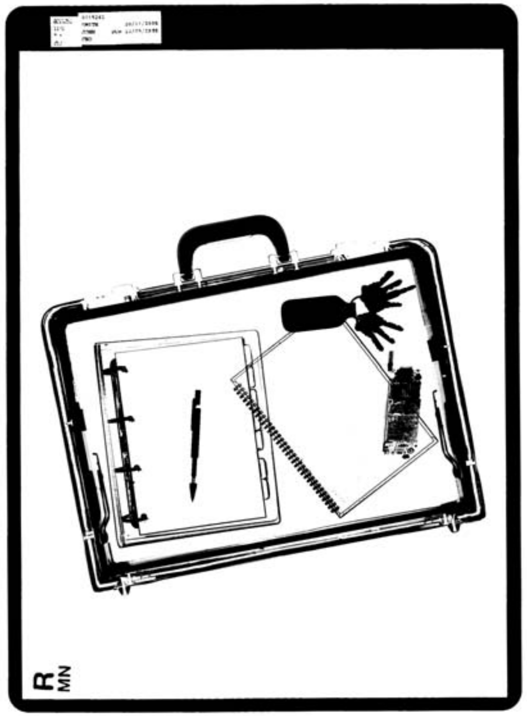


ERNST & YOUNG
Quality In Everything We Do

Investors on Risk.
The need for transparency.

Risk. Let's talk.

About Ernst & Young

Ernst & Young, a global leader in professional services, is committed to restoring the public's trust in professional services firms and in the quality of financial reporting. Its 100,000 people in 140 countries pursue the highest levels of integrity, quality, and professionalism in providing a range of sophisticated services centered on our core competencies of auditing, accounting, tax, and transactions. Further information about Ernst & Young and its approach to a variety of business issues can be found at www.ey.com/perspectives. Ernst & Young refers to all the members of the global Ernst & Young organization.

Contents

1. Foreword

Over the past decade, risk has become a predominant business topic. Driven by the fear of major business failures and under increasing compliance-related pressures, companies are focusing on their exposures, and risk management has become part of the essential fabric of the corporate governance structure. Senior management's expectations have been raised, the corporate culture and attitudes toward accountability have transformed, and the remit of the risk manager has changed beyond recognition, with dedicated organizational accountabilities and structures to address risk management.

At the same time, shifts in attitude by some in the business community have resulted in a growing appreciation of risk and opportunity as two sides of the same coin. Correspondingly, the risk focus is shifting to the positive side of business decisions. Business leaders are challenging whether the disciplines and approaches of risk management can be applied to add value to business performance.

To gain insight and contribute to the continuing debate around risk, Ernst & Young has initiated a series of research surveys in which we explore attitudes to risk and its management, comparing viewpoints across key stakeholder groups including investors, senior executives and audit committees.

This, the first report in the series, captures the thinking of over 130 major investors, incorporating the opinions of people who run some of the world's largest investment portfolios. Their ideas on risk and its management, which you will see extensively quoted in the following pages, provide informative and thought-provoking reading.

We would like to acknowledge and thank all respondents for their time and insights. We hope our report will stimulate further dialogue in your organization at Board level and below to keep risk, its oversight and management responsive to changing business needs.

Thomas McGrath
Global Managing Partner
Client Service and Accounts

This report is the first in a major series of surveys Ernst & Young is conducting on the subject of risk in 2005 and 2006. If you would like to contribute to this debate, please visit our dedicated risk website at www.ey.com/risk/letstalk

2. Executive summary

For investors, good risk management rests on communication, accountability, transparency – and ownership at senior level.

Risk is an inherent part of investing and has always been an important issue. However, it is now truly coming to the fore, as institutional investors' fiduciary duties have been made much more explicit following the new corporate governance regulations in many countries. New regulation is instructing businesses and investors to pay specific attention to their risk profile. Company leaders are also now more personally accountable if things go wrong. They must be able to demonstrate that they are making well-founded investment, business and strategic decisions, paying attention not just to financial performance but also to risk performance.

Of course, there is an inescapable trade-off between investment performance and risk. However, while investors are provided with a mass of information on a company's financial performance, on the whole, the investors we spoke to felt that they received very little information on risk management. How can it be possible to make an accurate assessment of the risk/reward ratio when they may only be seeing half the story?

We asked investors how they viewed risk and risk management in the organizations in which they invest. The message coming through is that investors want to engage with companies on the subject of risk: they want more information, more dialogue and more face-to-face contact.

- **Investors want transparency:** 69% of respondents identified transparency as top priority in considering an initial investment. Companies need a clear communication strategy to ensure they are giving investors the information they want in the most effective way.

- **Investors need better information on specific risks:** the survey results show that, at the moment, they may well be making investment decisions based on incomplete information about how companies are managing risk.

- **Investors don't like surprises:** they don't expect to eradicate risk – after all it is inherent to their own business model, the source of their livelihood. What they do want is to be made aware of the full range of risks which are inherent in their investments. With 29% of the vote, respondents ranked 'fewer negative surprises' as the most important benefit of good risk management.

- **Investors apply a penalty** if they think risk management is insufficient: 61% of respondents said they had avoided investing in companies for this reason and 48% had de-invested.

- Investors expect the **CEO or wider board to take ownership of risk** and play an active role in its management: a third of investors we spoke to believe that Boards should be setting the strategy for risk management, while over a half think the Board should provide guidelines.

