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**INVESTMENT MANAGERS AND TAKEOVERS:
INFORMATION AND ATTITUDES**

E. Victor Morgan and Ann D. Morgan

Hume Occasional Paper No.25

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INQUIRY INTO CORPORATE TAKEOVERS IN
THE UNITED KINGDOM

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The David Hume Institute has been commissioned by The Joseph Rowntree Memorial Trust to conduct an Inquiry into the issues raised by Corporate Takeovers in the U.K. This paper is the eleventh of a series presenting the results of research undertaken in the course of the Inquiry, and also submissions of opinion received from individuals and organisations which are thought to be of wide general interest. The Institute hopes in this way to keep the public informed of work in progress. The Final Report will appear in the late Spring of 1991.

A note on the Institute and a list of its publications appear on pp. 40-42.

The Institute has no collective views on any public policy question and is not committed to the views of any of its authors.

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PREFACE

This short paper arose out of a questionnaire survey that was undertaken as part of our research for The Stock Market and Mergers in the United Kingdom (Hume Occasional Paper, No 24). The main part (Chapter 2) analyses the survey results in rather more detail than in our earlier publication. However, there have been many changes in the organisation of institutional asset management over the past two decades, and especially since the drastic amendments to Stock Exchange rules in 1986, generally known as 'the Big Bang'. By way of introduction, therefore, Chapter 1 describes the most important of these changes, again in rather greater detail than space permitted earlier.

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October 1990*

CHAPTER 1

Institutional Funds and how they are managed

1.1 Types of Fund

The traditional classification of institutional investments is in four categories:-

- Insurance funds,
- Pension funds,
- Investment trusts, and
- Unit trusts.

TABLE 1.1: ASSETS OF UK FINANCIAL INSTITUTIONS
Market values at end-year £ million

	Unit trusts	Inv. trusts	Insurance Companies		Pension funds
			General	L-t funds	
Total assets					
1979	4,090a	5,752a	9,585	42,677	42,403
1984	15,312a	14,007a	24,766	113,561	134,402
1988	41,397a	19,298a	39,572	198,341	214,518
UK equities					
1979	2,977	4,012	1,724b	14,602	18,304
1984	7,925	6,074	4,361b	35,534	63,435
1988	24,040	8,817	7,014b	66,642	115,455

a - excluding short-term assets

b - including unit trust units

Source: Financial Statistics

Figures relating to these four types of fund have been published for many years by the Central Statistical Office in Financial Statistics, and Table 1.1 shows their total assets at the end of 1979, 1984 and 1988. This classification is based primarily on the characteristics of the funds and the purposes they are designed to serve. In the past, different types of fund tended to be managed by different institutions so there was a broad

relationship between type of fund and type of management. However, this relationship was never very strict and it has been changing dramatically in recent years, as will appear below.

1.2 Insurance Funds

In ordinary insurance (fire, theft, motor, etc.), the contract runs for only a short time (usually a year) and, if all goes well, the premiums of any year will cover the claims arising from that year's business, together with a margin for expenses and profit. Reserve funds are, of course, needed both for technical purposes (unexpired risks and unpaid claims) and to meet contingencies; but these are small in relation to those of long-term business. In long-term business, premiums are normally paid over a number of years and accumulated, with interest and capital gains, to provide a lump sum that is paid out on the maturity of the policy. As can be seen from Table 1.1, it is these sums that form much the greater part of the funds held by insurance companies.

The terms 'life insurance' and 'life assurance' are synonymous. The latter is obviously less accurate but is preferred by at least some sections of the industry. Originally, policies were what is known as 'whole life', i.e. they matured only on the death of the insured, when they provided money for funeral expenses and some support for dependents. During the nineteenth century, the lower end of the market derived stimulus from the fear of the "pauper's grave" that awaited those who died with no money to pay for their burial.

The industry has moved a very long way from these origins. Whole life policies have largely given way to 'endowment' policies maturing at an age well below the actuarial expectation of life of the insured. Such policies are a savings medium as well as a way of insuring (in the proper sense of the word) against early death. Companies now issue many different types of policy, in which the elements of saving and insurance are combined in varying degrees. Policies with a large savings

element are like pension schemes in that they provide income after retirement, and the resemblance is enhanced where policies are combined with guaranteed annuity rates that are available to holders of maturing policies.

Other important developments have been:

- The growing popularity of 'with profits' policies, under which the sum assured is increased periodically by 'bonuses' the size of which depends on the profits of the insurer. The size of such bonuses is now a very important competitive weapon among companies.
- The linking of endowment policies and mortgage finance. Instead of repaying his debt by instalments, as with a typical building society mortgage, a borrower can take out a policy maturing at the end of the mortgage period and use the proceeds to repay the lump sum; and
- The linking of the value of sums assured to the performance of a particular fund, usually a unit trust. If such a fund is invested in securities covering a broad range of industry, policy holders can expect some degree of protection against inflation and some participation in the benefits of economic growth.

These developments have several implications that are important in the present context. First, insurers no longer offer one basic type of contract providing a fixed sum of money per pound of premium on the death of the insured. Instead they offer a variety of contracts providing against different contingencies, and combining insurance and saving in different proportions. Different contractual obligations require different investment strategies, so that investment managers and their staffs need a much greater variety of skills and experience than was required in the past.

Secondly, insurance companies have come under increasing competition both from one another and from other institutions, including banks and building societies, that provide outlets for savings. As already mentioned, two important competitive

variables are bonuses or 'with profits' policies and the provision of contracts, such as unit-linked policies, that offer protection against inflation and participation in growth. Both these tendencies have increased pressures on investment managers to secure high growth rates both in capital values and income. One way of doing this is long-term investment in successful companies, but another is by taking advantage of short-term price fluctuations, including those generated by mergers and rumours of mergers.

Finally, insurance companies that have developed investment skills in the management of their own funds have offered to sell these services to others and some of them are now among the largest of fund managers (see section 1.6 below).

