An investigation into Stewardship

Engagement between investors and public companies: Impediments and their resolution

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Contributing Organisations

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Taskforce

The work for this report was conducted by a taskforce of the people listed below:

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Foreword

Company managements and their institutional shareholders both carry a responsibility for stewardship. For company managements it is about responsible management of the assets entrusted to them. For institutional shareholders it is about responsible and thoughtful ownership. The objectives of both converge to a single focus, namely the creation of economic value, and the value to society which follows.

Stewardship is important for other reasons. It underpins the capitalist system and is necessary for the preservation of trust in the investment process. Without trust between shareholders and boards, companies' access to the capital markets would be severely constrained with serious implications for economic development.

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 managements make sufficient efforts to engage. When engagement does take place the quality of dialogue is sometimes mutually disappointing. For it to be productive there must be a balance in the discussion between short term financial performance and longer term value creation, tactical demands and strategic ambitions and necessary performance and thoughtful governance.

Both company boards and institutional shareholders must recognise the importance of effective stewardship and 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 shareholder 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.

Sir Roger Carr, Chairman, Centrica plc

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Executive Summary

The financial crisis has raised the attention of policy makers and regulators to the potential inadequacy of the stewardship (thoughtful ownership) of investments by the investment industry, and has questioned the degree of integration of corporate governance analysis into the investment process. Examples of shortcomings by some institutional shareholders in the holding of company boards to account have even raised doubts as to the effectiveness of the shareholder model of corporate governance, which is central to a 'comply or explain' regime and our current model of capitalism.

This is not to suggest that there are no examples of good practice on both the corporate and investment sides, but rather that good stewardship practice is not sufficiently robust and universal. Nor is it to suggest that current investment practice, which includes a range of investment strategies encompassing both short and long-term, is inappropriate. On the contrary, preservation of liquid markets is essential to sustaining the market for capital and the provision of its supply for long-term projects. A well functioning market lies at the heart of an effective capitalist system. Additionally, investment strategies which do not include stewardship are appropriate and just as important to the functioning of capital markets.

The issues

This project has identified seven over-arching issues in relation to stewardship.

1. The initiative to raise the level of stewardship rests primarily with asset owners such as pension funds, but there are difficulties:
   - Asset owners are under no formal pressure to include stewardship in investment management mandates,
   - Investment consultants' advice does not give stewardship a high priority, and
   - Investment expertise, particularly amongst trustees of pension funds, ranges from those with professional experience to the majority who have limited or no such experience.
2. How the principles of fiduciary duty apply (or should apply) to the whole of the investment process is uncertain. Fiduciary duty requires restatement, beginning with asset owners who have the principal duty as fiduciaries and on through the agents – investment consultants and asset managers – so that all parties are aware of their responsibilities. For example, anecdotal evidence suggests that a misunderstanding of fiduciary duty principles is placing unnecessary and unhelpful restrictions on the investment decisions of pension fund trustees, in particular reducing the priority that might otherwise be given to stewardship.
3. A common failure by asset owners is not to include clear direction on stewardship in their investment mandates, so that asset managers are not engaging sufficiently with company boards. Even when stewardship is implied or expressed in investment mandates, reporting on engagement is either unsatisfactory or disregarded by asset owners.
4. The cost in both time and in people with the appropriate skill level and experience impedes sufficient engagement activity. There are insufficient numbers of appropriately qualified people to engage constructively with company boards, frequently preventing the dialogue from reaching an acceptable standard.
5. Cultural and structural barriers within the investment industry prevent sufficient priority being given to stewardship.
6. The increase in international ownership of UK equities makes stewardship more difficult to implement.
7. Insufficient attention is given to the interests of the ultimate beneficiaries (i.e. savers and pension fund members) in the investment process.

This project and its aims

This project has been conducted from the perspective of the United Kingdom (UK) but within a European Union (EU) context. It does not purport to address stewardship at an EU level, but nevertheless aims to contribute to the current debate on EU corporate governance.

The project focuses on three key impediments to stewardship which have been identified as particularly significant and requiring attention before progress on effective stewardship can be made. Other relevant impediments were given consideration and are listed in Section 4 of this report.

A. **Lack of direction** on the part of asset owners in mandates awarded to their agents, the asset managers

B. **Costs** both in time and people with the appropriate competencies

C. **Cultural and structural barriers** within the investment management industry itself.

A set of proposed solutions falls under three headings, namely:

- The investment chain and fiduciary duty
- Shareholder engagement
- Investment management practice

followed by:

- Recommendations on next steps for implementation

However, these recommendations are made acknowledging that the proposed changes in practice and behaviours will take time to achieve and can only follow from further debate amongst the constituencies involved, including government and regulators. The project has also revealed, and this report proposes, that more work should be done on some aspects in order to provide further and necessary substance to inform the debate and eventual conclusions for policy, regulation and, most particularly, practice by principals and agents in the investment chain.

In essence, therefore, this project aims to widen and deepen the debate to achieve progress in making the practice of stewardship effective, fulfilling its important place in the investment process.

