



YANNI
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DELIVERING
THE PROMISE

IN THIS
ISSUE

A review of
Corporate
Governance
principles.

MEASURING UP

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Corporate Governance *Empowering Investors*

A company's board and its executives bear a fiduciary obligation to manage a corporation's assets in the best interests of shareholders. Corporate Governance refers to a set of management practices to guide directors and executives toward good stewardship of corporate assets.

Yanni Partners' clients direct the management of various investment pools: pension funds, endowments, foundations, funded depreciation assets of healthcare entities, etc. Yanni Partners is devoting this issue of Measuring Up to Corporate Governance because an awareness of Corporate Governance principles will help individuals with such investment oversight responsibility to serve the interests of their constituents more effectively.

Individuals with investment oversight responsibility include members of the board, senior management, and administrative staff of entities that manage investment pools. One of the key duties of these individuals is the selection of investment managers. A prerequisite of a portfolio company's potential success is good Corporate Governance. Individuals with investment oversight responsibilities will therefore benefit from possessing a sound understanding of Corporate Governance.

Background

The economic vitality of a democratic society depends on efficient capital markets. Companies that develop innovative products and services must be able to access capital quickly and economically in order to succeed. The advent of the modern corporation in the 19th century separated two key functions: ownership and management. Prior to the modern corporation, individual proprietors managed their own enterprises. The size and complexity of the modern corporation required the development of a professional management class – individuals who possess specialized education and experience to execute the key functions of general management, production, finance, marketing, research/development, information technology and legal administration.

The separation of ownership and management poses a challenge. How do the owners ensure that the managers protect the owners' interests?



This challenge has spawned a set of principles (laws and management practices) known as Corporate Governance.

Corporate Governance has evolved during the past 100 years. Many investors believe that the body of securities legislation that began in the 1930's has eliminated many of the financial abuses that were prevalent in the 1920's. Examples of such abuses were issuances of worthless shares and manipulation of stock prices.

Most investors recognize that Corporate Governance practices must continue to adapt to changing circumstances in order to remain effective. Yanni Partners believes that two recent events have strengthened the prospects for good Corporate Governance:

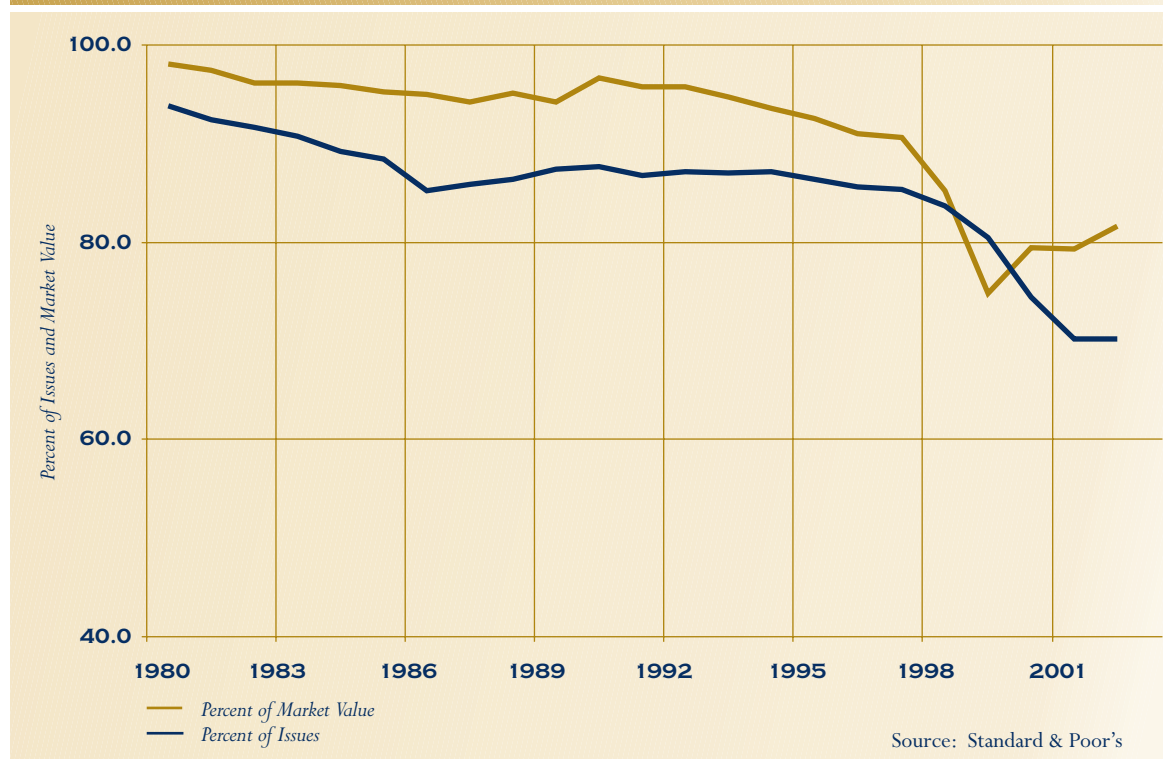
(a) The 2003 federal tax legislation that reduced the maximum personal tax rate on corporate dividends from approximately 40% to 15%, and

(b) The public's awareness of the need for continued vigilance on the issue of Corporate Governance in reaction to several high profile cases of corporate malfeasance that came to light during recent years.