There are about 280 companies authorised to write life assurance in the U.K. A number of friendly societies and some building societies also operate on a small scale; however, the ten largest companies control over 40 per cent of total assets. Table 1.2 shows these companies, together with their total ordinary life funds, at the end of 1988.

TABLE 1.2: TOP TEN LIFE ASSURANCE COMPANIES.
end-1988

Company	Life Funds (£ million)
Prudential	16,410
Legal & General	12,471
Standard Life	11,463
Norwich Union	10,173
Scottish Widows	6,984
Commercial Union	6,493
Friends Provident	5,352
Guardian Royal Exchange	5,326
Sun Alliance	5,093
Scottish Amicable	5,085

Source: Carter, R.L. and Diacon, S.R., The British Insurance Industry: A Statistical Review, 1990-1 Edition, Kluwer Publishing, 1990

1.3 Pension Funds

Some employers started pension schemes for their employees in the early years of the present century, and in the 1930s about 2½ million workers were covered. This number rose very rapidly in the two decades after the end of the Second World War, and reached a peak of 12.2 million in 1967. Since then, numbers have fluctuated narrowly but the value of funds has continued to rise rapidly.

Pension schemes that conform to Inland Revenue rules enjoy substantial fiscal privileges. Employees' contributions are free of personal income tax and employers' contributions can be offset against profits; the funds, themselves, are free of tax both on investment income and on capital gains; and, where a scheme provides for the payment of a lump sum on retirement, this, too, is tax free. The effect of these privileges on the growth of schemes has been partly offset by improvements to the State scheme and, recently, by the introduction of Personal Pension Plans as an alternative to membership of an employer's scheme.

The pensions paid by occupational schemes are generally related to length of service and to earnings at or shortly before retirement. Some public sector schemes provide pensions the value of which rises in line with the Retail Price Index. Most private sector schemes do not have any formal index-linking, but make 'ex gratia' payments to give pensioners as much protection as they can against inflation. The obligation of pensions schemes, and the value of the funds needed to meet them, thus grow with the growth of money incomes, whether that growth is a result of rising real incomes or of inflation.

This is one reason for the five-fold growth of pension fund assets shown in Table 1.1. Another is the relationship between numbers of pensioners and of working members. In the early days of a new scheme, the great majority of members will still be working, and very few drawing pensions, so that the fund will have a large inflow of contributions and only small

outgoings. As time passes, however, the number of pensioners will rise, relative to that of contributors, until the fund eventually reaches maturity when (if the assumptions made by its actuaries are fulfilled) income and outgoings will balance. This influence operated strongly in the 'sixties and 'seventies but is now diminishing and will continue to diminish in the future, as more and more funds reach maturity.

The characteristics of pension funds outlined above affect their investment strategy. Their obligations are long-term to an even greater extent than those of life insurance companies, and they are under even stronger pressure than insurance companies to achieve high performance from their investments. At the same time, their immunity from taxation means that they can choose freely between present income and future growth prospects, and also that they need have no inhibitions about realising capital gains when these are attainable.

There are three different ways in which the investments of pension schemes may be handled. Those of very small firms are usually insured; the firms, and sometimes also their employees, simply pay the premiums on an endowment policy maturing at retirement age and with a guaranteed annuity, and the chosen insurance company does the rest. No separate statistics are available for these, and the value of their assets is included with other types of life assurance in Table 1.1. At the other end of the scale are schemes that are fully self-administered. They have their own staff who organise the collection of contributions, the payment of pensions and the investment of the funds' assets. Most of the largest occupational schemes are fully self-administered but there are some in which the scheme administers the collection of contributions and the making of payments, but the investment of funds is contracted out to one or more of the asset management companies described in Section 1.6. Some large schemes split their fund between two or more such companies and compare their respective performance. This practice, which is probably becoming more common, intensifies still further the

competition for performance among investment managers.

TABLE 1.3: TOP TEN PENSION FUNDS, 1989

Pension Fund	£ million
British Coal Corporation	8,962
British Telecommunications	8,211
Electricity Council	6,236
British Rail Board	5,756
Post Office	4,810
Barclays Bank	4,566
British Gas	3,799
British Steel Corporation	3,659
ICI	3,575
National Westminster Bank	3,422
Shell	3,374

Source: National Association of Pension Funds Yearbook, 1989

The biggest pension funds are somewhat smaller than the biggest life assurance companies in terms of the value of assets; and the top ten account for little more than a quarter of all pension fund assets. Collectively, the value of pension fund assets has outstripped that of insurance companies' life funds and, as may be seen from Table 1.1, the pension funds are the biggest institutional holders of UK equities.

1.4 Investment Trusts

Investment trusts and unit trusts are both ways of spreading risk and obtaining professional investment management. Investment trusts are public limited companies which, in order to obtain Inland Revenue recognition, must be listed on the Stock Exchange. They operate within the general framework of the Companies Acts, and the difference between them and other companies is that their primary purpose is not to conduct industrial or commercial operations but to hold securities. Different trusts vary greatly in the securities that they hold. Some invest wholly overseas, either in the world at large or in specified areas; some invest only in fixed interest securities

and some only in equities, while some specialise in providing development capital for smaller companies.

There are about 160 trusts that are members of the Association of Investment Trust Companies; fourteen of these have their own independent management and the rest are managed by about fifty companies, each acting for several trusts. Some of these management companies specialise in investment trusts but others are the general asset management arms of other institutions; the merchant banks are particularly prominent.

An unusual and rather puzzling feature of these institutions is that the market value of the trust company tends to be less than the underlying value of the securities held. Hence, the purchase of investment trust shares, or even the takeover of whole trusts, is a cheap way for other institutions to build up their portfolios of other investments. About 70 per cent of investment trust shares are believed to be held by other institutions.