Introduction

The financial crisis of 2007-2008 prompted a serious review of the corporate governance of banks and, at the same time, triggered a review of corporate governance of listed companies generally. These reviews have occurred in both the UK and EU. Central to these reviews has been the important role of institutional shareholders in the prevailing shareholder model of governance. In the UK this analysis has resulted in the publication in July 2010 by the Financial Reporting Council (FRC) of the Stewardship Code for institutional investors[1]. This publication followed closely on the heels of a review of corporate governance in UK banks by Sir David Walker, published in November 2009[2]. The European Commission reacted by publishing a green paper on corporate governance in financial institutions[3], which has now been followed by a second green paper on the corporate governance of all listed companies[4].

The FRC states that the aims of the Stewardship Code are

> *"to enhance the quality of engagement between institutional shareholders and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities (p.1)",*

and states further that

> *"by creating a sound basis of engagement [the Code] should create a much needed stronger link between governance and the investment process (p.1)".*

The Stewardship Code is addressed primarily to asset managers, but is also directed at asset owners.

In the light of the evolution of UK corporate governance over the last 18 years, starting with the Cadbury Code[5] published in 1992 to the present day UK Corporate Governance Code[6] in 2010, the Stewardship Code will likely, and indeed necessarily, evolve over time. This is reflected in the FRC's intention to periodically review and update the Code to take account of lessons learned and experience gained from its application in practice. However, it is already evident that for stewardship to take proper effect, some potential difficulties in its acceptance as an important responsibility and its implementation need consideration.

CFA Institute, the global not-for-profit professional association of holders of the Chartered Financial Analyst® designation, portfolio managers, investment advisers, and other investment professionals in 135 countries, in a survey of its members carried out in 2010, identified a number of difficulties from the perspective of the investment community which need to be resolved before stewardship can be effective in practice. The survey, and the interpretation of the results, informed the CFA Institute response to the FRC's "Consultation on a Stewardship Code for Institutional Investors" in January 2010[7]. In summary, only a third of the survey respondents answered questions concerning the Code and its application. The CFA Institute interpretation of this behaviour was that either members did not understand the content, or possible application, of the Code, or they did not believe it was useful or practicable. On this second point, the results indicated that smaller funds did not have the resources to conduct stewardship, that the increasing number of portfolio holdings made stewardship impractical, and that reliance on the 'comply or explain' mechanism could result in the excessive use of 'boilerplate' disclosure of

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[1] Financial Reporting Council, 'The UK Stewardship Code', (July 2010): http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf

[2] David Walker, 'A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations', (26 November 2009): http://www.hm-treasury.gov.uk/walker_review_information.htm

[3] European Commission, 'Corporate Governance in Financial Institutions and Remuneration Policies', (2 June 2010): http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf

[4] European Commission, 'The EU Corporate Governance Framework, (April 2011): http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf

[5] The Committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd., 'The Financial Aspects of Corporate Governance' (1 December 1992)

[6] Financial Reporting Council, 'The UK Corporate Governance Code', (June 2010): http://www.frc.org.uk/documents/pagemanager/Corporate_Governance/UK%20Corp%20Gov%20Code%20June%202010.pdf

[7] CFA Institute, 'Financial Reporting Council—Consultation on a Stewardship Code for Institutional Investors—January 2010', (30 April 2010): http://www.cfainstitute.org/Comment%20Letters/20100430.pdf

limited use to investors, stakeholders, and regulators. In conclusion, CFA Institute believed that the Code would only apply to a rather small and exclusive part of the investment management industry, thereby placing the burden of improving corporate governance on a disproportionately small minority of investors.

In August 2008, the Foundation for Governance Research and Education (FGRE) published the results of its work on institutional shareholder engagement with the boards of FTSE-250 and small cap companies[8]. The publication noted that the evolution of corporate governance in the UK, since the Cadbury Committee Report of 1992, had been chiefly concerned with the roles and responsibilities of companies and their boards of directors. The roles and responsibilities of institutional shareholders, in contrast, had received relatively little attention in the then Combined Code (now the UK Corporate Governance Code). The publication included amongst its recommendations the need to give consideration to establishing a code for institutional shareholders, one to sit alongside the Governance Code. Recognising the importance of institutional shareholder engagement with boards of directors in the implementation of the Governance Code (i.e. 'comply or explain'), as well as the relationship between shareholders and boards, the publication also included recommendations to enhance the quality of dialogue.

Recognising the need for a clearer understanding of the difficulties and impediments to effective stewardship and the need to seek resolutions, FGRE, a charitable trust dedicated to thought leadership and best practice in governance, with the support of CFA Institute, has produced this report on stewardship.

[8] Foundation for Governance Research and Education, 'Engagement between Boards of FTSE small cap and FTSE250 Companies and Institutional Shareholders, (August 2008): http://www.foundationgre.com/FGRE%20engagement%20pub.no.1%20%208.08.pdf

Terms of Reference and Implementation

The terms of reference for the project and its implementation were agreed as follows:

1. To investigate the impediments institutional investors face which discourage them from engaging with issuers on matters of corporate governance and which inhibit effective implementation of the Stewardship Code and stewardship generally.