We believe that these two events are related. Corporate malfeasance that culminated in the late 1990's stemmed in part from many investors' preference for capital gains over dividends. The previous tax laws favored capital gains over dividends due to the lower rate for capital gains (20% for capital gains compared to nearly 40% for dividends). Investors' preference for capital gains induced some corporate managements to engage in aggressive accounting practices in the hope of stimulating immediate share price increases. Some corporate managements lost sight of the importance of generating free cash flow to pay investors consistent and growing streams of cash dividends.

FIGURE ONE

S&P 500 Dividend Payers: 1980 to 2002



Managements' diminished interest in paying dividends prompted poor uses of cash such as unnecessary capital expansions, ill-conceived acquisitions, and share repurchases at high prices.

Figure One illustrates the reduction in corporate dividend paying practices since 1980. *Figure One* shows two measures:

- (a) The percentage of companies in the S&P 500 that pay dividends, and
- (b) The market value of dividend-paying companies as a percent of the total value of the S&P 500.

In brief, the number of dividend payers and the relative market value of dividend payers have declined steadily from 1980, except for a recent uptick in the relative market value of dividend payers. Many analysts believe that both ratios will increase given investors' recent preference for dividends and the improved tax incentives.

Benefits to Investors

The renewed emphasis on dividends will prompt corporate managements to use cash more judiciously, thereby improving the prospects for better returns on investment. Investors' reactions to recent corporate malfeasance have prompted managements to strengthen financial reporting practices. Cleaner accounting practices will likely diminish the risk of future stock implosions stemming from excessive overvaluation.

Sound Management Practices

Yanni Partners believes that good Corporate Governance encompasses the following management practices:

- (a) *Independent and well qualified board of directors.* The board should consist primarily of outside directors who feel no sense of obligation to the corporate management. Moreover, the directors should have sufficient time and knowledge to evaluate the strategy and operations of the company.
- (b) *Sensitivity to good Corporate Governance.* Corporate Governance is likely to be effective when corporate boards and management understand the importance of this issue. One manifestation of good Corporate Governance is a compensation structure that aligns managements' interests with shareholders' interests. For example, when senior managers own significant amounts of company stock (not necessarily stock options), the managers' financial interests are likely to track those of shareholders closely. Limited executive "perks" is another sign of good Corporate Governance.
- (c) *Customer focus.* Management must focus on developing products and services that meet customers' key needs. A company's potential success depends on customers' demands for products and services to fuel growth in revenues and ultimately profitability.
- (d) *Strategic focus.* Management must have a thorough grasp of the company's strengths and limitations. Management must focus on the company's core competencies to ensure economical use of its resources. Effective management will prompt the company to develop a robust "business model" to ensure sustainable competitive advantages.
- (e) *Vision.* It is important to foresee shifts in customer preferences and advances in technology in order to continue to adapt to the future.
- (f) *Clean accounting.* Accurate financial reporting, consistent with rigorous industry standards, will help to ensure that the stock price conveys all relevant information about the company. An "accurate" stock price will help to lower the company's cost of capital because investors will not demand a risk premium due to uncertainties pertaining to the release of new information.
- (g) *Fair treatment of employees and communities.* Companies that treat employees and their communities with respect are likely to elicit loyalty and productive support from them.

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Conclusion

Good Corporate Governance practices will enhance a company's economic prospects and ultimately its stock performance. Individuals responsible for overseeing investment pools such as pension funds, endowments, and foundations can exercise their fiduciary responsibilities more effectively when they understand good Corporate Governance principles.



Karen Watson

Karen D. Watson, MBA, CFA, has joined Yanni Partners as a Consultant. Watson is expected to assume a full client load. She will provide professional investment consulting services to a number of corporate,

healthcare, municipal, Taft-Hartley, and charitable clients and will develop investment policies, provide asset allocation modeling and risk/return analysis, and portfolio monitoring for Yanni Partners' clients.

Watson comes to Yanni Partners from The Boeing Company in Chicago, IL, where she was the Equities Manager. While at Boeing, Watson managed a \$20 billion equity portfolio in the Defined Benefit Plan. Prior to Boeing, she was an Investment Manager at Baxter International, Inc.

Watson received her Chartered Financial Analyst designation in 2000, a B.S. in Finance from Penn State University and an MBA in Corporate Finance from the University of Dallas. She is a member of the Association for Investment Management and Research (AIMR) and the Pittsburgh Society of Financial Analysts.



Brian Holland

Brian T. Holland has joined Yanni Partners as a Consulting Analyst. Holland will support senior consultants in all aspects of the analytics involved in performance monitoring. He will assist in

developing analytical models to quantitatively classify manager styles and he will also participate in the Firm's Large Cap U.S. Equity Evaluation Team.

Holland is a graduate of Carnegie Mellon University where he obtained a B.S. in Economics and Policy & Management. He was on the Dean's List at Carnegie Mellon, along with being a National Merit Scholar, a member of the National Society of Collegiate Scholars, and a Baxter & Allegiance Scholarship Winner.

Calendar of Events

AUG. 25

**Yanni Partners
Client
Appreciation
Golf Outing
Philadelphia, PA**

SEPT. 8

**Yanni Partners
Labor Union
Golf Outing
Pittsburgh, PA**

*Attendance by
invitation only.*

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

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