1.5 Unit Trusts

Unit trusts, unlike investment trusts, are not corporate entities but funds managed under a trust deed. The legal framework for their operations is provided not by the Companies Acts but by regulations drawn up by the Department of Trade and Industry. There are over 160 management companies, some of which operate as many as fifty different trusts. Management companies include some specialist firms but also all the English retail banks except Nat West; nearly all the merchant banks; most of the biggest life assurance companies; and a number of large stockbrokers. Like investment trusts, unit trusts vary greatly in objectives and investment strategies; some aim to maximise unit-holders' income, while others seek capital appreciation. Some concentrate their investment on particular activities and some on particular geographical areas.

There are over 5 million unit trust holders, and about half of the total funds of £24 billion, shown in Table 1.1, is held by the

general public. The value of assets managed by individual fund managers is smaller than that of the largest pension and life assurance funds. At the end of 1987 only four managers had trust funds of over £2 billion, but since there were many very small trusts the top ten accounted for only close on 50 per cent of the market. It must be remembered, however, that some unit trust managers also manage investment trusts, insurance funds and pension funds.

1.6 Management Companies

The organisation of institutional investment is being transformed by two changes - the movement of some institutions outside their traditional spheres of activity to create 'financial conglomerates'; and the sale of financial management services on a fee-paying basis. Both have roots going back a long way, but the pace of change has accelerated during the past two decades and especially since the 1986 changes in the rules of the Stock Exchange, generally known as 'the Big Bang'. One of the earliest developments of the first type was the writing of pension policies by life insurance companies. Subsequently, banks and merchant banks have formed subsidiary companies to write life assurance, though they have not yet made very deep inroads into the business of the old-established insurers.

Banks, merchant banks and insurance companies are all heavily involved in unit trust management and some merchant banks also have subsidiaries that manage investment trusts. Besides managing their own funds, and those of trusts for which they are responsible, subsidiaries of banks, merchant banks and insurers also offer management services to others, including pension funds. For example, a large asset management company told us that it managed 120 pension funds, 13 UK unit trusts, one UK investment trust and a substantial volume of PEPs. The investment management subsidiary of a large merchant bank told us that it managed assets for 157 pension funds, 8 unit trusts, 2 governments, 76 charities and a few private clients.

Perhaps the most spectacular changes were those that occurred in the Stock Exchange during the run-up to the Big Bang and its aftermath. Of the two leading jobbing firms which had done about 80 per cent of the jobbing business of the Exchange, one was acquired by a retail bank and one by a merchant bank. Leading brokers were acquired by retail banks; by merchant banks; by at least one discount house that escaped the narrow confines of the traditional discount market and turned itself into a financial conglomerate; and by American and European banks. Of the top twenty broker firms of the mid 'eighties, only one has retained its independence. In view of the reliance placed on brokers' recommendations both for ordinary investment and in relation to mergers, these changes could be very important, but it is too early, as yet, to assess their full impact.

For a long time past, stockbrokers with a private client business have offered management services to their clients, deriving remuneration either from fees or commissions. Merchant banks also performed similar services, mainly for wealthy private clients and charities. Some 25 years ago, the Ford pension fund took the then novel step of winding up its investment management operation and splitting its assets between four management companies. The example has been followed by others, and out of 60 pension funds covered by the survey described in Chapter 2, twelve told us that their funds were externally managed. One result of this tendency has been the emergence of some very large funds. For example, the Prudential Corporation recently reported that its portfolio management subsidiary had £35 billion of funds under management, more than double the company's own life funds (The Independent, 13.9.90). Norwich Union, in an advertisement for staff, recently announced funds under management of £21 billion, compared with its own life fund (at the end of 1988) of £10 billion (Financial Times, 12.9.90). These are the two largest funds of which we are aware, but other insurance companies also have big portfolio management subsidiaries, as do some merchant banks including those that

have acquired brokers; and there are a few large management companies not involved in banking or insurance.

CHAPTER 2

The Questionnaire Survey

As part of the research reported in The Stock Market and Mergers in the United Kingdom (Hume Occasional Paper No. 24) we sought evidence on the sources and quality of the information available to institutional investment managers in relation to companies that may be involved in takeovers; the resources that they have for handling such information; and their opinions on its value. We also sought to test the assertion made in some quarters that institutions tended to support existing management unless they were dissatisfied with its past record or believed that an offer was 'too good to refuse'.

For these purposes, we prepared the questionnaire that is reproduced as an appendix to this chapter. Our original intention was to obtain information from the four traditional categories described in sections 1.2 to 1.5, but this presented problems, partly because of the erosion of traditional boundaries described in Chapter 1, and partly because of differences between institutions in the way in which their investment activities are organised. In some cases investments are handled by a division or department within the main body of the institution, and in others by one or more subsidiary companies. In some cases there is a quite complex corporate structure involving a number of different subsidiaries. To illustrate with a relatively simple example, the merchant bank Kleinwort Benson PLC has, as its investment management arm, a subsidiary called Kleinwort Grieveson Investment Management Ltd., formed when it acquired the stockbroker, Grieveson Grant & Co. This company manages six of the parent company's seven investment trusts and also operates as a broker dealer on the Stock Exchange. The remaining investment trust, specialising in development capital, is managed by a separate subsidiary, Kleinwort Benson Development Capital Ltd. The group's unit trust interests are managed by a subsidiary of Kleinwort Grieveson Investment Management,

Kleinwort Barrington Ltd., which also manages substantial funds that are not authorised unit trusts. Other subsidiaries include Kleinwort Grieveson Charlesworth Ltd. (a gilt-edged market maker), Kleinwort Grieveson Securities Ltd. (a market maker in equities), and Grieveson Grant International.

A further complication was that, in the hope of encouraging positive responses, we did not ask respondents to name their institution. Many volunteered this information, but some did not.

It soon became clear that many of our respondents who managed unit trusts were also heavily involved in other types of management, so we dropped unit trusts as a separate category and included such returns in a new category that we called 'asset management'. The small number of unit trust managers not involved in other activities were included in the residual 'other' category, along with returns from organisations that could not be identified. As noted in Chapter 1, twelve pension fund respondents told us their funds were externally managed, and did not complete the questionnaire. These were, perforce, omitted from the analysis.