- **Investors value face-to-face communications** about risk management over other channels. This creates a challenge for corporations to respond to this preference, while at the same time adhering to corporate governance requirements on the full and simultaneous disclosure of information to all those with an interest in the company.

- Investors are already **engaged in a dialogue** with companies on risk: they are asking companies to respond to their needs by disclosing more about the composition of their risk profile relative to other business metrics, and asking for more transparency when faults are found in risk control procedures.

3. Our survey approach

Global sample profile

Value of funds managed	% of respondents
Up to $10 million	7%
$10 million – $49 million	11%
$50 million – $99 million	10%
$100 million – $499 million	19%
$500 million – $999 million	5%
$1 billion +	36%
Not specified	12%
ALL RESPONDENTS	137

In June and July 2005, our researchers[1] interviewed 137 institutional investors, in charge of some of the world's largest portfolios: over a third of our respondents personally manage $1bn + funds. This represents organizations which manage funds running into trillions of dollars. Our sample included investment companies and trusts, pension funds and security brokers.

Respondents were fund managers, directors of investment funds, heads of fund management, portfolio managers and equities portfolio managers. We talked to people in 16 countries, with emphasis on the larger financial centers.

Country	Respondents
US & Canada	25
UK	13
China & Hong Kong	12
France	12
Germany	12
Switzerland	10
Netherlands	9
Italy	8
India	7
Australia	6
Poland	6
Russia	6
Sweden	6
Brazil	5
ALL COUNTRIES	137

[1] The telephone-based survey was conducted by Taylor Nelson Sofres, London, identifying Ernst & Young as the sponsor.

4. The changing face of risk management

Risk is very much a moving target. Whatever area you observe – strategy, operations, finance, reporting or compliance – is subject to constant changing pressures. However, essentially companies need a systematic and deliberate approach to identifying and evaluating a range of risks. They need to select and manage techniques to adapt to those exposures and make informed business decisions. In this light, good risk management consists of knowing three things:

- what risks your organization faces
- who is managing those risks
- how to communicate your control of your risk profile to give confidence to those with an interest in your business.

We approached investors first (future surveys will cover senior corporate executives and audit committees) because they are a key stakeholder group, with a serious interest in fuller disclosure of business risks and opportunities.

For our investor respondents, the cornerstones of good risk management are effective systems and controls; communication; accountability; and transparency. In making investment decisions, they clearly want to understand both the risks companies face, and what approaches (including accountabilities) companies are using to manage them. Better information on risk management means they can carry out more informed analyses and make better decisions on the risk/reward ratio of their investments.

Ultimately, however, good risk management should go beyond pure compliance. Whatever the driver behind risk discussions, an understanding of the risk portfolio, and how to mitigate threats while exploiting the full potential of opportunities, can be highly beneficial to business – enabling better-informed decisions at all levels.

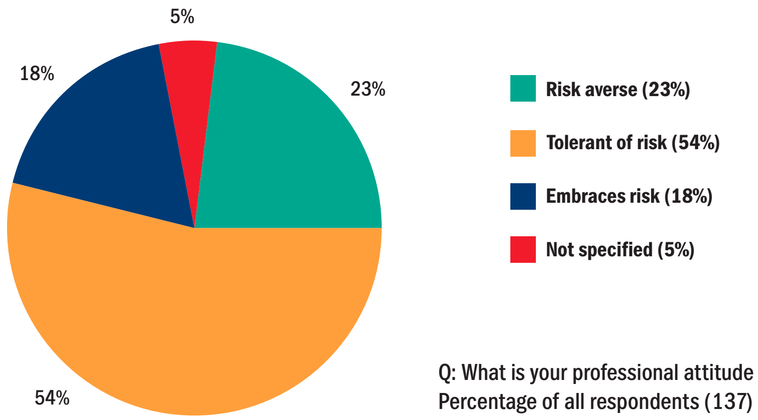
Whatever the case, companies themselves should be actively involved in the debate – providing the arguments and context for that dialogue – working with all stakeholders to set the agenda for risk and risk management into the future.

Ernst & Young defines risk management as:
"A systematic and structured way of aligning an organization's approach to risk with its strategy, helping the business to manage uncertainty more effectively, minimize threats and maximize opportunities."

5. Our findings

For investors, risk is a fact of life – major investors take risks for a living, and as such most describe their own personal philosophy as one that either tolerates or embraces risk. Under a quarter of large investors describe themselves as personally risk averse. As a group, they are not predominantly concerned with trying to eradicate or completely avoid risk in their investment portfolio, but with how companies effectively mitigate risk in their financial performance. They look for ambition and aggression in the pursuit of profitable growth, but they also want to see proof that risks are under control, with opportunities and constraints in balance: high levels of risk need to be compensated for by adequate upfront or expected returns.

