Foundation for Governance Research and Education

STEWARDSHIP AND ENGAGEMENT

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EXECUTIVE SUMMARY

Purpose of this Project

The purpose of this Project is to conduct a more detailed examination of engagement between institutional shareholders and company boards. It follows on from the work on stewardship published in 2011 by the Foundation for Governance Research and Education.

Shareholder engagement and fund management

1. Engagement incorporating constructive and challenging dialogue, based on trust and mutual respect between institutional shareholders and company boards, should be an integral part of stewardship. However, such engagement does not apply or is not relevant to all investment funds.

2. Investment funds cover a range from long-only funds to shorter term, e.g. hedge funds, high frequency trading funds. Investment strategies reflect the nature of the fund and for many engagement is not a relevant activity. This applies particularly to those with a short term investment focus. As a guide, this may be set at no more than one or, at most, two years.

3. Contemporary practice of engagement indicates that it falls broadly into two categories - reactive engagement and pro-active engagement:
   a) <u>Reactive engagement</u>, meaning reacting to events, is the practice most commonly observed amongst institutional shareholders .
   b) <u>Pro-active engagement</u> may have one or other of two objectives:
      i. Engagement over a limited period of time with the sole objective of driving up the company share price in the short term with a view to selling out and capturing the capital gain. This is the practice most commonly employed by so-called ‘activist’ shareholders.
      ii. Engagement with the objective of company long-term value creation. This engagement is described in 1. above and, as a result of supporting the increase in company value over the long-term, aims to benefit the economy and provide sustainable returns for investors and, ultimately, savers. This engagement is, therefore, necessarily linked into a long-term investment strategy.

   Effective engagement takes place in private (rather than in public) and through shareholders acting collaboratively, usually over an extended period of time.

Why this engagement matters

It has already been stated above that engagement linked into a long-term investment strategy has implications for the economy and savers, but the crucial point must surely be that sustained economic growth and efficient allocation of capital will not happen without it. Investment in research and development and in new industries with global growth potential, which our nation requires, is dependent upon a sustained and pragmatic relationship between capital and business. This requires a long-term investment approach and constructive engagement between the parties.

Engagement and holding company boards accountable

Engagement with boards is part of the process of holding company directors accountable and, therefore, an integral part of the corporate governance framework. It is regarded as an ingredient to the maintenance of the 'comply or explain' regime which underpins the UK Corporate Governance Code. Important though this is, it is ancillary to the main reason explained above of why constructive engagement over the long-term matters.

The economic case for engagement

By the very nature of the engagement which is the focus of this Paper, increase in company and investment value can only be realised over the long-term. It is, therefore, not surprising that sufficient robust evidence has yet to be accumulated to make the economic case. What evidence exists relates mainly to activist investors, such as hedge funds and focus funds, with a pro-active short-term focus on driving up the share price and selling out to realise the capital gain.

A new approach to engagement for long-only investors

This Paper is focussed upon engagement which rests on constructive and challenging dialogue between institutional shareholders and company boards, with a view to building trust and mutual respect between the parties, and with the all-important purpose of enhancing and sustaining company value to benefit the economy and savers. Necessarily, this conforms to the interest of long-only investment funds, those with a long-term perspective on investment. Specifically:

1. A more holistic approach to engagement needs to be adopted by aligning the dialogue more closely with the duties of directors as expressed in Section 172(1) of the Companies Act 2006, which binds directors to promote the success of the company for the benefit of its members as a whole and, in particular, to have regard to likely consequences in the long-term of any decision.

2. In line with adoption of the more holistic approach, long-only investors should also take into account the capital structure and needs (equity and debt) of the company as a basis for engagement.

3. With a view to a more effective holistic approach to engagement, organisations should synchronise the engagement activities and practices of equity and debt (bond) fund managers.

Review of incentives

1. Without meaningful incentives the quality and effectiveness of engagement practice is unlikely to make significant progress. To counter asset owner inertia, and with a view to winning investment business, asset managers should devise attractive long-only investment products which incorporate engagement. These products would be structured based upon intrinsic rather than relative value models, and would, therefore, differentiate these providers from the present mass of asset managers whose offerings are structured based upon relative performance criteria.

2. The limitation of quarterly reporting (already a Government action) should aid a shift in thinking from the short to a longer term view of fund performance, which in turn should encourage a longer term perspective on the part of asset owners.

3. To encourage long-term holding of shares, a variety of incentives have over time been proposed, and remain under consideration with typically firm views for and against. Perhaps some form of tax incentive holds the greater promise, for example, that which distinguishes between short and long-term investment with the former attracting a higher rate of income tax and the latter a lower rate of capital gains tax.

Recommendations for next steps

1. Asset managers should:
   a) review what lessons for fund managers might be drawn from comparing the engagement practice of holders of private and public debt (bonds)
   b) explore the practical implications of more synchronisation between equity and debt (bonds) analysis and engagement
   c) review and take into account any differences in approach to engagement for different sectors, e.g. capital goods, consumer goods, utilities, resource companies, financial services
   d) give serious consideration, in the light of the above, to resourcing for engagement and, in particular, the level of skills required and the implications for training and development.

2. Business School education, particularly at post-graduate and executive levels, has a crucial role to play in changing culture and mind sets to value the importance of constructive engagement between capital and business and a long-term investment approach. Programmes and courses should be redesigned to meet the need for change.

3. A data bank on the performance of selected long-only funds, adopting the approach to engagement advocated above, should be constructed with a view to

collecting records over a sufficiently long period of time (up to 10 years) to provide evidence to demonstrate the economic value of constructive engagement.