The other category where there is some ambiguity is insurance. When a respondent appeared to be managing only or almost only the insurance funds of his group, the return was put into the insurance category. Where management services appeared to be widely offered outside, the return was classified as 'asset management'.

A total of 189 questionnaires were sent out and 85 usable replies were received,¹ a response rate of 45 per cent excluding pension funds who told us they were externally managed, and 51 per cent including these funds. A satisfactory feature was the high proportion of respondents answering all or nearly

1. These figures differ slightly from those of our earlier report. A few returns were received after the initial analysis had been completed and, in one case, a re-check found that a duplicate return had been included.

all the questions.

Of our 85 responses, we were able to place 70 in one or other of our categories with reasonable confidence. The results were as follows:

Category	No. of returns
Investment trusts	16
Insurance companies	19
Pension funds	15
Asset management	20
Other and unclassified	15

Answers to our first question relating to the number of funds managed show a striking difference between pension funds and other institutions. Self-administered pension funds generally manage only their own resources. It is quite common for companies to have separate funds for manual workers and for salaried staff, and sometimes the fund of an acquired company retains its identity after a merger. However, the average number of funds per respondent was only 2.3 compared with 48 for the group as a whole and no less than 136 for management companies. Returns from investment trust managers showed an average of 32. Even the largest investment trust managers do not handle more than 10 or so trusts, so the responses confirm our impression that some companies whose main activities are in investment trusts also have significant interests elsewhere.

Of 81 respondents who disclosed the size band appropriate to their funds, 64 (79 per cent) reported total assets exceeding £1 billion, and 55 (68 per cent) reported holdings of more than £1 billion in UK equities. We deliberately confined the questionnaire to large funds, both because of their importance in the market and because of the practical difficulties of obtaining information about the very large number of small funds. With hindsight, the value of this question could have been increased by adding several size bands above £1 billion; as it is, we have confined the analysis described in the rest of

this chapter to funds above and below the £1 billion mark.

It is well known that the main sources of information used by investment institutions are in-house research and brokers' recommendations, supplemented by advice from other professional advisers and media comment.

As an indication of the volume of 'in-house' resources available, respondents were asked how many 'qualified staff' they had (Question 3). 'Qualified' staff were defined as 'graduates in relevant subjects and members of relevant professional associations, e.g. Institute of Actuaries, Institute of Chartered Accountants'. Qualified staff were not all involved with their funds' UK equity portfolio; some might be working on gilt-edged, overseas securities, or even property. The results are summarised in Table 2.1.

TABLE 2.1: NUMBER OF QUALIFIED STAFF EMPLOYED

No of Staff	1-5	6-10	11-20	21-30	> 30	N/R	Total
By size of funds							
Less than £1 billion	3	9	2	2	0	1	17
£1 billion and over	6	8	22	10	16	2	64
Not disclosed	0	0	0	1	1	2	4
By type of institution							
Investment funds	1	4	3	3	3	2	16
Insurance companies	0	4	9	3	3	0	19
Pension funds	7	2	3	0	1	2	15
Asset management	0	4	5	4	7	0	20
Other	1	3	4	3	3	1	15
Total	9	17	24	13	17	5	85

Note: N/R indicates no response

TABLE 2.2: NUMBER OF BROKERS EMPLOYED

No. of Brokers	1-10	11-20	21-30	Over 30	N/R	Total
By size of funds						
Less than £1 billion	7	6	1	3	0	17
£1 billion and over	12	17	14	17	4	64
Not disclosed	0	0	0	2	2	4
By type of institution						
Investment trusts	6	2	3	4	1	16
Insurance companies	4	7	3	4	1	19
Pension funds	6	3	2	1	3	15
Asset management	0	5	5	10	0	20
Other	3	6	2	3	1	15
Total	19	23	15	22	6	85

Note: N/R indicates no response

As would be expected, larger institutions tended to have bigger staffs, but there were a number of big funds with very modest resources. Eighty-one respondents answered both Questions 2 (size of funds) and 3. Of these, 17 had assets of less than £1 billion and 64, more. Twelve of the 17 smaller funds had 10 or fewer qualified staff. More surprisingly, 14 funds of over £1 billion had 10 or fewer, and 6 had 5 or fewer. The management companies were better off in regard to staff than other institutions, with 7 out of 20 having over 30, and with an average of 36, against 21 for the sample as a whole. At the opposite end of the scale came pension funds, with an average of only 9. The difference may be at least partly due to the large number of different funds handled by the management companies, which must add to the complexity of the work.

A similar question as to the number of brokers used for ordinary business was answered by 79 respondents with an average of 25 brokers each. Larger funds tend, as we would expect, to have larger numbers of brokers; and there are also

marked differences between different categories, with management companies averaging 40, against only 12 for pension funds. The large number used by most funds is consistent with other evidence but, nevertheless, surprising in view of the fact that there are probably no more than 40 (if as many) firms on the Stock Exchange that are capable of handling large institutional orders effectively. Part of the explanation lies in the fact that some smaller broker firms specialise in particular localities or types of security. Their advice may be valued, even though they do not have the dealing skills or the range of contacts needed for handling large orders. Such firms may be used for advice rather than dealing, and rewarded either by fees or commission sharing. Nevertheless different institutions share, to a very large extent, the same brokers, and most of the leading brokers are on the lists of most of the largest institutions. Since the mid 'eighties, nearly all these brokers have been part of financial groups whose other activities include market-making in securities; fund management; advice to companies on corporate strategy, including strategy in relation to takeovers; and the provision of finance either by bank loans or by arranging for new security issues.