2. To focus the investigation on structural impediments that lie within the institutional investment sector (from ultimate investor to issuer) by analysis of the existing framework and culture.

3. To recommend solutions to address these impediments.

4. To conduct the investigation by assembling and working with a group of experienced practitioners – representing institutional investors, issuers, and fund trustees – and academics, to provide objective input through discussion and debate. This analysis will be supplemented from time to time with other practitioners to gain the benefit of their experience.

The core group comprised a taskforce drawn from investment and governance specialists and fund trustees. This taskforce is listed on page 3 and was the principal body for discussion and debate. The issuers were represented by a selected group of chairmen of major companies. This group is listed in Annex 1.

The combination of a core group of specialists in investment management, governance and fund trusteeship, with legal expertise on the one hand, coupled with input from a selected group of chairmen from the corporate sector on the other, represents a unique source of expertise and experience covering all relevant inputs to a serious consideration of stewardship.

The "other practitioners" group is listed in Annex 2.

1. Stewardship

1.1 Definitions of stewardship by the FRC and FairPensions

The FRC's definition of stewardship, taken from the preface to the UK Stewardship Code[9], is –

> *"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. Engagement includes pursuing purposeful dialogue on strategy, performance and the management of risk, as well as on issues that are the immediate subject of votes at general meetings (p.1)."*

This description makes a clear link between stewardship and engagement and includes a brief explanation of what comprises engagement.

FairPensions[10] defines stewardship as –

> *"The responsibility to take all reasonable steps to ensure (i) that investee companies have business models which can deliver growth in shareholder value over the long-term and which have proper regard to the wider economy and environment, and (ii) that such business models are being effectively implemented (p.1)."*

It goes on to link engagement with stewardship –

> *"Engagement is the means whereby the stewardship responsibility is discharged (p.18)."*

In both these definitions stewardship implies engagement, although in the FRC definition this is more explicit.

1.2 Stewardship and engagement

This project has focused on stewardship and, in particular, on engagement between institutional shareholders and the boards of companies, where engagement means dialogue between those shareholders of companies as principals and company boards of directors as agents on relevant matters (including strategy but determined by particular circumstances).

Stewardship is therefore equally the responsibility of both institutional shareholders as agents of the owners of companies, and company boards charged with managing the company and the efficient use of the capital entrusted to it.

In practice stewardship extends beyond engagement. It requires what Adam Smith would term the "anxious vigilance" which would be performed by a good owner. Sometimes this vigilance can relate to broad issues of shareowner rights. Certainly it involves becoming sufficiently knowledgeable about the operations of a company to exercise ownership rights. This knowledge includes analysis of published information and considered exercise of voting rights. Engagement and information analysis, both implemented to a high standard, determine voting decisions, the ultimate means by which shareholders are able to hold company boards to account.

The project first addressed the question of what is stewardship before seeking to clarify the objectives of stewardship, focussing on the engagement element. The main points were tested through discussion with each of the selected group of company chairmen. The conclusions are presented on the next page.

[9] The UK Stewardship Code (July 2010): http://www.frc.org.uk/images/uploaded/documents/UK%20Stewardship%20Code%20July%2020103.pdf

[10] Fair Pensions submission to FRC stewardship consultation (April 2010): http://www.fairpensions.org.uk/sites/default/files/uploaded_files/documents/StewardshipCodeFairPensions.pdf

1.3 What is stewardship?

The taskforce of investment, governance specialists and fund trustees (page 3) produced its preliminary conclusions on "What is stewardship?", which, in discussion with the selected group of chairmen of issuers (Annex 1), were refined and agreed upon, resulting in a definition of effective stewardship which breaks down as follows:

1.3.1 *From the perspective of institutional shareholders:*

i) In the first place stewardship is responsible and thoughtful ownership. It is synonymous with an ownership mindset and adopts a long-term perspective, but with a focus on value creation.

A long-term perspective and focus on value creation does not inhibit the selling of securities in the shorter term. Short-term trading provides liquidity in the capital markets. At the same time, when executed thoughtfully, selling securities can send a signal to corporate boards and management of dissatisfaction with *their* stewardship. It is therefore an integral part of shareholders holding corporate boards accountable.

ii) It is also a mechanism to ensure the appropriate use of the power vested in institutions to properly and effectively manage the funds, such as savings and pension contributions, entrusted to them by the ultimate investors, the beneficiaries.

iii) In action stewardship includes engagement on a range of issues, such as corporate strategy, risk management (including environmental and societal issues), board composition and quality of management, remuneration, and so on.

1.3.2 *From the perspective of the company:*

i) Stewardship is about responsible management of the assets entrusted to it by the shareholders, also taking into account the interests of other stakeholders.

From the perspectives of both institutional shareholders and companies trust is fundamental.