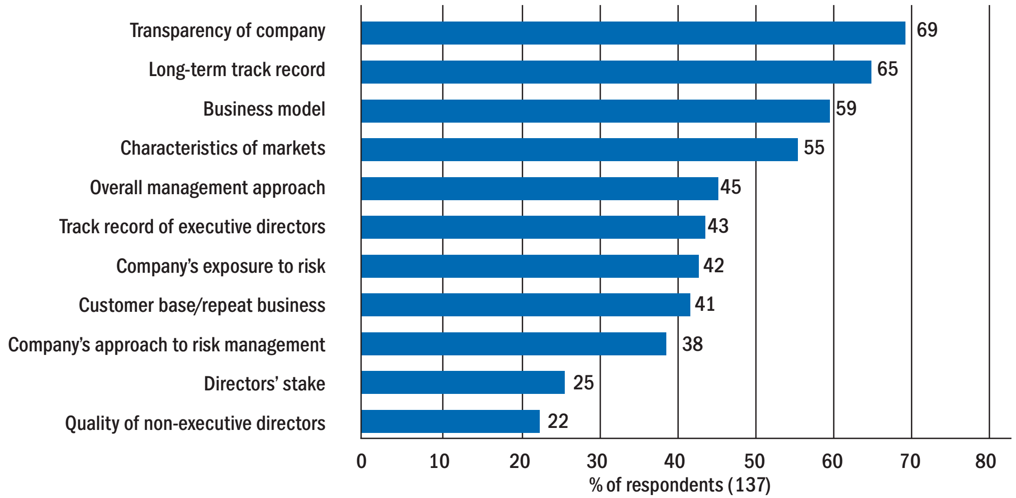
Figure 1: Investors accept risk



Q: What is your professional attitude towards risk? Percentage of all respondents (137)

> *"We want risks – without risks we will make no money."*
> Head of international equities, Sweden

Figure 2: Investors prioritize transparency in their investment decisions



Q: When you are considering making an initial investment in a company, what priority do you give to the following? (High rating – % respondents giving 8, 9 or 10 rating on 1-10 scale)

Investors are looking for transparency

Overwhelmingly, investors cited the need for transparency – open information – about a range of issues, including risk management. There are currently no definitive standards for the type of communications to investors about risk management which would be meaningful and enable decision making. What is clear, though, is that the investor market will differentiate in terms of transparency.

They want to make more informed analyses and take more soundly-based decisions on the risk/reward ratio of possible investment targets. They welcome the efforts companies make to give them insight into the specific, significant risks of their business and how these are being managed. Their comments showed that what they were also looking for was an attitude of transparency, readiness and cooperation.

What do investors mean by transparency?

Transparency = information

"Demonstrating how risk approach adds value; showing benefits of protection through risk management." Chief investment officer, Australia

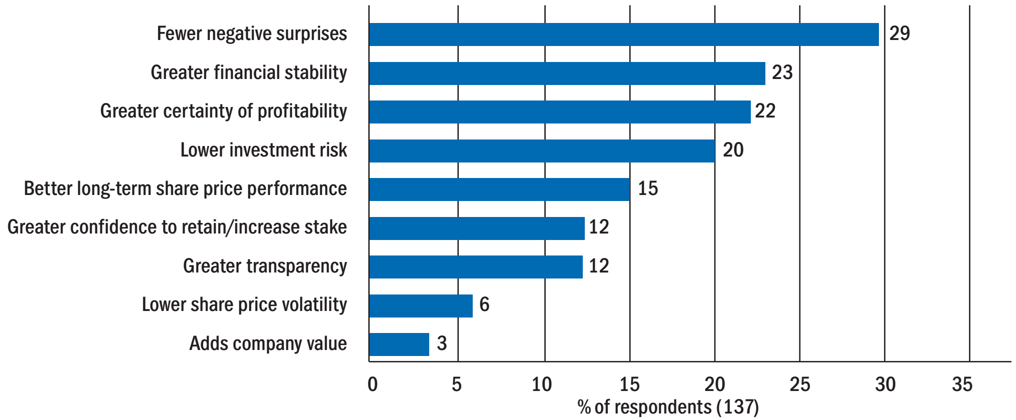
"The company has to show in detail how it operates its current risk management. It has to show it has a clear knowledge of the difference between business risk and financial risk." Senior investor, Brazil

Transparency = attitude

"Being more transparent, which means being willing to communicate the risk issue with investors." Investor, Hong Kong

"Transparency is not evading the issue when you want to talk about it." Chief investment officer, US

Figure 3: Reliable risk management offers fewer negative surprises, greater financial stability, profitability



Q: What do you see as the key benefits – for investors – of a company having a focused and reliable approach to risk management?

A key issue – and an interesting challenge – is for companies to find out what their investors want from these communications. What will be most helpful to them? Too much data, which can overwhelm investors, and make it difficult to see the forest for the trees, does not add up to good communication. What they need is relevant information on significant, specific business risks – and not (as can sometimes be the case) an endless list of potential risks. They need comfort that significant risks are being managed appropriately and that organizations have a strategy to deal with inherent risks should they arise.