In order to test the importance of different sources of information, managers were asked to indicate their reliance on them on a scale of 'entirely', 'largely', 'a little' and 'not at all'. This question was asked for ordinary investment decisions (Question 5) and for decisions on whether to accept or reject a bid (Question 10). The number of responses was greater than that of respondents, since many managers said that they relied 'largely' on both in-house research and brokers' recommendations. Replies are summarised in Tables 2.3a - 2.3c. For ordinary decisions, only one respondent claimed to rely entirely on in-house research, though six indicated no reliance at all. In the 'largely' group, there was a small majority (53 to 46) in favour of in-house research. There was a slight tendency for large funds to rely more than smaller ones on their own

research. As between different categories of fund, management companies indicated the most, and insurance companies the least reliance on their own resources. In regard to decisions on bids, the influence of brokers is weaker and that of in-house research stronger than for ordinary investment decisions. This is not surprising, since many brokers regularly telephone clients with recommendations for ordinary investment. There was, again, a slight tendency for larger funds and funds with larger staffs to rely more on their own resources, both for ordinary investment and bids. Seven respondents said they relied entirely on in-house research for decisions on bids, against only one for ordinary business, and this included 3 funds with staffs of only 6-10. Among categories of fund, management companies stand out as relying very much on their own efforts, with 18 out of 20 respondents saying that they relied entirely or largely on in-house research, compared with only 5 indicating a similar degree of reliance on brokers' recommendations. When it comes to 'a little' reliance, both brokers and the media are much more prominent in relation both to mergers and to ordinary investment.

TABLE 2.3a: INVESTMENT MANAGERS' RELIANCE ON INFORMATION SOURCES

	In-house research	Brokers' recommendations	Other advisers	Media Comment
Ordinary decisions				
Entirely	1	0	0	0
Largely	53	46	5	2
A little	22	37	49	58
Not at all	6	0	22	18
No response	3	2	9	7
Mergers				
Entirely	7	0	0	0
Largely	60	18	7	4
A little	9	49	40	47
Not at all	5	7	23	20
No response	4	11	15	14

TABLE 2.3b: INVESTMENT MANAGERS' RELIANCE ON IN-HOUSE RESEARCH AND NUMBER OF QUALIFIED STAFF

No of qualified staff		1-5	6-10	11-20	21-30	> 30	Not Known	Total
RELY ON IN-HOUSE RESEARCH								
Entirely:	investment	0	0	0	0	1	0	7
	mergers	0	3	3	0	1	0	
Largely:	investment	6	8	17	7	14	1	53
	mergers	8	9	15	12	15	1	60
A little:	investment	3	8	4	5	1	1	22
	mergers	1	4	3	0	0	1	9
Not at all:	investment	0	1	3	0	1	1	6
	mergers	0	0	2	0	1	2	5
No response:	investment	0	0	0	1	0	2	3
	mergers	0	1	1	1	0	1	4

TABLE 2.3c: INVESTMENT MANAGERS' RELIANCE ON
IN-HOUSE RESEARCH AND BROKERS'
RECOMMENDATIONS BY TYPE OF FUND

	Entirely	Largely	A Little	Not at all	No response
IN-HOUSE RESEARCH					
Investment trusts:					
investment	0	10	6	0	0
mergers	1	12	2	0	1
Insurance companies:					
investment	1	6	7	4	1
mergers	2	10	3	2	2
Pension funds:					
investment	0	10	3	1	1
mergers	1	11	1	2	0
Asset management:					
investment	0	15	4	1	0
mergers	1	17	1	1	0
Other:					
investment	0	12	2	0	1
mergers	2	10	2	0	1
BROKERS' RECOMMENDATIONS					
Investment trusts:					
investment	0	9	7	0	0
mergers	0	3	11	0	2
Insurance companies:					
investment	0	13	6	0	0
mergers	0	4	7	2	9
Pension funds:					
investment	0	8	6	0	1
mergers	0	4	7	3	1
Asset management:					
investment	0	9	11	0	0
mergers	0	5	13	2	0
Other:					
investment	0	7	7	0	1
mergers	0	2	11	0	2

Managers were asked (Question 6) about rules or guidelines that might constrain their freedom of investment. Unfortunately, this question seems to have been widely misunderstood, so the replies are difficult to interpret. However, they do show clearly that many funds place limits on both the proportion of the fund that may be invested in any one company and on the proportion of any company's capital that the fund may hold. Rules of the former type were reported by 44 respondents, and those of the second by 35. Twenty-two respondents reported rules restricting investment in politically sensitive situations, and eight said there were limits on the proportion of their fund that could be invested in any one industry. Because of the misunderstanding noted above, no conclusions can be drawn about guidelines, as distinct from rules.

Investment teams are normally headed by a manager who reports either to a company board, to an investment committee or to trustees. Subject to the general limitations described above, the manager has a lot of authority. In order to test how far this authority extended in relation to bids, we asked (Question 16) whether the ultimate decision to accept or reject was made by the investment manager or by a committee. Of 78 respondents answering the question, 53 (68 per cent) said that the ultimate decision lay with the investment manager. Some managers, however, qualified this by written comments saying that, in difficult or controversial situations, discussions might be held with one or more of the following: the Chairman; other directors; trustees; an investment committee; other members of the investment team; and individual clients. Among our different categories, the managers of pension funds seemed to have the most autonomy, and those of asset management companies the least. Twelve out of fifteen pension fund managers said that the ultimate decision lay with them, compared with 11 out of 19 insurance companies, 11 out of 16 investment trusts and only 8 out of 20 management companies.

In order to test managers' attitudes towards bids, respondents were asked whether their initial inclination would be to support an existing management, to support a bidder or to consider each case on its merits (Question 7). As might be expected, a large majority (61 out of 81 answering the question) said they would consider each case on its merits, but 20 said that their initial attitude was support for existing management while none expressed support for the bidder. The replies are, therefore, consistent with the hypothesis that institutional investors' initial attitude is one of support for existing management, provided that it has a sound track record. Support among smaller funds was less than among larger ones, but there was no clear relationship with either number of staff or reliance on in-house research. Managers expressing initial support were most common among asset management companies (8 out of 20) and insurance companies (6 out of 19), and least common among pension funds (2 out of 15).

