JUNE 2002

# Commentary

BUFFIN PARTNERS INC. INVESTMENT AND ACTUARIAL RESEARCH

## Some Steps in the Right Direction

Although widespread pessimism currently pervades Wall Street as a result of disclosures that have shaken the public's faith in the integrity of Corporate America, we see encouraging signs of some steps in the right direction to re-establish confidence in the securities markets.

Standard & Poor's has announced that it will confront the problem of interpreting misleading and overstated reported earnings by making adjustments to recognize the effects of stock options and pension income to arrive at a measure of "core earnings." While we are encouraged by this development, we were unable to suppress our "what took you so long" reaction to the S&P announcement.

Another encouraging sign emerged from the annual springtime ritual of shareholder meetings when corporate management and directors received "we're not going to take it any more" messages from shareholders on proxy issues. Shareholders at Mentor Graphics voted in favor of a resolution requiring that all stock option plans be submitted to shareholders for approval and shareholders at EMC Corporation voted in favor of a resolution requiring a majority of independent directors on the Board.

We applaud the sentiments expressed in a recent *Barron's* article by Philip Angelides, California State Treasurer, and Amy Domini, author of *Socially Responsible Investing*. The article emphasized the importance of proxy voting as a means of affirming management's activities and providing input on important social issues. In the institutional sphere, only trustees of private pension plans are legally required to vote proxies, maintain records and monitor compliance as part of their fiduciary responsibilities, whereas mutual funds and public pension funds are not required to do so. Most mutual fund shareholders and pension plan participants, if able to vote directly, would probably not vote for non-diverse, self-perpetuating boards, excessive executive compensation or substandard environmental, labor or human rights practices, although this is often precisely what happens by default when mutual fund managers and pension plan trustees simply vote all shares in accordance with the recommendations of corporate management. Mutual fund shareholders and pension plan participants have a right to know how their fund managers and trustees are voting their proxies. We support the view that proxy voting is an important right and should be exercised in a manner consistent with shareholders' interests. Mutual fund managers and pension fund trustees should be required to disclose their proxy voting records and make the information available with respect to each company stock held in the investment portfolio. This would represent a significant step in the right direction to reflect shareholders' interests, improve corporate governance, enhance corporate responsibility and restore confidence in corporate ethics.

After New York Attorney General Elliot Spitzer brought attention to the manner in which analysts at major investment firms may be influenced by potential conflicts of interest in assigning ratings and recommendations on stocks, there have been some encouraging moves to present a more rational assessment of the investment merits of stocks in terms of buy, hold or sell ratings. Spitzer's findings disclosed that there was bias in favor of buy recommendations and very few sell recommendations emanating from ostensibly objective investment analyst research. But kudos and our "encouraging signs but what took you so long" award to Charles Schwab Corporation who have suddenly discovered the "bell-curve" and are now taking the initiative in rating a universe of 3500 stocks and classifying them with 30% as A-rated, 40% as B-rated and 30% as C-rated. Schwab is to be commended for leading the way with this initiative and setting the stage for other investment firms to present the results of their analysts' research in a more professional and objective manner.

We also see some encouraging signs that healthy debates over serious issues are taking place within the actuarial community. Actuaries are actively addressing the implications of financial economics, the concept of risk premiums for various asset classes and risk-adjusted returns as well as exploring how to assist investment analysts in arriving at rational stock valuations with appropriate allowance for the perplexing elements that constitute pension expense or income. In another area, actuaries are debating whether stochastic projection methods, if applied to Social Security, might be useful in adding to the understanding of the nature of the uncertainties involved in making 75-year projections of the demographic and economic factors that result in the computation of the actuarial balance (deficit or surplus) in the Social Security Trustees' Reports.

Finally, we note the recent paper by Peter Bernstein and Robert Arnott in the *Financial Analysts Journal* relating to prospective real returns and risk premiums for equities relative to bonds. They acknowledge the expedient practice of forecasting the future by extrapolating from the past, but conclude that expectations embedded in the collective psyche of the investment community for prospective real returns and risk premiums are both unrealistic and considerably overstated.

Buffin Partners Inc.
P.O. Box 1255
Sparta, NJ 07871
Phone: (973) 579-6371
Fax: (973) 579-7067
Email: k.g.buffin@worldnet.att.net