1.3.3 *Dialogue*

Dialogue between institutional shareholders and company boards is fundamental to engagement. The discussions with the selected group of chairmen of issuers on engagement and dialogue generated significant and instructive views on current status and effectiveness. These views are presented in a series of points below, which are summarised versions of non-attributable quotes:

i) *"Dialogue is for the purpose of creating better economic value."*

Engagement has an economic purpose and, therefore, the agenda for discussion between corporate boards and shareholders is to be constructive and conducted with this sole objective in mind.

ii) *"Good quality dialogue builds trust. Trust is an essential element of the relationship between boards and shareholders."*

Trust between the parties (corporate boards and shareholders) facilitates open dialogue, but is also important to raising capital.

iii) *"The dialogue, so far as stewardship is concerned, should focus on non-financial issues such as ethics and behaviour as well as, the societal, environmental, and political implications of the business model/strategy, and the quality of management and governance."*

Dialogue that is limited to financials alone is inadequate and misses the purpose of constructive and effective engagement, which should focus on issues that have economic and financial implications.

iv) *"There are insufficient numbers of fund managers capable of constructive dialogue."*

v) *"The quality of dialogue between fund managers and boards is patchy."*

What examples of good dialogue there are often take place with experienced representatives from the fund management industry.

vi) *"Strategy is a key subject for dialogue. The board is ultimately responsible for strategy."*

vii) *"Engagement is a 'two-way' responsibility – between boards and shareholders. It is not universal practice that institutions engage or that company management make a big effort to engage."*

Each of the chairmen welcomed constructive challenge and discussion of strategy. This is an important signal to the investment management community and suggests an appetite for constructive engagement on the part of corporate boards.

viii) *"Constructive challenge to management by shareholders is invaluable."*

See comment on (vii).

ix) *"Ownership without engagement is dangerous."*

Ownership **by the market as a whole** without engagement is dangerous. It undermines accountability. For corporate boards this means operating in a vacuum with insufficient contact with their sources of capital to which they are accountable. For shareholders this implies a dereliction of duty for failing to hold corporate boards to account for their stewardship of the assets entrusted to them.

These points illustrate the seriousness with which these chairmen view engagement and dialogue and, from their perspective, the value they place in constructive dialogue.

In summary companies have expectations that institutional shareholders, especially major shareholders, will engage.

1.4 The objectives of stewardship

The taskforce of investment, governance specialists and fund trustees also produced its preliminary conclusions on the objectives of stewardship, which in discussion with the selected group of chairmen of issuers were similarly refined and agreed upon.

The objectives of stewardship by institutional shareholders are fourfold. They are:

i) To generate and maximise sustainable risk-adjusted returns for shareholders and ultimate beneficiaries.

ii) To hold company boards accountable for good governance.

iii) To facilitate the fair pricing of assets and the efficient allocation of capital, in order to promote economic development.

iv) To ensure the interests of all relevant stakeholders are taken into account.

2. The Case for Stewardship

A key part of the stewardship of public companies relies on the engagement between institutional shareholders on behalf of asset owners and boards of directors.

The case for stewardship rests on the following:

i) Stewardship underpins the capitalist system which, if it were to fail, would *inter alia* have severe consequences for the investment industry.

ii) Stewardship builds value over the long term by aligning the actions of the company with those of its ultimate owner (not the owner's agent). The increase in value resulting from stewardship activity is difficult to quantify and attempts to do so have been equivocal. As a mechanism it promotes the efficient allocation of resources; the additional value of the process is measured over the issuer's investment horizon, which is generally longer than the investor's.

iii) Stewardship helps to preserve value by addressing issues which might destroy value. There is, therefore, an opportunity cost of not exercising stewardship, which is the suboptimal allocation of shareowners' scarce capital.

iv) Effective stewardship is necessary for the preservation of trust in the investment process.

v) The engagement between shareholders and boards helps build trust between the parties which is necessary for companies to have access to the capital markets.

vi) Stewardship is fundamental to the 'comply or explain' model of governance by holding boards to account. The 'comply or explain' model is accepted as a more flexible and practical alternative to regulation.

The importance of stewardship to trust (i.e. a belief that those who manage a client's money will be doing so in that client's best interests) lies at the heart of the investment system and cannot be overstated. This in turn has implications for fiduciary duty and its execution.

3. The Investment Chain – Trust and Fiduciary Duty

3.1 The investment chain

The investment chain is described below. At its heart is trust.

The exercise of trust runs right through the system. For the ultimate beneficiary the question is, "What are you doing with my savings?"

3.2 Trust and fiduciary duty

Trust (as already noted, a belief that those who manage a client's money will be doing so in that client's best interests) lies at the heart of a successful financial system. Elements which help to create trust include:

- Open markets, where clients are offered different products, and choose those which best meet their requirements;
- Regulation designed to prevent unscrupulous behaviour;
- The skill, the culture and the ethics of those involved in the investment chain; and
- Stewardship, which includes investment managers accepting their responsibilities as owners' agents in holding boards accountable. This is likely to involve engagement by investment managers with the companies in which they invest to enhance the effective management of those companies, in particular by encouraging that due weight be given to issues which influence long-term value creation.

