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## Letter to Clients



By William W. Priest, CEO/CIO

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### Sunlight and Transparency

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“Sunlight is said to be the best of disinfectants” stated Louis Brandeis, a U.S. Supreme Court Justice of great renown. It has been quoted often when financial scandals are studied, including a 1914 book entitled Other People’s Money, and How the Bankers Use It. Today, as we look back on the events that unfolded over the past twelve months, we see a proliferation of scandals and meltdowns that seems entirely unprecedented in American financial history. If sunlight is indeed the best disinfectant, one thing is certain about 2008: it is the year the sun never stopped shining.

Perhaps the most notable of the past year’s many game-changing events was the collapse of the investment banking model in its entirety. Today, as we enter 2009, not a single investment bank exists, except as part of a federally insured bank. Similarly, the hedge fund community has displayed record-breaking lows in terms of both results and behavior, and is in the throes of serious account liquidations. The private equity world has also emerged from 2008 in far from pristine condition: many of these organizations won’t make it through 2009 without witnessing the failure of many of their over-leveraged investments. In short, the entire shadow banking system has been torn asunder: deleveraging has crippled a system built on the perilous foundation of securitization and bad debt; the financial models and assumptions that seemed to generate such enviable returns have been exposed as the products of greed rather than good design; and the asymmetric compensation arrangements associated with these products are now known to benefit the purveyors at the expense of their clients. To the extent clients relied upon regulators, accounting firms, or corporate Directors of these institutions for constructive oversight, such confidence proved misplaced.

Ultimately, one example can be said to best illustrate the failure of all parties to conduct appropriate due diligence: the Bernie Madoff scam. This scam proved to be the largest Ponzi scheme in world history, weighing in at over \$50 billion of mishandled assets and persisting for decades. In our view, the single largest contributing element to this and other scandals in 2008 and those of the prior years is the lack of transparency.

When my three founding partners and I formed Epoch Investment Partners, Inc. almost five years ago, we reviewed our collective 100-plus years of experience in this industry and asked ourselves, “What will be the most significant changes our industry will face for the next ten to twenty years?” We came up with two paradigm shifts that we believed would dominate our industry. First, we saw a change in the order of the drivers of total return<sup>1</sup> in the equity market from the period 1980 through 2000. In our view, this change would eventually lead investors away from accounting metrics and toward financial metrics (i.e. cash flow measures). This insight reflected the increasing unreliability of accounting terms and the simple fact that few people in the business of allocating real capital actually used accounting metrics to drive their investment decisions in most cases.

The second observation underlying Epoch’s founding principles was that clients and potential clients would desire and ultimately demand transparency of an investment manager’s business practices. They would want to know not only about the manager’s investment philosophy and process, but about the manager him or herself. “Who are these people? What is their character? What are their credentials? What motivates them? Are our interests and their interests aligned?” To paraphrase Ronald Reagan, trust would be required but verification would be demanded. In other words, the more sunlight shone on a firm’s business practices and measures, the better.

As a result, we decided to become a public company from the very start of the Firm’s existence. The dollar costs in doing so were high, but so were the benefits to both our organization and our clients. Not only did we aspire to deliver the highest ethical standards, they were required of us as a result of our public status. In our view – and based on our century of combined experience – a successful investment firm is managed not from the office of the CEO or CFO, but from the office of Compliance. It begins with a demand from the firm by its leadership to the individual employee that his or her conduct must be unimpeachable: a demand that must be backed up by an ethical code of conduct signed by every employee. The penalty for non-adherence is job termination.<sup>2</sup>

Because of the transparency requirements inherent in being public, many of the details of a company’s structure, practices and operations become common knowledge, including the ages of the principals, the compensation they receive, and their equity holdings. At Epoch, for example, approximately 50% of the stock is owned by employees, officers, and corporate Directors. As a result, we are effectively an owner-operated firm held to the standards of a public company.

In the spirit of full transparency, Epoch also provides a detailed balance sheet. We are debt free, pay a modest annual dividend to all shareholders (\$0.12 per share) and have

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<sup>1</sup> Only three drivers determine equity investment returns: dividends, earnings, and changes in P/E ratios. For the 20 year period 1980-2000, P/E expansion comprised almost 8% of these returns, earnings growth 6%, and dividends nearly 4% for a total CAGR of 17.6% for this extraordinary period in investment history.

<sup>2</sup> In my forty-three years in this industry, no firm in which I have served as part of its governance structure has ever been fined, sued by a client, or sanctioned by a regulatory body.

more cash on our balance sheet than annual revenues. The latter is extremely important, as our cash position is what allows us to grow our firm and serve our client needs through periods of great stress, including years such as 2008.

In addition to transparency, we believe experience is the key to building a firm of substance. Our eighteen investment professionals have a median of 20 years of industry experience, which leaves each one with an average age of about 45. Why are these numbers so meaningful? Because judgment comes from experience, and experience provides context. Without the latter, the likelihood of poor decision making rises. In our view, an experienced staff goes hand-in-hand with our commitment to transparency, integrity, and the pursuit of excellence.

As further disclosure, we also provide a representative list of our largest clients and/or largest client relationships. Some of our relationships date back more than 30 years, with composites that, in some cases, span nearly 14 years in duration. How is this possible? Continuity of key team members over long time periods, independent verification of investment performance by an independent, accredited reviewer, and the physical possession of the books and records on our premises allows us to include these clients and composites as part of our firm's historical context. To each of our clients or client prospects, references of long-time relationships are provided upon request. Furthermore, the Company is subject to review by regulatory and oversight bodies, must be fully compliant with Sarbanes-Oxley demands, and its corporate accounting and financial records are audited by an independent certified public accounting firm.

Transparency alone, however, does not guarantee competence or a successful client experience with an investment manager. But it is, in our view, a necessary condition for both of the above, as it seeks to align the interests of the investment manager with the interests of the client. Disclosures of personal histories, governance structures, compliance processes, financial statement measures, compensation policies, ages and experience of investment team members, and a willingness to be scrutinized by the appropriate regulatory and oversight bodies are good for business and provide evidence of best practices. It is the disinfectant to which Brandeis refers; it is the sunlight required to ensure and facilitate that the interests of manager and client are properly disclosed and are as closely aligned as possible.

Epoch may fall short from time to time in the execution of its investment strategy. Such is the peril of doing business in an unpredictable world. But we will never fail in our pursuit of the continued transparency of our business practices. It was one of our founding principles, and it will always remain so.