Structure of the Paper

1. The work and subject of this Paper follows on from the publication of "An Investigation into Stewardship: Engagement between investors and public companies: Impediments and their resolution", co-directed and co-authored by Dr John Mellor (the author of this Paper) and Charles Cronin, CFA Former Head of Standards and Financial Market Integrity, EMEA, CFA Institute.

2. The Introduction to this Paper outlines the purpose of the Project, expands the meaning of engagement between institutional shareholders and company boards, and points out the context in which engagement is relevant.

3. In Section 1 the complexity of the issues surrounding engagement are reviewed. Some of the issues were distilled from a Stewardship Roundtable of participants representing asset managers, asset owners, investment consultants, investment trusts, trustees, lawyers, and the FRC. Members of the Kay Review team, at the Department of Business, Innovation and Skills, sat in as observers.
The roles of asset owners and asset managers in the engagement context, fiduciary duty and the implications for engagement of different investment fund structures are summarised.

4. Section 2 makes a link between engagement by institutional shareholders and company directors' duties, and considers the limits to engagement. Engagement is further considered from the perspective of debt (bond) as well as equity holders. The implications overall for the quality of dialogue between the parties and for resourcing are examined.

5. Through examples of practice in the real world, Section 3 examines engagement with a view to its further development as an effective tool for both companies and investors. Examples are drawn from the debt (bond) as well as the equity side and include the perspective of the asset owner.

6. Section 4 advocates a new approach to engagement with a review of incentives and proposals for next steps for asset managers to consider, with a view to enhancing the cost effectiveness and quality if engagement.

STEWARDSHIP AND ENGAGEMENT

INTRODUCTION

This Project follows on from the work on stewardship co-directed and co-authored by Dr John Mellor (the author of this Paper) and Charles Cronin, CFA Former Head of Standards and Financial Market Integrity, EMEA, CFA Institute, entitled "An Investigation into Stewardship – Engagement between investors and public companies: Impediments and their resolution"[1]. A key conclusion of this work was the important role played by asset managers in the engagement process, albeit the initiative to include the requirement for engagement should lie with asset owners.

Purpose of this Project

The purpose of this Project is to conduct a more detailed examination of engagement between institutional shareholders and company boards by:

1. Considering the asset manager's role in engagement in relation to company directors' duties

2. Expanding the range of asset classes beyond equities to include debt (bonds)

3. Providing some insights on engagement practice from observation of engagement activity

Stewardship, investment funds and engagement

In the preface to the July 2010 Edition of the UK Stewardship Code[2], the FRC defines stewardship thus:

> "Stewardship aims to enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities."

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[1] See No.12 in Bibliography

[2] See No.9 in Bibliography

Whilst engagement is an integral part of stewardship, it does not necessarily follow that all stewardship activity must include engagement. Indeed, this reasoning might be taken to be implied in the Introduction to the updated UK Stewardship Code of September 2012[3]:

> "Stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole."

Investment funds cover a range from long-only funds to shorter term, e.g. hedge funds, high frequency trading funds. Investment strategies reflect the nature of the fund and, for many, engagement is not a relevant activity. This applies particularly to those with a short-term investment focus. As a guide, this may be set at no more than one or, at most, two years.

Current investment practice, including this range of investment strategies encompassing both the long and short-term, is accepted practice in today's financial markets and aids the preservation of liquid markets. Such preservation is essential to sustaining the market for capital.

The contemporary practice of engagement indicates that it falls broadly into two categories which can be differentiated as reactive engagement and pro-active engagement:

a) <u>Reactive engagement</u> is reacting to events as they occur or are announced and, in this sense, is somewhat defensive in nature. An example of such an event would be the announcement of levels of remuneration which institutional shareholders deemed to be excessive. Reactive engagement is the shareholder practice most commonly observed.

b) <u>Pro-active engagement</u> may be described by reference to one or other of two objectives:

    i. Engagement over a limited period of time with the sole objective of driving up the company share price in the short term with a view to selling out and capturing the capital gain. This is the practice most commonly employed by so-called 'activist' shareholders.

    ii. Engagement with the objective of company long-term value creation. This engagement is defined here as engagement, the basis of which is constructive and challenging dialogue between institutional shareholders and company boards founded on a relationship of trust and mutual respect. As a result of supporting the growth in company value over the long-term, it aims to benefit the economy and provide sustainable returns for investors and, ultimately, savers. This engagement is, therefore, necessarily linked into a long- term investment strategy.

[3] See No.10 in Bibliography

The essence of this engagement approach from the perspective of the company board was succinctly summarised by Sir Roger Carr in the Foreword to "An Investigation into Stewardship"[4].

> "From the corporate standpoint, constructive challenge by institutional shareholders is a necessary and invaluable part of the value creation process. From the shareholders' perspective engagement is the foundation of understanding and influence."

The implication of the latter part of this statement is that, for engagement to be effective, that is to be influential on the decision-making by boards of directors, it must take place over a long period.

Why long-term engagement matters

It has already been noted above that engagement linked into a long-term investment strategy has implications for the economy and savers, but the crucial point must surely be that sustained economic growth and efficient allocation of capital will not happen without it. Investment in research and development and in new industries with global growth potential, which our nation requires, is dependent upon a sustained and pragmatic relationship between capital and business. This requires a long-term investment approach and constructive and challenging engagement, based on a relationship of trust and mutual respect between the parties. This takes time to achieve and depends upon a willingness on the part of both company boards and institutional shareholders.

Engagement and holding company boards accountable

Engagement with boards is part of the process of holding company directors accountable and, therefore, an integral part of the corporate governance framework. It is regarded as an ingredient to the maintenance of the 'comply or explain' regime which underpins the UK Corporate Governance Code[5]. Important though this is, it is ancillary to the main reason why engagement matters explained above.