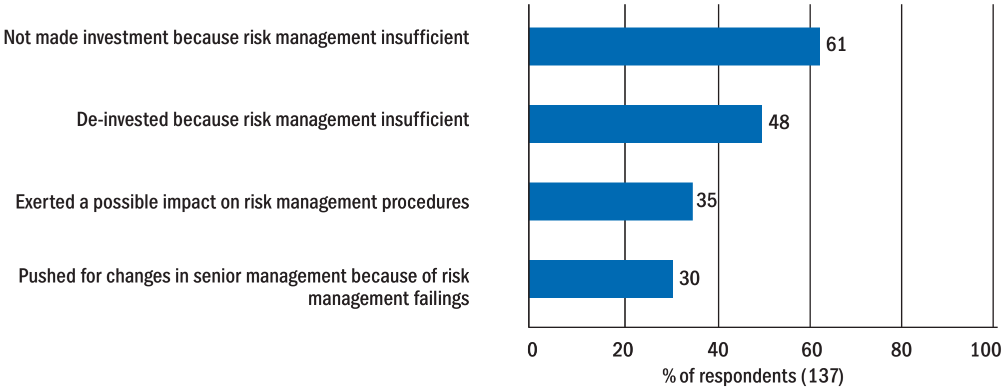
The motivation in producing any communication on risk should be a genuine desire to provide helpful, relevant information (or to open up constructive debate). Companies which take a purely legalistic or compliance-driven approach might be suspected of stonewalling.

Of course, any discussion around risk has to deal with negative eventualities: the investors we spoke with clearly prioritized reducing the downside of risk – that is, a negative shock or surprise. What they also want, though, is certainty and stability: to feel they are getting the whole story. Good risk management practices allow companies to address the potential for negative deviations from expected standards and build them into the plan, from policies and procedures through to communications.

How do investors think companies are managing risk?

On a scale of 1-10, investors gave companies a 5.6 in terms of how well they judge them to be managing risk – in other words, they are doing acceptably well, but with definite room for improvement. The ambiguity of this judgment is understandable in the absence of defined parameters for 'good' risk management. Can investors really judge how successfully companies are managing risk based on what companies are communicating to them? What would successful risk management look like? According to our respondents, *"Constant improvement and questioning of procedures and control of risks at different levels"* was a key sign for one fund manager in France; for another fund manager in the US, the ultimate answer is that time will tell. *"The bottom line is that they prove it over time."*

Figure 4: Investors apply a penalty when they consider risk management to be insufficient



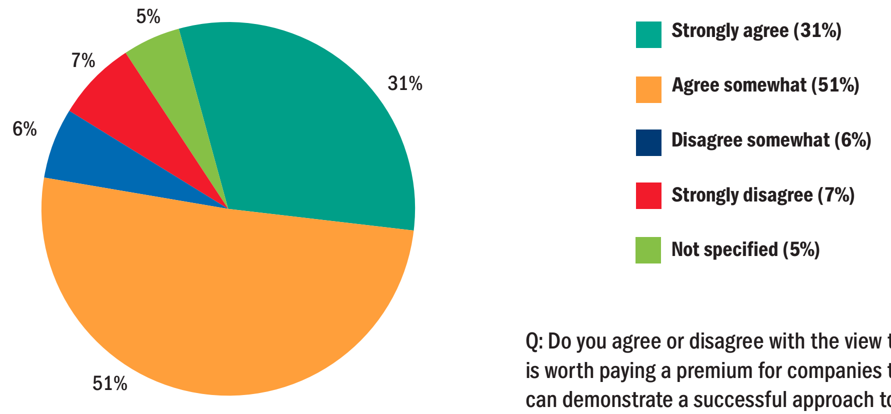
Q: Have there been any instances you can recall where you, as a major investor, have...?

We have heard that investors want information, dialogue and visibility. We also asked them if they would apply a penalty if they felt a company was not successfully demonstrating good risk management; in essence, not being open and transparent.

The majority reply (61%) was "yes" – investors could, and did, avoid investing in companies whose risk management they perceived to be lacking, and 48% had de-invested where risk management performance was insufficient.

> There is a value chain from compliance to transparency to premium.

Figure 5: Large investors believe that good risk management is worth a premium price

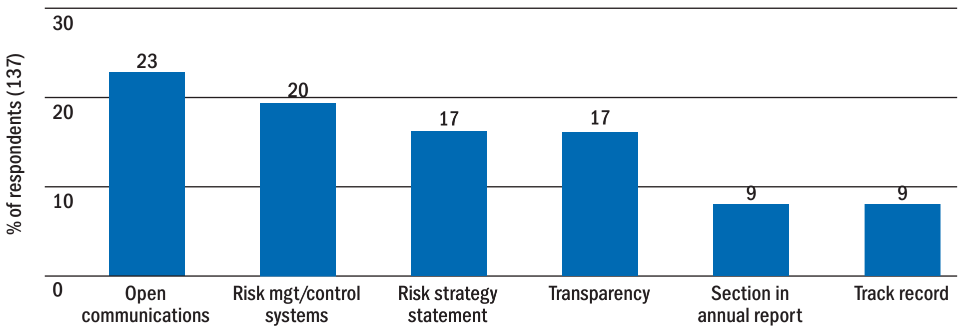


Q: Do you agree or disagree with the view that it is worth paying a premium for companies that can demonstrate a successful approach to risk management?
Percentage of all respondents (137)

At the same time, we asked whether respondents would pay more to invest in a company with good risk management. 31% strongly agreed – a positive finding implying that if there was transparency, if companies were able to demonstrate good risk management practices, they could achieve a premium. Overall, 82% of investors tended to agree that good risk management was worth a premium.

Investors tell us they will pay more: how can companies access that premium?

Figure 6: Open and transparent communications are key to demonstrating successful risk management



Q: How can a company best demonstrate to a major investor that it has a focused and reliable approach to risk management? (Spontaneous)

> Investors want companies to communicate, take ownership, and be active on managing risk.