TABLE 2.4: INITIAL ATTITUDES TO A CONTESTED TAKEOVER

	Inv. trusts	Ins. comp.	Pension funds	Asset mgmt	Other	Total
Support existing management	3	6	2	8	1	20
Support bidder	0	0	0	0	0	0
Consider merits	12	13	13	12	11	61
No response	1	0	0	0	3	4
Total	16	19	15	20	15	85

Empirical research has shown that shareholders in bidding companies seldom gain much, and often lose, as a result of a bid. It might be expected, therefore, that institutions would oppose bids which they thought unlikely to bring benefits. Of 81 managers who replied to Question 8, 19 said that they 'often' opposed such bids and 60 that they 'sometimes' did. In reply to a further question (Question 9), 69 out of 79 respondents said that they would carry such opposition to the point of

voting at a general meeting if necessary. There was little difference in the responses to these questions either between large and small funds or between different categories of institution. In view of the rarity with which reports of opposition appear in the press, these replies should probably be treated with caution. It could be, however, that effective informal pressure is brought to bear more often than is realised by the general public.

When bids are actually made, major sources of information are the offer documents and, in the case of contested bids, the defence documents. Investment managers were, therefore, asked for their opinions on the value of these documents (Questions 11 and 13) and for suggestions as to how they might be improved (Questions 12 and 14). Managers' rating of these documents can be summarised as follows (by number of respondents):

	Offer documents	Defence documents
Very useful	8	11
Moderately useful	60	58
Little or no use	13	12
Positively misleading	3	3

The pattern of responses is very similar for both types of document, though defence documents get rather more 'very useful' ratings than do offer documents. A majority of respondents rate both documents as 'moderately useful', but only a small minority regard them as very useful and, in both cases, these are outnumbered by those who regard them as of 'little or no use'. In both cases, three respondents describe them as 'positively misleading'. There is no clear relationship between these views and the size of funds, the size of qualified staffs, or the extent of reliance on in-house research. There are, however, small differences between different types of fund. If we measure satisfaction by the percentage of respondents who found the documents either very or moderately useful,

satisfaction levels were (in per cent of responses):

	Offer documents	Defence documents
Investment trusts	75	77
Insurance companies	84	79
Pension funds	73	87
Asset management	80	80

Over 50 (almost two-thirds) of all respondents made suggestions for the improvement of the style and content of offer and defence documents. Around half of these expressed dissatisfaction, one way or another, with the information given in offer documents on the rationale for a bid and the bidder's policy for the merged company. The following comments were typical: "more information about synergies/advantages of takeover and why it's necessary for improvement of company"; "more details of the advantages of the acquisition or the alternative strategic options"; "greater detail on what and how the bidding company proposes to improve performance of target company and benefit its own shareholders' existing investments". The requirements might be summed up, in the words of one respondent, as: "a medium-term plan giving the major changes that a bidder would make to the target company" and "proper medium-term earnings, cash flow, dividend and balance sheet projections for the new company". There was a good deal of emphasis on financial forecasts; one respondent went so far as to suggest that profits forecasts might be made compulsory.

The other chief cause of complaint was the presentation of offer documents - their tone, the lack of hard information and their length. "Less rhetoric, read like advertising circulars. Some control on amount of paper offered in a protracted bid". "More detail and numbers, and less hyperbole". "More details on pro forma accounts; details of markets concerned; much more information about prior dealings - a general trend towards the US level of disclosure". Several respondents commented on the selective presentation of past performance data and

suggested the introduction of standardised periods for calculations, while acknowledging the difficulty of avoiding bias altogether.

Other suggestions made only by one or two respondents included: the auditing of financial information; details of the costs of acquisition; information on previous acquisitions, particularly the employment record and investment policies. A few wanted statements of intention to be legally binding and one respondent wished lawyers, accountants, auditors and banking advisers to be jointly liable with the company for aspects of subsequent performance.

Comments on defence documents were very similar, sometimes identical, to those on offer documents. Respondents again asked for "less rhetoric", a more objective approach and more concise presentation. Defence documents should "accurately reveal the state of the business and the balance sheet". They should provide "quantitative reasons why shareholders should stay with current management". They should be less defensive and at the same time, when promising future changes, should offer "better explanation why these changes not made previously". There was the same concern as with offer documents that a more consistent and readily verifiable basis should be used for comparisons: "selection of non-representative time-span" should be avoided.

There were rather fewer comments on the desirability of specifying future plans and prospects than in the case of offer documents, but about one-third of comments asked for fuller and more precise information, for example: "what the target company is going to do to ensure its further survival over a three-year period to warrant independence". One respondent suggested that "the financial consequence of rejection" should be described and, in common with several others, that "the assumptions of profit forecasts should be clearly specified". Another proposed "full audited disclosure of long-term target". Individual proposals, such as detailed estimates of defence

costs, paralleled those made for offer documents, save one that advocated "no defence documents: management should be judged on its merits".

Respondents were also asked to indicate on a scale of 'very', 'moderate', 'little' or 'none', the importance of various factors that might influence them to accept or reject a bid. The results are summarised in Table 2.5. These results are very interesting in relation to the current debate on 'short-termism'.