[4] See No.12 in Bibliography
[5] See No.11 in Bibliography

SECTION 1

Fiduciary Duty and Engagement

A Roundtable was convened, with participants representing asset owners, trustees, asset managers, and investment consultants, supplemented by lawyers, a representative from the investment trust industry and the FRC. The purpose of the Roundtable was to gather input on fiduciary duty and the engagement process from these key participants in the investment chain, interacting together. The discussion took into account the scope of the investment funds market comprising trust-based and contract-based schemes.

1.1

Fiduciary duty

Participants agreed the need for clarification of the fiduciary duties of the asset owners as principals, asset managers as their agents, and investment consultants as their advisers in the investment process.

The concept of fiduciary duty has exercised the minds of Fair Pensions, the IMA and ICGN[6]. Fair Pensions[7] has placed particular weight on the need for the strengthening of fiduciary duty in law, whereas the IMA, accepting that asset managers owe fiduciary duties, points out that those duties may be modified and shaped by contract, i.e. the investment mandate. For its part, the ICGN, in its model investment mandate, emphasises the role of contract law in the investment agreement between asset managers and asset owners. Latterly, the Kay Review of UK Equity Markets[8] pointed out that fiduciary standards should underpin all good practice along the investment chain, and apply to all participants in the chain. It cannot, for instance, be written out of the contract between asset owners and asset managers.

A proposal on how to proceed on clarification of fiduciary duty was included in the Kay Review which recommended the Law Commission be asked to review the legal concept of fiduciary duty, a recommendation subsequently accepted by the UK Government in its response[9].

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[6] See No.17 in Bibliography
[7] See Nos. 7 & 8 in Bibliography
[8] See No.3 in Bibliography
[9] See No.2 in Bibliography

1.2

Engagement

The initiative for including engagement in the investment mandate between asset owners and managers should rest with asset owners. Its inclusion is dependent upon the investment strategy adopted. This is the straightforward position explained, for example, in the publication on "An Investigation into Stewardship"[10]. However, this is not the 'real world' and, as participants in the Roundtable pointed out, asset owners are often not in a position to engage themselves, or instruct their asset managers on engagement, because they do not have the required skills and knowledge. This situation, therefore, places the asset manager at the centre of the engagement process.

Below is a paraphrased description of engagement by an asset manager participant in the Roundtable with an experienced and thoughtful insight.

> "Every engagement is different although there are a handful of points common to all engagements. The agenda for engagement follows from defining the objective. However, sometimes there is no specific objective other than building relationships and getting to know the company. The engagement can be with several different people over a series of meetings. It is important to remind the company, by discussing the business and its strategy, that shareholders care. The crucial skill is the ability to listen, which is a very rare skill in the City. Engagement is about emphasising and reading between the lines. There is a need to understand the softer issues. The relationship is with the company, not with the share price, and this aligns with the directors' duty to promote the success of the company."

Many of the themes contained in this description will emerge in the following Sections of this Paper.

Attention paid to engagement tends to focus on trust-based investment schemes, and its relevance is wider ranging and includes contract-based schemes, such as insurance company investment funds, and the investment trust sector for example. Fair Pensions has published work on contract-based schemes[11] and there is anecdotal evidence to indicate that the investment trust sector takes engagement with investee companies seriously and to good effect. The explanation may well lie in the fact that this Sector is, to a large extent, populated by investment professionals.

[10] See No.12 in Bibliography
[11] See No.6 in Bibliography

SECTION 2

ENGAGEMENT EXAMINED

2.1

Directors' duties

The second part of the Introduction to Stewardship in the latest September 2012 edition of the UK Stewardship Code[12] states the following:

> "In a publicly listed company the responsibility for stewardship is shared. The primary responsibility rests with the board of the company, which oversees the actions of the management. Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities."

Engagement is an integral part of stewardship, and stewardship should be understood as an all embracing term to include all the elements involved in the running of a company. This means more than its corporate governance structure and processes listed in the UK Governance Code[13], but also matters of strategy, risk management, etc. With this understanding of stewardship in mind, a company board's stewardship responsibilities are enshrined in the general duties of directors, and in particular Section 172(1) of the Companies Act 2006[14]. The 2006 Act codified directors' general duties, i.e. put them on a statutory basis in law. It is important to note that these codified general duties continue to be owed to the company and not to the shareholders.

Section 172(1) defines the director's duty to promote the success of the company. This duty has effect subject to any enactment of rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company. This duty was the outcome of the extensive debate on enlightened shareholder value, which was explored at length during the Company Law Review, which led to the 2006 Act. It replaced the common law duty to act in good faith in the interests of the company. The over-riding duty is that a director is required to act in the way he or she considers, in good faith, will be most likely to promote the success of the company for the benefit of its members as a whole. In doing so the director must have regard (amongst other matters) to the following six factors:

[12] See No.10 in Bibliography
[13] See No.11 in Bibliography
[14] See No.1 in Bibliography

i. the likely consequence of any decision in the long-term
ii. the interests of the company's employees
iii. the need to foster the company's business relationships with suppliers, customers and others
iv. the impact of the company's operations on the community and the environment
v. the desirability of the company maintaining a reputation for high standards of business conduct
vi. the need to act fairly as between members of the company.

At times these six factors, and any others that are being considered, may be in conflict, but the key issue for decision making is that the directors should choose the action that will promote the overall success of the company for the benefit of members as a whole, even if that may sometimes have a negative impact on one or more of the above factors. The six factors are matters which directors must have regard to, but considerations such as profitability, the financial effects on shareholders, etc., are still of critical importance as they are central to the duty to promote the success of the company for the benefit of the members as a whole. In fact, shareholders still retain primacy in the deliberations and decision-making of the directors.