Communicate

How do companies demonstrate that they are successfully managing risk? Understandably, investors don't like negative surprises – they want to know things are under control; they want open communication and information on control systems. Notably, a substantial number of investors used the term 'control' interchangeably with risk management. Whether or not risk management equates to control systems in the eyes of the investor, what evidence do they want that controls are working – and in how much detail? Answers varied widely here, encompassing legal risk and guarding against surprises on earnings, through to quality management and cashflow. In the end, it still comes back to transparency and disclosure of effective risk management.

How should companies be reporting on risk to investors?

"Being able to communicate risks, the controls for those risks, and how they are evaluated across the entire risk spectrum."
Investment officer, Australia

"To put into place procedures for risk control, including a department dedicated to risks, indicators and a hierarchy attached to risk control."
Funds director, France

"Full and honest disclosure, demonstrate a management focus on risk management by their levels of reinvestment and dividends." Fund analyst, US

"To be very transparent on risk management policy and the diversified activities of its client portfolio." Fund manager, France

The question that follows is, are the majority of companies in a position to communicate – to give investors the information they want?

One thing is certain: investors can't value what they can't see. As well as being critical to the overall success of a business, a good investor communications program is a key tool of risk management. Investors (as well as analysts and the media) need a clear, accurate picture of performance and prospects and a means to give their feedback. The communications program needs to be robust enough to withstand major events – both negative and positive – like profit warnings, hostile bids, CEO resignation, demergers or listings. It can provide a means to manage expectations and avoid surprising the investors. And if something does go wrong, it will help to contain the damage and reputational consequences.

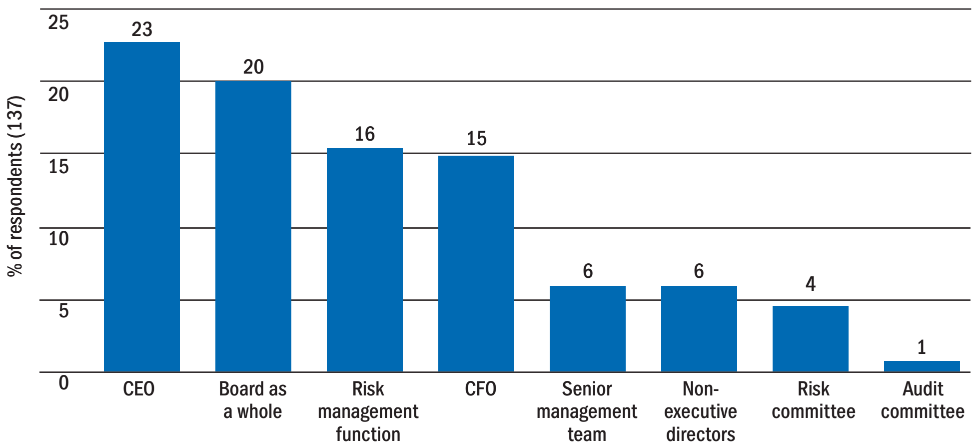
There may be a high level of legal influence over what is disclosed in relation to risks – either in terms of unwillingness to disclose, or at the other extreme disclosing a plethora of all potential risks. In the face of this companies need to find the right balance of disclosure. It is also worth remembering that transparency can provide an excellent defense. Over time, a positive and ongoing dialogue can help to build up goodwill which can be called on in the case of unfortunate events.

Take ownership

When asked to evaluate the various factors which contribute to successful management of risk, investors focused on ownership, communication and dialogue to a greater degree than those related to structure or approach, or having a documented strategy. On the surface, this seems a straightforward viewpoint – the best way to demonstrate successful risk management is to establish clear accountability and tell people what you are doing. Significantly, investors pointed to the need for risk to be understood and owned right across the organization. Managing risk cannot be based on a division of labor – separating risk management from line management.

> *"The whole company should bear in mind that avoiding risks should be everyone's aim."*
> Senior investor, Brazil

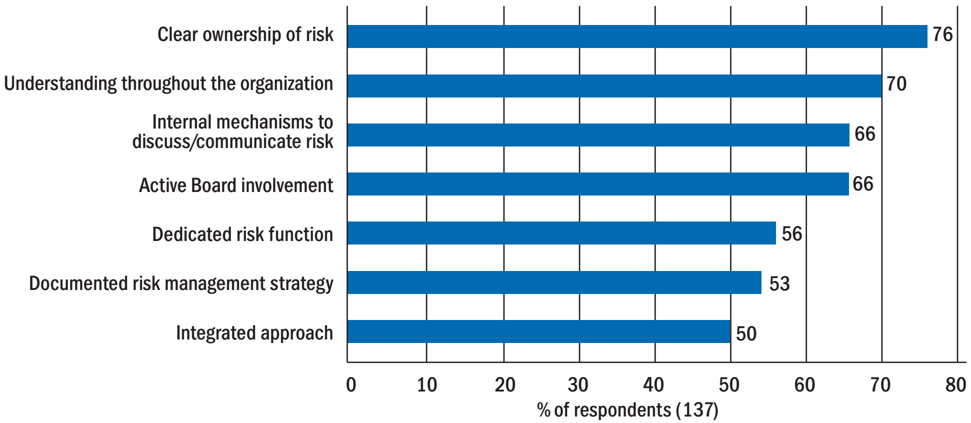
Figure 8: Investors prefer the CEO or wider Board to take ownership of risk.