The assumption with reference to stewardship is that investment managers enter into dialogue with the management of issuers in order to refine their understanding of the business and, in the process, discuss issues that could potentially enhance the long-term value of the business. This assumption is predicated on the assertion that the value of a business is the sum of its discounted cash flows. Hence, the dialogue will consider all opportunities for creating sustainable cash flows and all inputs necessary in order to deliver those cash flows. This process promotes price discovery and the allocation of funds (both internal and external) for investment. One consequence of shareholders failing to engage with management on these issues is that corporate managers may pursue short-term personal reward at the expense of the long-term viability of the business.

The system of oversight just discussed is critical to the trustworthiness of the financial system, but the stewardship element in particular means that investment managers need to be good ‘stewards’ of their investments. Without such stewardship it cannot be expected that companies will be run in the interests of those to whom they ultimately belong. However, it does not follow that the long-term ownership of shares is either a necessary or a sufficient condition for stewardship.

Appropriate stewardship actions depend on the situation. Each situation should be judged with reference to the intrinsic value which can be added to the company. At the same time, short-term trading of shares must be respected as an important activity integral to the workings of the capital markets and necessary to the provision of liquidity.

Clients give money to investment managers to manage on their behalf, i.e. the managers are simply agents and invest the money in companies on the basis that those companies will be run as the law prescribes and in the interests of their shareholders. For the system to promote trustworthiness, the investment managers must work, and be seen to work, on the client’s behalf. They must behave as fiduciaries. This fiduciary obligation extends beyond simply buying and selling securities. It encompasses the broader interest of investors, who are generally well diversified, to ensure the effective management of the companies in which they own securities. If they do not do this, the financial system risks being severely damaged and subjected to overly extensive and expensive regulation.

Over the last few decades the fund management industry has become skilled at diversifying risk and creating liquidity for investment. All else being equal, it is to be praised for these innovations. Diversified investment lowers the cost of capital, and liquidity allows investors with a short time horizon to support long-term projects.

However, many have observed, and our own project has confirmed, that despite these advances, the fund management industry provides an inadequate level of stewardship. Where there is a significant gap, it is likely to be costly in terms of company performance, investment returns, and the economic performance of the nation.

4. The Impediments to Effective Stewardship

This project focuses on three key and particularly significant impediments to stewardship which require attention before progress on effective stewardship can be made.

The three key impediments are:

A. Lack of direction: Direction requiring engagement by fund managers is not explicit in most investment management mandates. Hence, fund managers are not accountable to their clients for their stewardship activity.

B. Cost: Engagement requires investment in people with the appropriate skill level and experience to hold constructive dialogue at the board level. This investment in people, and time spent on engagement, add significant costs to the investment process. The economic benefits of stewardship, in contrast, are realised through the life of a company by the return on investment (from the ultimate sale of the asset) and the return of investment (from dividends or other distributions). Paradoxically, the asset owners' investment performance measurement horizon, usually quarterly, is too short to capture these benefits.

C. Cultural and structural barriers: Cultural and structural barriers underpinning common practice in the investment management sector result in engagement being given a low priority. For example, portfolio strategy (construction and the number of holdings) may undermine the scope for meaningful engagement.

It is important that other impediments to effective stewardship are recognised. The project considered the ones listed below as particularly relevant.

1. Conflicts of interest

   Conflicts of interest are ever present in many institutions and a robust policy to deal with them needs to be designed and put into effect.

2. Widely dispersed institutional share ownership including significant foreign investment.

   Dispersion of share ownership and, in particular, ownership of UK equities by overseas entities, which now accounts for around 40 percent of the market, has made stewardship the more difficult and challenging, slowing down the rate of progress.

3. Resistance to collaborative engagement amongst institutional investors, notwithstanding recent clarification (by the FSA[11]) on what constitutes a 'concert party'.

   This applies not only to UK shareholders, but also to overseas shareholders who may be unfamiliar with or wary of UK market practice.

4. Blockages and confusion in the investment chain, e.g. custodians, which make for inefficiencies in the casting of votes.

   This also includes both the length and complexity of the investment chain.

5. Resistance to public disclosure of voting records by institutional investors.

6. Pooled investment schemes preventing investors engaging directly with investee companies.

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[11] Financial Services Authority, 'Shareholder Engagement and the Current Regulatory Regime' (19 August 2009): http://www.fsa.gov.uk/pubs/other/shareholder_engagement.pdf

4.1 Addressing the Impediments to Stewardship

A close look at the investment chain provides a way to address the three key impediments to stewardship. The investment chain, in its entirety, is a collection of many principal-agent relationships, but the diagram (see Figure 3.1) is drawn so as to emphasise two particular principal-agent relationships, namely: ultimate beneficiary – asset owner; and asset owner – asset manager. In this relationship the asset owner is both principal in relation to the asset manager as agent, and agent in relation to the ultimate beneficiary as principal. Ultimate beneficiaries have entrusted the management of their funds to the asset owner and the asset owner owes a fiduciary duty to the beneficiary, by inference the asset owner delegates this fiduciary duty with the management of the funds to the asset manager.