2.2

Limits to engagement

Because the duties of directors are owed to the company and not directly to the shareholders, then it must follow that engagement by shareholders must be subject to limitations. Aside from the rights of shareholders enshrined in company law, e.g. right of a majority of shareholders to remove some or all of the directors, or the rights written into the constitution of the company, effective engagement by shareholders rests upon influencing decisions by directors rather than the rule of law. This influence can only be effective if it is based on trust and mutual respect between the parties, which can arise from engagement which is constructive, challenging and reflective of a deep knowledge and understanding of the company over the long-term.

Company directors, on the other hand, because of the duties to which they are subject, must promote the success of the company over the long-term to the benefit of the shareholders (members) as a whole. It is self-evident that, in fulfilling these duties, directors should give serious consideration to engagement with their shareholders, particularly their principal shareholders.

From the above it is clear that, for engagement to be effective, there has to be effort from both sides – company boards and institutional shareholders. But, since business success is dependent upon decisions made by directors whose first duty is to the company, there must be a limit to what can be achieved by engagement. However, decision-making does benefit from this dialogue, but the benefit will arise from engagement over the long-term and the establishment of trust and mutual respect between the parties.

2.3

Dialogue and engagement

Sir Roger Carr, in the Foreword to "An Investigation into Stewardship"[15], put the case succinctly:

> "Central to the exercise [of stewardship] is engagement between institutional shareholders and company boards. Constructive dialogue between the parties is at the heart of that engagement and, for this to happen, positive commitment to dialogue from both sides is necessary. Presently not all institutional shareholders or company management make sufficient efforts to engage. When engagement does take place, the quality of dialogue is sometimes mutually disappointing. Both company boards and institutional shareholders must be prepared to give the time and effort to regular communication.
>
> From the corporate standpoint, constructive challenge by institutional shareholders is a necessary and invaluable part of the value creation process. From the shareholders' perspective, engagement is the foundation of understanding and influence. Only by working together in a climate of mutual trust and transparency will the real potential of the partnership be built and liberated for the benefit of all stakeholders."

The engagement process is a more complex process than first sight reveals, however, and its resourcing presents a challenge. This is discussed below under 2.6 – Engagement and dialogue.

2.4

Holding company boards accountable

Much has been written on the role of shareholders in holding company boards to account. Examples of shortcomings by some shareholders have been pointed out and may (justifiably) raise doubts about the effectiveness of the shareholder model of corporate governance. Such shareholders are often referred to as 'absent owners'. There are a variety of tools available to shareholders to effect accountability, some more extreme than others, e.g. calling an extraordinary general meeting.

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[15] See No.12 in Bibliography

Holding boards to account can include some measure of engagement, but engagement with the objective of long-term value creation, and all that is captured by this objective, extends beyond holding boards to account. It embodies constructive and challenging dialogue between the parties over the long-term.

2.5

Engagement, equity and debt (bond) markets

Engagement is usually considered in relation to holders of equity. One reason is that shareholders in their capacity as owners with voting rights might be expected to engage, and also in this capacity have more 'leverage' over companies which permits better access to company boards than is the case for debt (bond) holders. A second reason is that, because equity and debt (bond) are different financing instruments, equity owners seek a return (capital growth and dividends) on their investment, whereas debt (bond) holders seek payment of interest and return of principal. Also debt (bond) holders rank ahead of equity holders in any liquidation.

All this might suggest a different approach to company analysis and engagement, even to the extent that engagement is uncommon for debt (bond) holders or, at the least, does not take place with company directors but, for example, with company treasurers.

But this differentiation overlooks two important points. Firstly, capital markets furnish both equity and debt (bond) financing for companies and, typically, a company's capital structure includes both equity and debt (bonds). There is indeed evidence from capital market activity to suggest the decline of equity markets relative to debt (bond) markets, although for how long this situation might exist is arguable.

Secondly, there is no *prima facie* reason why analysis by equity and debt (bond) holders should be different because both should be concerned about the company (investee or borrower) continuing on a going-concern basis. This requires analysis of company fundamentals in both cases which will include strategy, risk and governance analysis, as well as analysis of financials. It follows that, if the analysis underpinning equity and debt (bond) investment is markedly similar, then so should be the matters for engagement. Clearly, this is not an exact match because of the differences between the two instruments, but sufficient of a match to warrant careful consideration in devising and resourcing engagement practice. Nor should there necessarily be any differentiation on points of contact with the company. A banker operating in the debt (bond) markets should be as concerned to meet and discuss issues with board members (and frequently is) as should the banker operating in the equity markets. The same should apply to asset managers.

What the above suggests is some meaningful cross-over between equity and debt (bond) holders on engagement practice which could be exploited to advantage. It also suggests that a more holistic approach to engagement than currently exists, could be advantageous.

2.6

The engagement process

The high-level pro-active engagement, with the objective of building value over the long-term, is not a straight-forward process.

The most effective forms of engagement are those where constructive dialogue takes place on a confidential basis, i.e. in private and not in public, on high level issues determined by circumstances on a case-by-case basis between board directors and investment managers. For this dialogue to be constructive, investment managers need a sufficiently high level of skills, typically to think strategically and laterally, explore what lies behind the numbers, and ask constructive 'what if' questions while being able, often because of depth of experience, to relate to senior corporate board members and to interact effectively. The dialogue should take place against a clear understanding of expectations on the part of both parties and should typically cover the current and future opportunities of the company and the risks its faces, to enable a fundamental appraisal of value.

The building of trust and mutual respect between the parties, shareholders and boards, is a pre-requisite of effective engagement. Only then can the dialogue be open and constructive. Commenting on the operation of financial markets, the Kay Review[16] noted that trust has almost evaporated from relationships and that its restoration is key.