TABLE 2.5: IMPORTANCE OF FACTORS IN BID DECISIONS

	Very	Mod.	Little	None	N/R
Long-term prospects of bidder	59	16	3	2	5
Long-term prospects of target	74	9	0	0	2
Immediate value of bid	57	22	4	0	2
Gearing of bidder	37	34	5	1	8
Nationality of bidder	1	13	37	30	4
Regional effects	0	11	34	37	3
Effects on employment	1	16	38	26	4
Other	9	3	0	5	68
Funds less than £1 billion					
Long-term prospects of bidder	11	5	0	0	1
Long-term prospects of target	16	1	0	0	0
Immediate value of bid	13	4	0	0	0
Funds £1 billion and over					
Long-term prospects of bidder	45	11	3	2	3
Long-term prospects of target	55	8	0	0	1
Immediate value of bid	43	16	4	0	1

Of 82 respondents answering the question in whole or in part, 74 (90 per cent) regarded the long-term prospects of the target company as 'very important'. Second in order of the number of 'very important' ratings was the long-term prospects of the bidder, with 59 mentions (72 per cent). The immediate value of the bid came only third, being mentioned by 57 respondents (70 per cent). The gearing of the bidder was regarded as very

important by 37 respondents (45 per cent), but the nationality of the bidder, regional effects and effects on employment were regarded as very important by only a few, and as of little or no importance by about three quarters of our investment managers. Respondents were also invited to list and rate other factors that they would consider, but this produced only a very low response rate and showed no significant support for any other factor. The proportion of small funds regarding the immediate value of a bid as very important (76 per cent) was substantially higher than that for larger ones (64 per cent) but a very high proportion of small funds also rated long-term prospects of the target company as very important. The proportion of managers rating the long-term prospects of both bidder and target as very important was rather greater among those relying largely on in-house research, but there was no difference in this respect in the rating of the immediate value of a bid.

The following table summarises, for our various categories of fund, the percentage that gave 'very important' ratings to the three factors, 'long-term prospects of bidder', 'long-term prospects of target' and 'immediate value of bid'.

Percentage of respondents answering question who rated each factor as very important

	Long-term, bidder	Long-term, target	Immediate value
Investment trusts	75	94	56
Insurance	58	68	79
Pension funds	80	87	40
Asset management	65	95	70
All, including other	69	87	67

Insurance companies appear to take the shortest view. Their scores are below average in relation to both the long-term factors, and well above average for 'immediate value'. At the other end of the scale, investment trusts are above average for both the long-term factors and well below average for

'immediate value'. Pension funds are above average for 'long-term prospects of bidder' and a long way below average for 'immediate value', but average for 'long-term prospects of target'. Management companies have a relatively low score for 'long-term prospects of bidder', but a very high one for 'long-term prospects of target'; they are slightly above average for 'immediate value'.

In two final questions, respondents were asked whether they were satisfied with the operation of the City Takeover Code and the Takeover Panel and, if not, what changes they wished to see. Of 80 managers answering the first question (Question 17), 61 (76 per cent) said that they were satisfied. The proportion saying that they were satisfied was lowest among investment trusts (62 per cent) and highest among management companies (85 per cent).

The invitation to suggest changes produced a number of general criticisms but very few practical and constructive proposals for change; it also revealed some confusion between the Code and the Financial Services Act. There were a number of general criticisms, such as that the Code was "too legalistic" and "lacked teeth". One respondent expressed concern as to whether the Code gave sufficient protection to small investors, and two thought that the 30 per cent threshold for mandatory bids was too high. One respondent believed that the Code was too favourable to bidders: he commented that

- “1. Timetables are far too favourable to bidders, and very disruptive to managements of target co.
2. Too much freedom of bidders to transact in the market. Often this presents majority of shareholders with a fait accompli, and pre-empts defence arguments.”

CHAPTER 2 APPENDIX:

The Questionnaire

Graham Bannock & Partners Ltd

THE DAVID HUME INSTITUTE
INQUIRY INTO CORPORATE TAKE-OVERS

INTRODUCTION

It would help us greatly if you would kindly complete and return the attached questionnaire. All responses will be treated in strict confidence and any results published will be in aggregate form which will make it impossible to identify any individual or fund. Since our studies relate to mergers in the UK, it is the UK equity market in which we are interested and we would ask you to relate your answers to this section of your portfolio.

Most of our questions can be answered by ticking the appropriate box, but if you feel that some qualification or additional information is needed, please do not hesitate to write this in.

If you have any queries or require more information please telephone Graham Bannock or Robert Pringle on: 01-723 1845

1. Number of funds managed

Note: Where two or more funds are under common management please answer subsequent questions for all these funds as a group.

2. Please indicate the total assets of fund or funds and holdings of UK equities managed by you:

	Total	UK equities only
Under £100 million		
£100 million and under £500 million		
£500 million and under £1,000 million		
£1,000 million and over		

3. How many qualified staff are employed in investment management?

Note: Please treat as "qualified" graduates in relevant subjects and members of relevant professional associations, e.g. Institute of Actuaries, Institute of Chartered Accountants.

4. How many firms of brokers do you normally employ for equity dealing?

.....

5. In your ordinary investment decisions how far do you rely on the following?

Entirely Largely A little Not at all

In house research				
Brokers' recommendations				
Other advisers				
Media comment				

6. Do you have any rules or guide-lines on the following?

	Rules		Guide-lines	
	Yes	No	Yes	No
Maximum proportion of fund in any one company				
Maximum proportion of fund in any one industry				
Maximum proportion of a company's equity in fund				
Political issues (e.g. investment in South Africa)				

7. Which of the following statements best describes your initial attitude to a contested takeover ?

Support existing management unless dissatisfied with its record

Support bidder as probably more dynamic

Consider each case on its merits

8. When you hold shares in a bidding company do you oppose bids that you do not regard as in the interest of that company ?

Often

Sometimes

Never

9. If you did oppose such bids, would this be by:

Informal approach to management

Voting at shareholders meeting

Both, if necessary

10. As a shareholder in a target company, how far do you rely on the following in deciding whether or not to accept a bid ?

Entirely Largely A little Not at all

In house research

Brokers' recommendation

Other advisers

Media comment

	Entirely	Largely	A little	Not at all
In house research				
Brokers' recommendation				
Other advisers				
Media comment				

11. Do you consider that offer documents of bidders are generally :

Very useful

Moderately useful

Little or no use

Positively misleading

12. In what ways would you like to see offer documents improved ? Please write your answers in the box below.

13. Do you consider that defence documents are generally :

Very useful

Moderately useful

Little or no use

Positively misleading

14. In what ways would you like to see defence documents improved? Please write your answers in the box below.

15. How important are the following in decisions to accept or reject a bid?

Very Moderately Little None

Long term prospects of bidder

Long term prospects of target

Immediate value of bid

Gearing of bidder

Nationality of bidder

Regional effects

Effects on employment

Others (please specify)

	Very	Moderately	Little	None

16. Is the final decision on acceptance or rejection taken by :

The investment manager

An investment committee

17. Are you satisfied with the operation of the City Takeover Code and the Takeover Panel?

Yes

No

18. If the answer to Q.17 is "NO", what changes would you wish to see? Please write your answers in the box below.

19.