Q: Who do you prefer to see own the issue of risk within the companies you invest in?
Note: Respondents were asked to make a single selection only.

We have seen that investors want senior people to talk to them about risks and risk management. In fact, they want more than that: when asked who should ultimately be responsible for risk, the investors' top choices were the CEO and Board members, ahead of a specialized risk function or the CFO. Putting the CEO in the front line speaks to their pragmatism: we could hypothesize that Boards and particularly the audit committee tend to care more about the risks of compliance. CEOs might tend to be more concerned about the risks which affect performance – always a key investor concern.

Figure 7: Ownership, understanding and communication are top risk management success factors



Q: How important are the following to the success of a company's approach to risk management? (High rating – % respondents giving 8, 9 or 10 rating on 1-10 scale)

Investors do not expect CEOs to know the minutiae of strategy and performance. However, their comments indicate that they do want to see them exerting visible leadership on this issue, and setting the 'tone from the top'. Respondents commented on this expectation:

"Sharing with investors should be a senior level initiative."
Chief investment officer, US

"It needs to be the CEO who has ultimate responsibility for risk under the control of the Board as well…" Investor, UK

A considerable amount of recent discussion has focused on the emerging role of the chief risk officer, with divergent points of view. On one side, there are those who believe risk and risk management is such a vast and increasingly important area that it warrants full-time focus at a senior level. Appointing a CRO is a visible indication of how seriously a company is taking this issue. And of course, risk professionals have a vital role to play in, for example, financial services organizations where 'risk' is much broader and embedded in all aspects of the business.

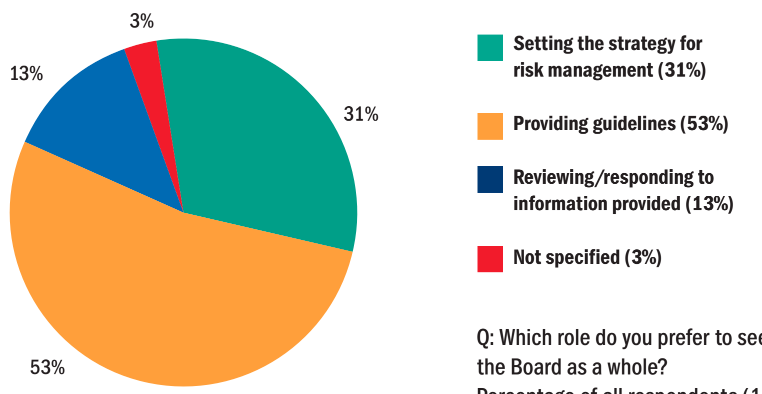
However, we also hear a contrasting view: that appointing a CRO could eventually prove counter-productive, putting risk in a silo and making it 'not the Board's business'. Under this philosophy, a company which successfully embeds risk management in its management and operational processes would use the CRO more as an agent of change, to share best practice and stimulate action. Many believe that the only real CRO is the CEO – it is the CEO who makes the decision on the risk appetite of the business, and this is not a responsibility that can be delegated.

Ultimately, the conclusion this points us to is not surprising: no matter what responsibilities are defined for managing an organization's response to risk, the accountability will rest with those at the very top of the business. However, the most effective risk management programs spring from a culture of collective accountability for results, with the risk manager acting as a catalyst to expand the horizons of management and encourage forward-looking behavior by key decision-makers.

Take an active role

Investors have a perfectly reasonable expectation that the Board should take an active role in risk management. Just under one third of the investors we spoke to believe that Boards should be setting the strategy for risk management (31%), while around a half think that the Board should provide guidelines (53%). In both cases, a Board would need to ensure delivery responsibility was accepted by management and have sufficient, appropriate, and clear reporting from across the organization.

Figure 9: Investors want the Board to play an active role in risk management

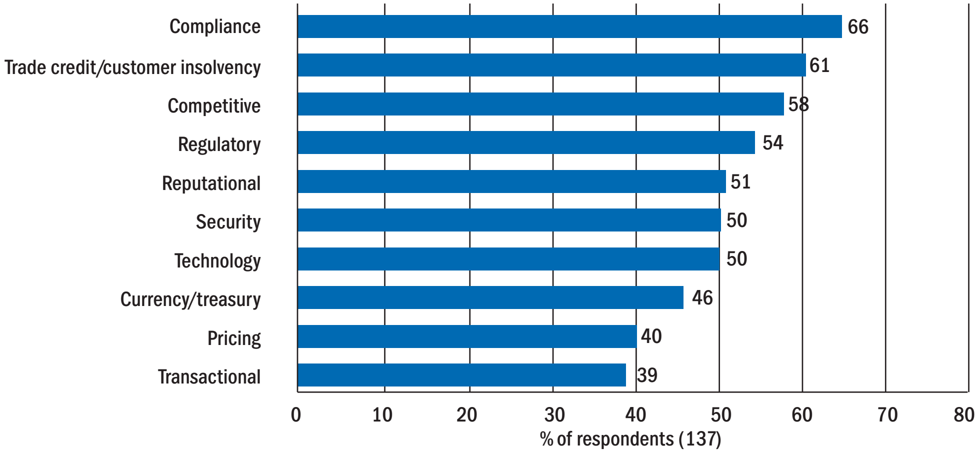


Q: Which role do you prefer to see performed by the Board as a whole?
Percentage of all respondents (137)

Compliance is the top risk management priority

> *"Companies have become more careful; people are daring to say no."*
> Portfolio manager, Netherlands

Figure 10: Investors say strategies are most important for compliance, trade and competitive risk



Q: How important is it for companies to have clear strategies in place to manage the following types of risk? (High rating – % respondents giving 8, 9 or 10 rating on 1-10 scale)
Risk definitions. We asked respondents how important it is for companies to have clear strategies to manage a range of types of risk. In most cases, the risk types were immediately apparent to them, and they were able to comment easily; in a small number of cases, individual respondents asked us what we meant by the risk type. The descriptions we gave them for the purposes of this study are in the Appendix at the end of the report.