The Cox Report[17] cites the results of interviews, particularly with the investment community, who

> "commented on the diminishing amount of meaningful dialogue between listed companies and their shareholders".

The quality of the dialogue between shareholders and company boards is fundamental to, and determines, the quality of engagement. It is the quality and not the quantity of engagement that matter. The Kay Review[18] also came to the same conclusion.

Work on "An Investigation into Stewardship"[19] included discussions on dialogue with a selected group of company chairmen. This highlighted the seriousness with which these chairmen viewed engagement and the value they placed on constructive and challenging dialogue.

It is self-evident from the above that effective pro-active engagement has resourcing implications which add to asset management costs. But these costs need to be set against the objective of building sustainable value and returns for investors (savers) over

[16] See No.3 in Bibliography
[17] See No.18 in Bibliography
[18] See No.3 in Bibliography
[19] See No.12 in Bibliography

the long-term. At the same time, adopting a more holistic approach to engagement, incorporating both equity and debt (bond) perspectives, as well as a more focussed approach from an operational standpoint, should reduce the pay-back period. This is discussed more fully in Section 4.

SECTION 3

ENGAGEMENT IN PRACTICE

3.1
Current status of engagement practice

Clearly this Paper is concerned with engagement between shareholders and company boards with the objective of building value over the long-term and makes the case for the importance of such engagement. However, at the same time, it acknowledges that engagement practice covers a range of styles depending upon investment strategies.

20/20 Stewardship – "Improving the quality of investor stewardship"[20] – have proposed a "stewardship framework" for asset managers which includes a number of engagement categories ranging from "engages pro-actively on a full spectrum of topics (e.g. strategy, performance, financials)", through "engages principally on a reactive basis on a limited range of topics", to no engagement whatever. This helps asset owners (no doubt with advice from investment consultants) to decide which asset management service best fits their requirements.

An insightful perspective on an asset manager's view of their stewardship responsibilities and engagement towards their clients can be gleaned from BlackRock's statement on the subject, included in the Cox Report[21]:

> "For our part, we define stewardship as protecting and enhancing the value of the assets entrusted to us by our clients. A subtle but important distinction exists between this and the stewardship responsibilities of the board of directors and company executives, namely to protect and enhance the value of the company over time. As shareholders, our stewardship responsibility is to our clients. Yet we perceive a widespread belief that shareholders have a responsibility to engage with companies and 'make them better'. This confuses the two responsibilities. Sometimes fulfilling one's stewardship to clients will involve engagement with companies, other times it will necessitate selling or reducing a shareholding if we cannot protect our clients' interests through engagement, which should not be seen as a derogation of our duty, but a fulfilment of it."

This is an entirely reasonable position, which also makes the important point that, by implication, directors' duties are to the company and not to the shareholders. At the same time it also makes clear the use of 'exit' (selling the shares) over 'voice' (applying influence to cause change for the better) if that, in the asset manager's opinion, is in the best interests of clients. This latter point might suggest a less than long-term investment philosophy and probably reflects the lack of interest in engagement from

[20] See No.19 in Bibliography
[21] See No.18 in Bibliography

clients (asset owners). This would seem to be born out from an interview with BlackRock's Head of Global Governance and Responsible Investment[22] which included the following:

> "Corporate governance is part of an asset manager's fiduciary duty to enhance the value of clients' assets and ensure that management are running the company in the long-term interest of shareholders. There is a large silent majority of asset owners that need to think more clearly about this."

Notwithstanding the central role played by asset managers in the engagement process, this reference to asset owners again emphasises the important role they have as clients of asset managers in thinking carefully about the need for engagement and initiating the process by insisting it is part of their investment mandate, including regular reporting back by asset managers on engagement activity. This point was made at some length in "An Investigation into Stewardship"[23].

For major investment houses, such as BlackRock, with numerous funds with holdings in the same company, it is important to establish a 'house policy' on engagement and investment philosophy to deal with any conflicts.

3.2
Matters for engagement

As to matters for engagement, this can naturally only be resolved on a case-by-case basis. A list of broad headings would include, but not necessarily be limited to:

- strategy (including mergers and acquisitions)
- board composition and effectiveness
- succession planning
- risk management and board oversight
- environmental and societal impact
- remuneration

To these should be added all matters financial, including capital structure, to put into effect an holistic view of engagement which befits the reality of running a business and reflects a fully integrated investment process.

3.3
The economic case for engagement

By the very nature of the engagement which is the focus of this Paper, increase in company and investment value can only be realised over the long-term. It is therefore not surprising that sufficient robust evidence has yet to be accumulated to make the economic case. At the same time there are difficulties inherent in proving something

[22] See No.13 in Bibliography
[23] See No.12 in Bibliography

when the counter factual cannot be observed, in other words, what the outcome would have been without engagement.

What evidence exists (see, for example, ECGI Working Paper[24]) relates mainly to activist investors, such as hedge funds and focus funds, with a pro-active short-term focus on driving up the share price and selling out to realise the capital gain.

However, there are examples of studies which have been made to measure the impact of engagement on share price and company performance, using US public company data sets stretching over periods of between 10 and almost 20 years. Apart from being confined to US stocks, these studies are also somewhat limited in their scope. “Active Ownership”[25] uses an extensive proprietary data set of corporate social responsibility engagements on ESG issues and, with some reservations depending on company circumstances, finds positive market reaction to the engagements over a period from 1999 to 2009.

A Harvard Business School study on “The Impact of a Corporate Culture of Sustainability on Corporate Behaviours and Performance”[26], using a matched sample of 180 US companies and data from 1992 to 2010, found that “high sustainability” companies, i.e. those taking CSR into consideration, significantly outperformed over the long-term those that did not, both in terms of stock market and accounting performance.