There are numerous examples of other principal-agent relationships in the investment chain which make for complications, such as the relationships with brokers and investment banks, all of which take fees from the pool of invested funds. An important relationship for this study, in addition to the two cited earlier, is the asset owner (principal) – investment consultant (agent) relationship.

The asset owner is central to addressing all the three key impediments.

4.2 Three key impediments

4.2.1 A – Lack of direction: Direction requiring engagement by fund managers is not explicit in investment management mandates.

The decision to engage rests ultimately with the asset owner and, with advice from the investment consultant (where a consultant is involved), it is incumbent on the asset owner to devise the appropriate direction and wording in the investment mandate to the asset manager. This is a responsibility of the asset owner in the exercise of its fiduciary duty to the ultimate beneficiaries.

Evidence drawn from our project indicates that asset owners (with some notable exceptions) are not paying sufficient attention to this, which further suggests that a thoughtful and responsible ownership mindset is not common amongst asset owners. For the lay representatives of asset owners this could prove difficult, because many pension fund trustees have limited investment experience and depend heavily on the advice of agents, particularly investment consultants. The trustees' burden of responsibility, combined with a lack of investment expertise and statutory regulation, encourages the delegation of responsibility to competent agents. It may have never occurred, nor ever been suggested, to these representatives that their responsibilities go beyond quantitative measures framed by a series of short-term returns.

Resistance or omission by asset owners to paying proper regard to engagement as being part and parcel of their responsibility as owners lies at the heart of the lack of effective and constructive shareholder engagement with boards of companies. This could be construed as an abrogation of fiduciary responsibilities.

4.2.2 B – Cost: Engagement requires investment in people with the appropriate skill level and experience to hold constructive dialogue at the board level. This investment in people, in addition to time spent on engagement, adds significant costs to the investment process, but the economic benefits can only be realised over the longer term.

Engagement with investee companies is not relevant for all institutional shareholders. It is ultimately the responsibility of institutional asset owners exercising their fiduciary duty to the ultimate beneficiaries (i.e. savers and pension fund members) to decide the requirement for engagement as part of an investment strategy.

Engagement is most likely relevant when investment portfolios are large in financial terms but contain a limited number of stocks – possibly no more than 40 – and where shareholdings in each are significant. Hence, the performance of individual holdings is important to the overall performance of the fund, and the reward for action is potentially significant. Engagement with the management of the investee companies will likely be integral to the investment strategy. The human resource commitment of this engagement strategy naturally places a limit on the number of securities that can be managed within the portfolio. This strategy is not without cost;

such actively managed portfolios typically demonstrate greater tracking errors than active funds with more index-like characteristics. If the manager is skilled, the return of the limited stock portfolio will exceed that of the passive manager's portfolio.

Conversely, index fund managers who are in effect permanent owners of all companies in an index have an interest in the overall health of all companies. Hence they are sometimes described as universal owners. Because of the skewed distribution of security weightings in the indices, they are most likely to focus on engagement with the top 40 issuers in the portfolio and most often on proxy or other contentious matters. In some markets these can represent more than three-quarters of the weighting in a portfolio that could contain many hundreds of securities.

Our project has revealed that, with some exceptions, the present quality of dialogue between the investment management industry and boards of directors is insufficient to facilitate effective and constructive engagement.

The most effective forms of engagement are those where constructive dialogue takes place on a confidential basis 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 it faces to enable a fundamental appraisal of the issuer's value.

It is for asset owners to decide, based on the case for stewardship described earlier, the relevance of engagement to the investment strategy of a portfolio, bearing in mind at all times their fiduciary duty to the ultimate beneficiaries.

4.2.3 C – Cultural and structural barriers: Cultural and structural barriers underpinning common practice in the investment management sector result in engagement being given a low priority.

The most important barriers are:

i) A focus on quantitative analysis at the expense of appropriate regard for qualitative factors, both short and long term.

Quantitative analysis focuses on the issuer's historical financial data (usually expressed as comparable ratios: price to earnings, prices to sales, etc.) percentage changes in consensus forecasts (such as earnings growth, short and long-term), and other momentum indicators such as historical stock price performance. The output of quantitative analysis is to place the current price of a stock in terms of its relative historical value or historical relative value to the broader market. This is a very cost effective method of analysis, where the analyst can rapidly identify relatively cheap stocks from a large universe of securities. However the method is limited by the profile of the consensus forecasts that are incorporated into the model and their forecast horizon, which is typically between two and five years.

Unless the quantitative analyst performs further due-diligence on management's strategy, capability and business risks, he is dependent on the analysts who supply forecasts to the consensus estimate compiler to perform that work. These analysts, in the main, working for the investment banks and brokers (sell-side) communicate their findings through published research. This published research may not be used by quantitative analysts, except in summary data form, and may only contain very limited narrative on the qualitative factors. As the name suggests numbers drive quantitative analysis, hence there is little scope for qualitative input.

ii) Short-term investment performance measurement (typically quarterly) which can work against taking a longer-term perspective.

There is a clear mismatch between the portfolio performance measurement interval, and the time it takes to determine the success of an issuer's capital investment programme. As a norm, institutional fund managers are measured quarterly over a three- to five-year evaluation horizon.