Eighty-one per cent of our respondents recognize that the approach of publicly quoted companies to compliance has changed over the last three-five years.

The majority (79%) observe that the change has occurred in response to corporate governance rules, but 36% also believe companies have changed in search of competitive advantage, and a further 30% see a drive for best management practice.

When asked to describe the impact of those changes, most were positive, some referring to the widening implications of compliance:

"People have been forced to be more responsible." Investor, Canada

"All aspects of business have become stricter." Senior portfolio manager, Netherlands

"There is better transparency and clearer, more competitive business strategies." Portfolio manager, Sweden

"People are holding themselves up to higher moral standards in reaction to past corporate scandals." Chief investment officer, US

However, this was balanced by a significant number who said that the increased focus on compliance has had negative consequences in terms of increased caution and 'by the book' behavior:

"There are negative consequences. People respond to what they have to do rather than thinking what they need to do."
Funds director, UK

"The focus on risk management has reduced overall competitiveness. We've had these risk programs in place for the last 3-4 years but there has to be a balance where we actually take risks. The nature of risk management is not taking those risks." Senior investor, US

Although compliance alone does not make for commercial success, it can be seen as a 'license to operate' and, as such it has to be demonstrated – preferably in a way that engages and convinces investors, and helps to add value. Comments from these investors reflect that the implications of compliance now extend beyond financial reporting and corporate governance to encompass a range of legal, statutory and voluntarily adopted requirements. They also suggest that they see compliance widening beyond external regulation to embrace internal standards.

How are investors and companies engaging on the subject of risk management?

On the whole, investors felt that they could exert a reasonable amount of influence on a company's approach to risk management (42%). One in five thinks they can exert a significant amount of influence, with 36% saying they do not wield a great deal of influence. Respondents commented:

"We can get companies to increase awareness, force their hand in terms of disclosing risk, and get them to show the composition of their risk profile."
Chief investment officer, Australia

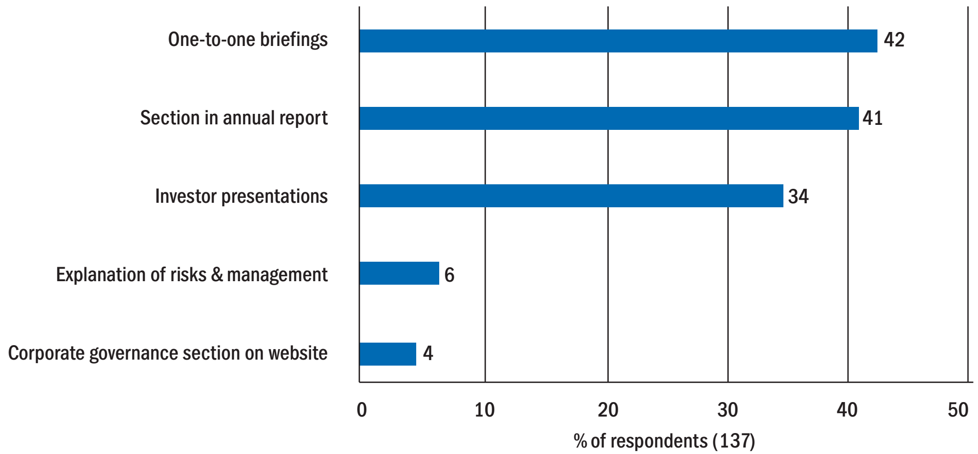
"There's a significant ability to influence senior management decisions through dialogue with senior management as a major shareholder." Chief investment officer, US

"Demand for change and better risks control… for better information about the risks taken and more transparency when faults are found in the risks control procedures." Fund manager, France

One-to-one briefings on risk management scored highest, marginally ahead of the annual report. In effect, investors obviously like both, and companies need to make sure they get both to a level that satisfies them. Investors like to feel that they have the opportunity to ask individual questions and raise their personal concerns. The challenge is to respond to this desire for personal communication whilst adhering to corporate governance requirements, which demand that any information that could have an impact on stock prices should be distributed to all shareholders at the same time. There is a general tendency to keep investors and analysts apart, but it is important to ensure that no meeting leads to selective disclosure.

This demand for face-to-face communication also means that CEOs need to feel comfortable talking about risk management and control, and need to be able to inspire confidence in discussion.

Figure 11: Investors value face-to-face communications about risk management



Q: What are the most appropriate methods for companies to communicate their approach to risk management to investors?