Some interesting observations were included on stakeholder engagement in ‘high sustainability’ companies. Effective stakeholder engagement necessitates the adoption of a longer-term time horizon. There is also the likelihood that such companies attract long-term investors rather than long-term investors making traditional firms more sustainable. The results overall suggested that any outperformance occurs only in the long-term.

In spite of the lack of evidence to date to firmly establish the economic case for engagement, intuition continues to play its part in some people’s view. For example the Kay Review[27] states that “effective engagement will directly increase the value of the company”.

3.4

Engagement examples

The most recent IMA survey on adherence to the FRC’s Stewardship Code[28] indicates that engagement activity across the asset management industry is increasing, albeit slowly. Evidence is also building of shareholders acting collaboratively to address issues of

[24] See No.5 in Bibliography
[25] See No.4 in Bibliography
[26] See No.15 in Bibliography
[27] See No.3 in Bibliography
[28] See No.16 in Bibliography

common concern. The survey makes no comment on the key issue of quality of the engagement.

Evidence from examining examples of engagement from a small sample of asset managers, supplemented by anecdotal evidence from the fund management industry generally, suggests that much of the engagement activity is reactive to events, albeit some addresses less immediate issues such as succession planning or future strategy. Reactive engagement is typically of short-term duration, limited in its range of issues discussed, and not aimed at building relationships founded on trust and mutual respect. Nevertheless, reactive engagement is commonly claimed to be in the clients' (asset owners and their beneficiaries) best interests to protect their investment. This is an entirely reasonable and understandable position. Constructive engagement, on the other hand, requires a more pro-active approach by asset managers over the longer haul, and fits with a more long-term investment strategy.

Examples of a more reactive and defensive style of engagement include on issues such as remuneration and, more recently, with companies such as Bayer & Syngenta, producers of fertilisers of the neonicitionoid family which are alleged to be responsible for the destruction of the bee population in Europe. These are instances where the engagement does not extend beyond a limited range of issues at the expense of building a long-term relationship and a more comprehensive understanding of a particular investee company's fundamentals and drivers of value.

3.4.1

An equity investment example

A major investment house's shareholding in Unilever, as an example of long-term engagement from an equity perspective, is an instructive example of the engagement which is the focus of this Paper. The engagement reflects a long-term view of the investment, the acceptance of any short-term share price volatility, and, on the initiative of the investment house, has led to Unilever dropping quarterly reporting of results. Over the years the engagement has covered a wide range of topics, and has been constructive with, for example, suggestions on strategy and asking big 'what if' type questions. A relationship built on trust and mutual respect has provided the ground for robust and challenging dialogue.

The history and evolution of this engagement since 2003 is explained by the investment house as follows:

"In 2003 Unilever had a structure whereby there were (and remain) 2 parent companies – Unilever NV and Unilever PLC - owning the operating companies. The formal directors of each parent company were all executives with the chairmen of each company being also CEO. The group had 'advisory directors' who were not directors. The 2002 Annual Review stated:

> "Advisory Directors, although neither non-executive directors nor members of a supervisory board, are the principal external presence in the governance of

> Unilever, providing a strong independent element. They are chosen for their broad experience, international outlook and independence. Advisory Directors give advice to the Boards in general, and to the Executive Committee in particular, on business, social and economic issues. One of their key roles is to assure the Boards that our corporate governance provisions are adequate and reflect, as far as possible, best practice. They form the Audit Committee, the External Affairs and Corporate Relations Committee, the Remuneration Committee and the majority of the Nomination Committee."

Whilst the advisory directors provided advice, legally they had little power.

The performance of Unilever had been under-whelming for many years. The group had reputable brands which provided a solid base for performance but the group performance was barely in line with the performance of the FTSE100.

Early in 2004, the group announced a restructuring of the board. The chairman of Unilever NV, Antony Burgmans, would become non-executive chairman. The chairman of Unilever PLC would retire and the Foods Director, Patrick Cescau, would be appointed CEO. The group would also appoint the advisory directors as non-executive directors of both companies. We welcomed the changes but thought they did not go far enough.

We considered that it was essential that the chief executive was able to consider and implement radical changes to the business, if necessary. Changes may have meant undoing the work of the chairman in his former executive role. The incoming CEO was informed of our view that the board should take the opportunity to appoint an independent non-executive chairman.

We also met Lord Simon, who was appointed the senior independent director. The issues discussed included the appointment of an independent chairman, the portfolio of businesses, operational performance and a view that Unilever appeared to be more a civil service than a commercial organisation. Product lines were being refined but were not optimal. Rumours of 10,000 people in the finance department when competitor Reckitt Benckiser had 17,000 staff in total added to the impression. We were advised by Lord Simon that Unilever was like a super-tanker – it would take time to turn.

In 2005, the chief executive informed us that the relationship with the chairman worked and that the chairman presented no obstacle to change. Lord Simon also made this point.

Further meetings with the senior independent director followed, where we sought to encourage faster progress on governance, the portfolio and performance.

In 2007, the company appointed an independent chairman, Michael Treschow. We had a positive first meeting: he knew the problems at Unilever and intended to be a facilitator of change. We anticipated that shareholders would benefit as Unilever improved the performance of its portfolio and/or disposed of under-performing assets. It was heartening that he emphasised that Unilever must be fast (reacting and/or leading the market more quickly) and efficient.

In 2008, we welcomed the appointment of a new CEO from outside the organisation. We had supported and appreciated the efforts of Patrick Cescau, but felt that the group would benefit from Cescau's successor coming from outside Unilever and the Unilever culture.