In effect, the manager manages the performance measurement risk by seeking to achieve incremental quarterly gains over this three to five-year horizon. However, in the absence of specific news, the price movements of securities are determined by a whole host of non-stock specific factors, such as macro economic news and changes in sentiment. These factors have the capacity to change the value of a security by a multiple of the real change in the value of the business. An illustration of this effect is that the mean monthly return on the FTSE All-Share Index for the last 30 years is 0.65 percent; however, the monthly standard deviation of return is 4.76 percent (see Appendix III for the comprehensive set of data). Individual stock volatility within the index is much greater. Therefore, the potential gains derived from trading stocks on their volatility are a multiple of those derived from changes in underlying value. Investment managers address this market risk by being vigilant to short-term trading opportunities and owning a portfolio that closely resembles the index or performance benchmark to minimise tracking error. Unfortunately, the focus on quarterly tracking error makes it difficult to incorporate longer-term themes into the portfolio. If the market is only assimilating near-term rolling forecasts, it is uncertain that research expenditure into these longer-term themes will add value to the customer portfolio, because the fruits of this research may be ignored by the market.

iii) Insufficient understanding of investee companies through lack of fundamental analysis and risk assessment leading to imperfect discovery of intrinsic value.

As discussed earlier, many exogenous factors influence the price of a security. These factors will move the price of a security more than the underlying change in its intrinsic value. Why does this happen? There is no simple answer because markets are composed of many players using different investment styles, with different investment horizons. However, what is clear is that the fundamental performance of a security, in the short-term, is a minority factor in determining its value. Other factors, such as behavioural biases and changes in sentiment from economic data and changes in bond yields and commodity prices, dominate short-term price movements. Therefore, fundamental analysis and the issuer engagement that follows from this process are not a priority for some portfolio management strategies. In principle, where the portfolio contains many stocks, so as to control for tracking error, it is possible to ignore fundamental analysis and focus on relative-value analysis.

iv) Compensation structures geared to short-term performance, with insufficient account taken of investment performance over the longer term.

The compensation structures of fund managers are typically composed of a base salary with a potential bonus that can be many times the base salary. The argument supporting this structure is that it affords variable cost flexibility on what is typically a fixed-cost input, that of human capital. The bonus can either be related to the performance of the individual, the team, the total enterprise, or some combination of all three. The revenue growth of fund managers is directly dependent on the growth of assets under management. This growth in assets comes from gathering new funds and price appreciation of the existing assets under management. The annual accounting period, which defines the firm's profitability, has no relationship with the longer-term performance of the portfolios, unless, as occurs at some firms, there is deferral of bonus payments, controlled on longer-term performance measures and client retention.

v) The interests of the ultimate beneficiary are not given sufficient priority.

There is alignment in the interests of the asset owner and asset manager on achieving the best risk-adjusted return. The asset manager prospers from having the client's business and growing the value of the client's assets. The asset management industry has a high degree of operational leverage and derives economies of scale through standardisation.

The divergence occurs where the manager streamlines the costs of his investment process, at the expense of the ultimate beneficiaries' interests. If the fund manager considers stewardship only as a cost, rather than an asset, the fund manager is unlikely to market his services to asset owners on the basis of engaging in stewardship activity. If stewardship is not advertised as being in the long-term interests of the ultimate beneficiary, then its value can be lost in the agent-principal relationship between asset owner and manager, in the belief that a cheaper service (one without stewardship) offers better value.

However, addressing all three impediments does not provide a complete solution. Further progress requires close consideration of the nature and law underpinning fiduciary duty to which all members of the investment chain are subject. This critical issue is considered further in the following section.

5. Fiduciary Duty

This project has indicated that the current interpretation of fiduciary duty promulgated by professional advisers, primarily in the legal profession, and adopted by asset owners, is causing trustees to limit what their agents, the fund managers, should have regard to in both selecting and monitoring portfolio investments. This finding applies particularly to equities. Interpretation of fiduciary duty is laying undue emphasis on maximising financial returns in the short term at the expense of a longer-term perspective, that takes into account non-financial matters (including governance, environmental and societal issues and an assessment of risks) and of shareholder engagement with company boards. This interpretation results in significantly narrow investment mandates.

The current environment has therefore raised many questions about our understanding of fiduciary duty and its application. There is a need to take a close look at how asset owners exercise their fiduciary duty, as well as asset managers' understanding and application of the fiduciary duty delegated to them. Similarly, the duty owed by investment consultants to asset owners needs careful consideration.

In a current study on fiduciary duty, Professor Keith Johnson traces the evolution of fiduciary duty to the present day and points out the existing tension between present legal views and economic reality[12]. Our own research supports this contention.

