more) it was less easy to sell and then rebuild the holding a few months later after prices had returned to more normal levels. In the fourth organisation, a house view was developed by the head of the team handling the particular market, the main criterion being prospects for long-term dividend growth. Individual funds might, however, vote different ways according to their circumstances. The shares might be sold in the market if post-takeover prospects made it seem the appropriate course.

Merchant banks

The merchant banks appeared to show less bias towards the incumbent management than was the case for some of the other fund managers, although the procedures for reaching a view differed between the various houses.

In the case of one of the houses, the standard procedure was for their analysts to examine and comment on the proposal. They would then arrange for all interested parties, directors, portfolio managers, analysts and dealers to discuss the bid with both parties and come to a corporate view. If the corporate finance side of the house was involved, each client would be contacted before they acted. In other cases a concerted view would be imposed on all funds. They would consider selling in the market, and felt that with pressure to produce good short-term performance they had to be careful about continuing to hold, for example, an offeree's shares, if they thought that a bid was likely to fail and that the price would then fall sharply.

Another organisation would receive visits from the management on each side of the bid and senior managers would formulate one view for all the funds under their control. In most cases they would hold on to the shares until the last moment and then would take a decision based on their view of their clients' best interests. They would sell (either side) in the market if the offer price was too high. A similar analytical process was used by another house, but the house view, although imposed on the large holdings, was not necessarily universal—they might assent some shares and abstain for others. If a takeover was not thought to be in the best interests of the companies involved they would not support the bid. The process in another house also depended on the size of holding. Where they had a major holding, a fund manager's position was fairly circumscribed. A team would be set up to discuss the management and meet representatives of both companies involved, and the decision would be considered by the main board. Once established, the decision would be applied to all funds, although in sensitive situations clients might be consulted. For smaller holdings a similar process would apply except that the board was unlikely to be consulted. Nonetheless they were prepared to trade their holdings during a bid irrespective of its merits. If prices were inflated they might sell just before the close and then buy back when the price had reverted to more reasonable levels.

The main findings from the survey

Pressures on fund managers

There was a general view that pressures on fund managers to achieve good performance have increased markedly in recent years. The activities under the greatest pressure are the management of unit trusts and investment trusts and the outside management of pension funds.

Objectives

Some pension fund trustees seem to set unrealistic objectives for their external managers—for example the achievement of consistent top quartile performance. Although pension fund trustees have relatively clear objectives in terms of the return on a portfolio, in the main they do not seem to discuss or lay down guidelines for the risk profile, particularly in the case of portfolios in the hands of outside managers.

Turnover

The pressure on fund managers has led to the more intensive management of portfolios. This, facilitated by lower transaction costs, has tended to lead to increased turnover of UK equities. But, even so, the turnover of UK equities held by long-term insurance funds and pension funds is not high—on average each share changes hands once every five years. The survey indicated that the managers of these funds were not in general moving into and out of complete holdings in particular companies—for companies of any size they just alter the weight of the shares in their portfolio and a number of the managers set out to achieve a change in the weight through the distribution of the cash flow. Some in-house pension fund managers and insurance companies also index-match a large part of their portfolios. The high turnover is in the smaller unit trust and investment trust portfolios, where equities change hands on average once every two years and at the extreme once a year.

Investment horizons

More intensive management of equity portfolios with increased turnover does not seem to mean that managers are necessarily taking a more short-term view of the prospects for companies—paying more attention to earnings in the near rather than the longer term. For a number of the managers in the survey the reverse seemed to be true. They were trying to beat the index by looking for shares (in the less heavily trawled end of the market) which were undervalued relative to the fundamental strength of the company and which were likely to gain in price, relative to the market, in the next two to three years. One manager was explicitly discounting expected earnings over the next seven years to check whether the market was overvaluing or undervaluing the shares. Others were concentrating on developing close links with companies in the beta and gamma ranges to enable them to assess more clearly the strengths of the companies, particularly the management. To the extent that fund managers are finding undervalued shares, by looking for strengths not previously recognised, this should help to make share prices reflect those fundamentals more rather than less. However, this was not true of all fund managers. Some seemed to place more reliance on market fashions and short-term fluctuations in the price. In the main, managers seemed to be looking for superior relative performance of between 15% and 30% before they would consider changing their existing holdings, but some managers did give the impression that they would take advantage of more marginal opportunities.

Research and development

The general view of fund managers included in the survey was that their reaction to investment and research and development expenditure which would depress reported earnings in the short term, though boost it in the long term, would depend on the confidence which they had in the management of a company. A company which had a good track record in respect of the success of previous investment projects would be expected to do well in the future. Managers did, however, stress the need to be kept as closely in touch with a company's plans as possible (subject to commercial constraints), to enable them to make a realistic assessment of future prospects. They would naturally take a conservative view of future earnings streams about which they were uncertain.

Contact with companies

The general impression that a number of the fund managers gave was that they were placing more rather than less importance on developing close contact with companies. However, there was a general view that some company managements did not welcome closer contact. One disappointing result was that the majority of managers do not exercise their voting rights on a regular basis.

Takeovers

A number of the fund managers said that they had a strong predisposition to support the incumbent management of the target company, particularly if they had a substantial holding. In general, the fund managers seemed to look in detail at the effects of proposed takeovers on the companies concerned before reaching a decision.