In 2009, we informed Unilever that we did not support quarterly reporting. The company was grateful for our support on the issue. We – and Unilever – consider quarterly reporting to emphasise short term trading. We had reached a degree of acceptance of the 'Unilever as supertanker' view and considered quarterly reporting would not present a true view of Unilever.

Throughout, our engagement had included regular one-to-one meetings with the CEO and/or CFO where the issues discussed included operational performance, investment and the portfolio.

We last met the chairman in 2012. The meeting followed several years of engagement with the company. The changes made by the company during this time have been significant and positive. The chairman reinforced this change to a higher performance, fast moving culture, overseeing the appointment of a chief executive who has continued the improvement. We discussed the speed of progress and the company's strategy and operational performance. It was a positive meeting and confirmed that we were justified in supporting the company."

3.4.2

A debt (bond) investment perspective

Reflecting the difference between equity and debt (bonds), the prime objective of engagement for debt (bond) holders is clearly the preservation of principal and interest. Without the ownership rights enjoyed by shareholders, debt (bond) holders can draw some measure of influence over borrowers from covenant structures and, in some cases, voting rights. Also debt (bond) holders are in a senior position relative to equity holders, which position can be further strengthened if the debt (bond) is secured against collateral. However, in practice, this position only becomes significant in the event of a liquidation.

To throw light on engagement practice for debt (bond) holders, six questions to cover both the asset manager and asset owner perspective were addressed to another major investment house, and their insightful response is given below.

Question 1 Do your clients consider dialogue and engagement with investee companies to be important? How do funds under management value this engagement?

> "There are various ways of looking at this question. At a general level most of our clients are focused upon achieving a good return from their assets. However, undoubtedly, there is an increasing emphasis on social responsible investment (SRI). This reflects the view that SRI will produce higher returns due to the emphasis on the long-term sustainability of business models. For fixed interest investors, who by the nature of their investments should have long term horizons, SRI makes sense.

In relation to clients with specific requirements, we offer a tailored approach. One client specifically emphasises Environmental, Social and Governance factors and we incorporate their requirements into our security selection. This raises the issue of how much dialogue and engagement we can have with issuing companies to influence their behaviours."

Question 2 Over what range of issues are funds expecting dialogue and engagement, or is this limited to ESG matters? What in practice are the matters for engagement you are typically most concerned with on behalf of the funds under management?

"In the case of one specific client, the focus is on ESG factors. However, we and the client acknowledge that, whilst debt investors are important stakeholders, they are not owners of companies and have no direct influence or control over management. Debt investors enjoy a more senior claim over a company's assets, but a subordinated control position.

Against this background we have developed an approach to governance that maximizes our potential influence. This has three components parts - (1) pre-emptive control, (2) long term investment horizons, and (3) targeted engagement:

- Maximising pre-emptive control is the most tangible way of improving our relative position as stakeholders. The vast majority of benchmark corporate bonds are unsecured and lightly covenanted, with transitory protections such as liquidity and ratings more highly regarded by the wider investment community. We construct our portfolios with much larger exposures to secured bonds with protective covenants, ring-fencing investments against unforeseen and unquantifiable future liabilities. Furthermore, the fact that the market does not value more objective credit enhancements as highly provides the opportunity to construct more secure portfolios without compromising yield.
- We adopt a longer term investment horizon. We have always considered ourselves as lenders to companies rather than traders of corporate bonds and this, coupled with our ownership structure, naturally affords us a longer- term perspective.
- We believe in targeted engagement and that we can exert further influence over our companies by focusing our engagement where we believe we have the greatest potential traction, such as within social housing, building societies and securitisations. As members of the Association of British Insurers, we also have a useful forum to co-ordinate more disparate bondholder groups. Although our approach is by no means a perfect answer to the corporate governance conundrum, it is a pragmatic and realistic solution. Understanding the practicalities of governance and capital structure is central to mitigating risk.

The clear barriers to governance and engagement imply that the potential for bond investors to play an active role in the management of other less traditional factors, such as environmental and social risks, is more limited. This is recognized by our client and we have developed a process that meets their requirements. The simple over-arching philosophy is that companies with the largest environmental impact have to evidence the most effective mitigation through reporting, management systems and processes, and demonstrable environmental improvement (Mitigation Score)."

Question 3 - Since engagement is most relevant when investors adopt a long term investment perspective, is it correct to assume that this is your investment philosophy?

> "We believe that the best returns are to be achieved by focusing on medium term investment horizons; we focus upon this when constructing our portfolio. Generally, our bias towards secured bonds means that a low turnover portfolio strategy is to be favoured."

Question 4 - Can you justify in economic terms the value of this engagement to your clients?

> "As explained above, most of the engagement undertaken focuses upon the governance factor in the ESG range. From an economic perspective we strongly believe that engagement with an issuer, most particularly in the pre-issuance stage, is a very powerful positive factor. This applies particularly in those sectors highlighted above.
>
> Maximising control and position in the creditor hierarchy is a key driver of enhancing risk adjusted returns in corporate bond funds."

Question 5 – Do you recognise the limits to engagement, and how is this reflected in the relationship you have with your clients?

> "We have worked closely with one particular client to develop an approach to SRI that meets their requirements. We have been explicit on those areas where we can engage in a dialogue with issuers, hence our emphasis on pre-emptive control and targeted engagement.
>
> The relationship works on an interactive basis and we are always liaising with the client to improve coverage within their portfolio."

Question 6 – For the client you refer to above, when did the requirement for dialogue and engagement with investee companies begin, and how has the requirement evolved?