Future challenges for companies

We asked investors to describe the challenges in terms of risk and risk management facing the organizations in which they invest. Their answers underline the main themes emerging from the survey:

"To comply more and more with laws and regulations, and still be able to see through the tangle of guidelines."
Senior portfolio manager, Netherlands

"Deciding what risks to mitigate and what risks to leave exposed." Fund director, UK

"Simply making sure that everything they say is the truth." Senior investor, US

"As an investor, I want the companies to truly commit themselves to change what is wrong when it comes to risk management."
Senior investor, Brazil

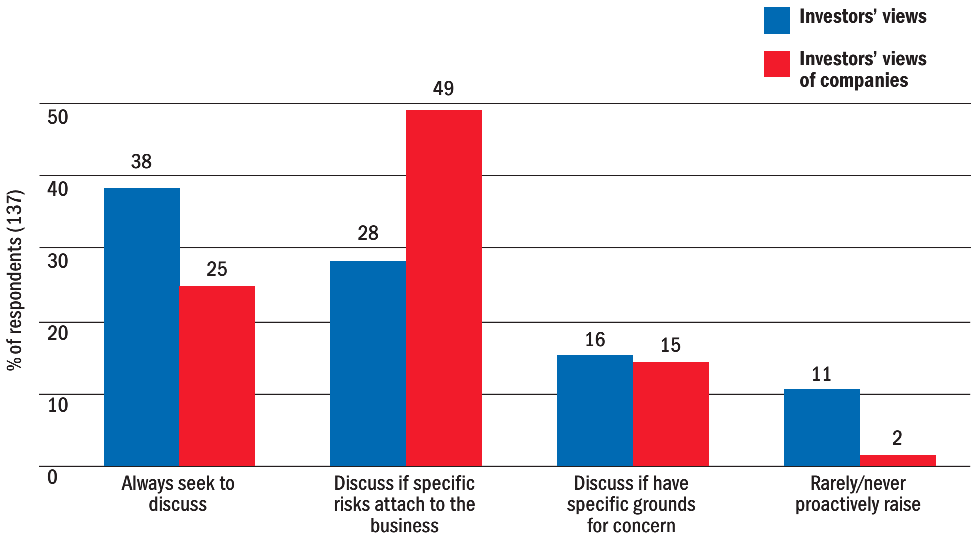
6. Conclusion

Investors want specific, relevant and open communication about risk.

Investors want companies to declare and manage risk, not to remove it altogether. Our survey suggests that many investors are currently making investment decisions based on incomplete information about how companies are identifying and managing risk.

They have also said that there is a premium available for companies which can demonstrate how they successfully manage risk.

Figure 12: Investors and companies are engaged in a dialogue around risk



Q: To what extent is a company's approach to risk management an issue that you proactively seek to discuss with companies in which you have, or might take, a stake?

How are companies to do this? The short answer is, by being more transparent about both the risks they face and how they are handling them. Transparency has implications: it means identifying relevant and significant risks, acting to control them, communicating internally, and then communicating confidently to external stakeholders. Based on our results, it would seem these implications are not being fully addressed.

Investors want to engage in an open and ongoing dialogue with companies about risks. But they are not driving the debate – companies taking action to address investor concerns will probably also be making positive changes for the benefit of their business.

What our results have clearly shown is that investors are already engaging with companies on risk, and they are focusing primarily on output – dialogue – rather than detailed processes. Their desire for more communication, more dialogue, should be viewed as wholly positive.

One respondent's advice to companies summed up this attitude:

"Recognize that their objectives actually do coincide with ours."
Portfolio Manager, Netherlands

The need for information is not just another demand, another burden for the Board, yet another stakeholder group with a big stick. Investors want to make money, be profitable and grow. Companies want the same thing, and they want to attract investors. It makes sense to be as open as possible: demonstrating excellence in managing risk is already – as our results show – attracting a premium from some investors. For those who fall behind, the converse could also be true: if investors feel they are not getting the full story, they may apply a risk premium to the cost of capital – or stay away altogether.

7. Appendix

Risk definitions

We asked respondents how important it is for companies to have clear strategies to manage a range of types of risk. In most cases, the risk types were immediately apparent to them, and they were able to comment easily; in a small number of cases, individual respondents asked us what we meant by the risk type. Below are the descriptions we then gave them for the purposes of this study.

Compliance: the risk relating to a company's non-compliance with applicable laws and regulations.

Trade credit/customer insolvency: the risk and cash flow implications of bad debt or slow payment of trade debt.

Competitive: the risk that actions of competitors or new entrants to the market could hurt an organization's competitive advantage or even its ability to survive.

Regulatory: the risk that changing regulations, locally and across global jurisdictions, could threaten the organization's competitive position and its capacity to conduct business efficiently.

Reputational: the risk that negative public opinion may impact earnings and capital.

Security: the risk that failure to restrict access to information adequately may result in unauthorized knowledge and use of confidential information.

Technology: the risk that the information technologies are compromising the integrity and reliability of data and information, or are threatening the organization's ability to sustain the operation of critical processes.

Currency/treasury: the risk that volatility in foreign exchange rates exposes the organization to economic and accounting losses.

Pricing: the risk that prices of key resources and services are higher than their expected levels, resulting in increased costs or lower margins.

Transactional: the risk that strategic transactions (eg M&A) will fail.

Contact us

To contact our experienced risk management professionals, please call your local Ernst & Young partner or visit **www.ey.com/risk/letstalk**

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