Name: _____

Position: _____

Tele No: _____

20. Would you be willing to give one of our senior researchers' a short interview?

Yes

No

By Telephone

Face to Face

CHAPTER 3

Conclusions

The conclusions of this paper can be briefly stated. The accept/reject decision when a bid is made is obviously relevant, but so are the decisions on ordinary investment. It is the deals resulting from these decisions that largely determine the relative values that the market places on different companies and, hence, the bids that are likely to be made. Both types of decision have, therefore, been covered in the survey.

The organisation of investment management has changed greatly over the past ten years with the erosion of the boundaries that used to separate insurance, pension funds, investment trusts and unit trusts; the growth of financial conglomerates; the virtual disappearance of independent institutional brokers at about the time of the 'Big Bang'; and the emergence of very large managed funds, especially in the hands of insurance companies but also of banks, merchant banks and specialist fund management companies.

We found that many unit trust managers were so heavily involved elsewhere that we dropped 'unit trusts' as a separate category for our analysis. Unit trust managers with other large interests were assigned to 'asset management', a group that included banks, merchant banks and insurance companies offering external management services. Almost all the firms in the asset management category manage unit trusts, but they also have many other interests, some of which may be much more important. The number of unit trusts that did not appear to have other large interests was too small for separate analysis, and they have been included in our 'unclassified' category.

The main sources of information available to investment managers are in-house research and brokers' recommendations, supplemented by advice from other professional advisers and media comment. Answers to our questions indicated that in-house research was rather more important than brokers'

recommendations (especially in relation to bids), and that both were a long way ahead of other advice and media comment. There were wide variations in the number of qualified staff by whom managers were supported. Many appeared to be well staffed, but some managers of large funds had very meagre resources. As between different types of institution, asset management companies appeared to fare best in terms of qualified staff, and pension funds worst.

Nearly all funds use a substantial number of brokers; the average for the sample was 25. This is surprising in view of the limited number of stock exchange firms (probably no more than 40, if as many) who are capable of handling big institutional orders effectively. The implication is that, as is generally believed in the City, different institutions are served, to a very large extent, by the same group of brokers. This does not mean, of course, that they necessarily receive uniform advice; anyone who has sat on a university investment committee will know that it is not exceptional to get a 'buy' recommendation from one broker and a 'sell' recommendation from another.

Asset management companies not only had, (on average) more qualified staff than other types of fund, but also employed more brokers. This is partly explained by their size, but it is also a reminder that brokers' recommendations and in-house research are not perfect substitutes. An important, and time-consuming, in-house activity is the comparison and evaluation of brokers' recommendations.

For accept/reject decisions on bids, managers can also derive information from offer documents and, where bids are contested, defence documents. Respondents were, therefore, asked for their opinions on the usefulness of such documents. A high proportion regarded them as 'moderately useful', but there were more who said that they were of 'little or no use' than that they were 'very useful', and a few described them as 'positively misleading'. Over 50 respondents accepted an

invitation to make written comments, and some of these were very critical. Among the main criticisms were:

- Lack of detailed information in offer documents of the benefits expected from the merger and of proposed medium- and long-term strategies to attain them.
- A similar lack of detail in defence documents on the reasons for remaining independent, and on strategies to improve performance, when the past record has been poor.
- Use of misleading base dates in statistical comparisons.
- Excessive 'hype' in presentation.

Clearly, there is room for improvement here.

A second aim of the survey was to test the attitudes of respondents to mergers and, especially, to some controversial issues such as 'short-termism' and support for the existing managements of target companies. When asked which of three statements best described their initial attitude towards a bid, a majority voted for 'Consider each case on its merits', but there was a substantial minority vote for 'Support existing management unless dissatisfied with its record', and no support at all for 'Support bidder as probably more dynamic'.

In another interesting answer, 83 per cent of respondents claimed that they 'often' or 'sometimes' opposed the making of a bid by companies in which their fund held shares, either by informal contacts with directors or at a shareholders' meeting, or both. Reports of such opposition by the media are very rare. It may be that bidding companies have to face closer scrutiny from their institutional shareholders than is generally apparent, or it may be that managers have exaggerated the frequency of such action. After all, neither 'often' nor 'sometimes' are precise words.

Our respondents were also asked to rate the importance of six factors that might be expected to have some influence on their decision to accept or reject a bid. 'Long-term prospects of target'

scored much the highest number of 'very important' ratings, with 'long-term prospects of bidder' second and 'immediate value of bid' only third. This would seem to suggest that accusations of 'short-termism' made against the institutions are not wholly justified. However, a word of caution is needed. Where questions deal with controversial and emotive issues, there is always a temptation for respondents to claim more virtue than is apparent in their actions.

Nevertheless the general 'flavour' of the responses, taken as a whole and including the written comments on offer and defence documents and of the Takeover Code, suggest a group of people who are concerned with medium- and long-term issues, and who are prepared to give existing boards the benefit of the doubt, where doubt exists. If there is, as we believe, a bias towards too many takeovers, it is probably in the system itself and not in the minds of those who work it.

Whatever the truth about these controversial matters, one thing is beyond doubt. A large majority of voting rights in British industrial and commercial companies are in the hands, not of those who ultimately gain or lose by these companies' performance, but of a group of professional managers whose reward comes in salaries and career prospects, not from the shares in 'their' companies. The government's observation that 'the people best placed to make a judgement of commercial prospects, are those whose money is at stake', however true in general, is almost wholly irrelevant here.

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