> "The client has been explicit in wanting a dialogue with issuers from the beginning. The process has evolved, with the main focus being on mitigating the ESG impact.
> The dialogue/engagement aspect continues to be a major factor for Governance, particular in those secured sectors favoured by us."

A long-term investment strategy, which goes hand-in-hand with engagement, applies equally to debt (bond) holders investing in instruments with maturities of up to 10 to 15 years, for instance, if the intention is to hold them to maturity or a long way to maturity.

SECTION 4

CONCLUSIONS AND RECOMMENDATIONS

4.1

A new approach to engagement for long-only investors

This Paper is focussed upon engagement which rests on constructive and challenging dialogue between institutional shareholders and company boards, with a view to building trust and mutual respect between the parties, and with the all important purpose of enhancing and sustaining company value to benefit the economy and savers. Necessarily, this conforms to the interest of long-only investment funds, those with a long-term perspective on investment.

The Paper examines the engagement in relation to the duties of directors and concludes that there is a case for aligning the dialogue between the parties more closely to these duties. Further examination of engagement in relation to the capital structure of companies, i.e. equity and debt (bond) sources of finance, provides the case for some overlap in engagement practice. These conclusions point in the direction of a new approach to engagement for long-only investors:

i. A more holistic approach to engagement needs to be adopted by aligning the dialogue more closely with the duties of directors as expressed in Section 172(1) of the Companies Act 2006[29], which binds directors to promote the success of the company for the benefit of its members as a whole and, in particular, to have regard to likely consequences in the long-term of any decision. Directors' duties also require them to have regard to other stakeholders, e.g. employees and creditors, and to the societal and environmental impact of their actions, whilst preserving the concept of shareholder primacy.

ii. In line with adoption of the more holistic approach, which necessarily requires incorporation of the analysis of corporate governance into a complete analysis of the company to generate a comprehensive view of its fundamentals and value-drivers, long-only investors should also take into account the capital structure and needs (equity and debt) of the company as a basis for engagement.

iii. With a view to a more effective holistic approach to engagement, organisations should synchronise the engagement activities and practices of equity and debt fund managers, notwithstanding the voting rights that attach to equity holders.

[29] See No.1 in Bibliography

4.2
Review of incentives

4.2.1
Meaningful incentives

Without meaningful incentives the quality and effectiveness of engagement practice is unlikely to make significant progress, notwithstanding its relevance for long-only investors, and its important place in enhancing understanding and relationships between shareholders and companies to generate long-term value and sustainable returns for savers. For some more enlightened asset owners this may be incentive enough for them to instruct their asset managers to engage, but anecdotal evidence would suggest that this is more the exception than the rule. To combat this, and with a view to winning investment business, asset managers should devise attractive long-only investment products which incorporate engagement. These products would be structured based upon intrinsic rather than relative value models, and would, therefore, differentiate these providers from the present mass of asset managers whose offerings are structured based upon relative performance criteria. To put this into practice, asset managers will need to give serious consideration to more concentrated portfolios (to better enable engagement) or accept that engagement must necessarily be limited to their larger portfolio positions for it to be effective.

A recent example of the former is Amsterdam-based Ownership Capital[30], which was launched in January this year, with a long-term engaged approach remit managing a highly concentrated portfolio of around 20 stocks. Fund managers will actively engage with all of the portfolio companies "in close partnership". Ownership Capital's Chairman, Sir George Buckley, the former chief executive of 3M, is quoted as saying –

> "There is a pressing need for shareholder engagement and a sustainable approach to business in the current turbulent economic environment. The chance to chase a quick dollar, and the fear of not doing so, has distracted investors in the past, often to the detriment of long-term growth and good returns, and this simply has to change if we are to get the economy back on track."

4.2.2
Quarterly reporting limitations

The limitation of quarterly reporting (already a Government action) should aid a shift in thinking from the short to a longer-term view of fund performance, which in turn should encourage a longer-term perspective on the part of asset owners.

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[30] See No.14 in Bibliography

4.2.3

Encouragement for long-term share holding

To encourage long-term holding of shares, a variety of incentives have over time been proposed, and remain under consideration, with typically firm views for and against. These include (but are not necessarily limited to): tax incentives, differential voting rights to enhance the voting power of long-term holders, and increased dividends for this same class of long-term shareholders. Each give rise to complications, but perhaps some form of tax incentive holds the greater promise; for example, that which distinguishes between short and long-term investment with the former attracting a higher rate of income tax and the latter a lower rate of capital gains tax.

4.3

Recommendations for next steps

The following recommendations are focussed on asset managers, but also include recommendations on education and further research.

4.3.1

Asset managers

Asset managers should:-

i. review what lessons for fund managers might be drawn from comparing the engagement practice of holders of private and public debt

ii. explore the practical implications of more synchronisation between equity and debt (bond) analysis and engagement

iii. review and take into account any differences in approach to engagement for different sectors, e.g. capital goods, consumer goods, utilities, resource companies, financial services

iv. give serious consideration, in the light of the above, to resourcing for engagement and, in particular, the level of skills required and the implications for training and development

4.3.2

Business School education

Business School education, particularly at post-graduate and executive levels, has a crucial role to play in changing culture and mind sets to value the importance of constructive engagement between capital and business and a long-term investment approach. Programmes and courses should be redesigned to meet the need for change

4.3.1

Research

A data bank on the performance of selected long-only funds, adopting the approach to engagement advocated in this Paper, should be constructed with a view to collecting records over a sufficiently long period of time (up to 10 years) to provide evidence to demonstrate the economic value of constructive engagement.

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ABBREVIATIONS

CSR	Corporate Social Responsibility
ESG	Environmental, Social, Governance
FRC	Financial Reporting Council
ICGN	International Corporate Governance Network
IMA	Investment Management Association

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