According to Johnson, this tension can arise from a number of causes: obsession with short-term results, increased use of passive investing, market complexity, and the expanded role of investment consultants and advisers. In connection with the latter he states –

> *"…relaxation of limits on delegation of fiduciary responsibility has created a powerful user cadre of agents and experts, often with interests that conflict with those of pension scheme members. They wield increasing power and influence over fiduciaries' investment decisions. (p.2)"*

FairPensions[13], in a timely and exhaustive project about fiduciary duty, has concluded the need for fiduciary duty to be reviewed and made 'fit for purpose' for the 21st Century. In particular, FairPensions points out the fundamental flaw in current understanding and application of fiduciary duty is that the best interests of the beneficiaries, the purpose of fiduciary duty, is not accorded the priority it demands by the principals and their agents in the investment chain.

This project supports this assertion and agrees that a proper review of fiduciary duty is needed, as it applies not only to asset owners but also to other participants in the investment chain, in particular investment consultants and fund managers.

5.1 Fiduciary duty, investment mandate, and engagement

Accepting that the fiduciary duty of trustees and other asset owners must begin and end with what is in the best interests of the beneficiaries (with trustees exercising their best informed and independent judgement) does not, however, mean that engagement is a part of all investment mandates, or that all investment managers must include engagement as part of their fund management offering. Asset owners need to decide (with the help of their investment consultants, when appropriate) whether engagement is a requirement of a particular investment strategy which has been formulated based on the best interests of beneficiaries.

It is likely that present understanding and application of fiduciary duty needs clarification in order to avoid this being a barrier to asset owners including, where a necessary part of an investment strategy, a requirement for asset managers to engage.

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[12] See http://www.fairpensions.org.uk/POBI/Seminar1

[13] See http://www.fairpensions.org.uk/

5.2 Fiduciary duty, fund boards, and investment consultants

Boards of trustees of pension funds and other externally managed funds can suffer from having an insufficient number of members with investment experience. This is not an unusual situation. In these cases, the expertise of investment consultants or investment advisers becomes important. However, boards of investment trusts or in-house boards of investment funds (e.g. boards of insurance company investment funds) do not experience the same shortfall in investment expertise.

All of these boards (i.e. pension funds and other investment fund boards) owe a fiduciary duty to their ultimate beneficiaries to place the best interests of those beneficiaries at the heart of their investment decisions, and are accountable to beneficiaries for doing so. Also in the case of pension fund trustees, the fiduciary duty relationship between them and their investment consultants requires careful consideration and clarification.

6. The Regulatory Environment and Political Context

6.1 The UK

Following the financial crisis and the Walker report on the corporate governance of UK financial institutions, which referred to shortcomings in institutional shareholder engagement, there have been two notable and relevant developments on stewardship by the FRC and the UK Department of Business Innovation and Skills (DBIS).

Taking the Institutional Shareholders Committee's "The Responsibilities of Institutional Shareholders and Agents – Statement of Principals" as a basis, the FRC published the first-ever Stewardship Code for institutional shareholders in July 2010.

6.1.1 The Stewardship Code

The preface to the Stewardship Code points out that the Code

> *"sets out good practice on engagement with investee companies to which the FRC believes institutional investors should aspire (p.1)",*

and that

> *"by creating a sound basis of engagement it should create a much needed stronger link between governance and the investment process (p.1)".*

While the Code is addressed in the first instance to asset managers, in the preface it recognises that asset owners can have an important influence on engagement activity through their mandates to fund managers. Most importantly, the Stewardship Code states that

> *"institutional shareholders are free to choose whether or not to engage but their choice should be a considered one based on their investment approach (p.1)".*

This statement establishes a proper context for shareholder engagement, but the Code itself is mainly guidance on procedure. The list of Code principles below makes this evident.

"Institutional investors should:

- *publicly disclose their policy on how they will discharge their stewardship responsibilities;*
- *have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed;*
- *monitor their investee companies;*
- *establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;*
- *be willing to act collectively with other investors where appropriate;*
- *have a clear policy on voting and disclosure of voting activity;*
- *report periodically on their stewardship and voting activities. (p.4)"*

6.1.2 UK Department of Business Innovation and Skills (DBIS) Consultation "A Long-term Focus for Corporate Britain – A Call for Evidence"[14]

The DBIS consultation has raised questions on the effectiveness of shareholder engagement as well as on other connected matters. Work is still underway to analyse the responses, with the conclusions expected shortly.

The UK government believes that shareholders have responsibilities to engage as stewards in a constructive dialogue with the companies in which they invest. Further, the responsibility for monitoring company performance does not rest with fund managers alone; pension fund trustees and other owners can do so either directly or indirectly through the mandates given to fund managers. As a result, their actions can have a significant impact on the quality and quantity of engagement with UK companies. Nevertheless it is claimed that such activities are falling short because not enough effective engagement is taking place on issues of substance.

6.2 The EU

6.2.1 Green Paper on "Corporate Governance in financial institutions and remuneration policies"[15] (issued in June 2010)

In response to the financial crisis the EU issued this important green paper, which questioned the robustness of the shareholder owner model by citing shortcomings in the effectiveness of institutional shareholder engagement with the boards of financial institutions, and in their holding of boards to account. The green paper includes a section on shareholders (see Appendix II).

The green paper stimulated wider concern by the European Commission on shareholder engagement across all listed companies. The Commission's statement on this reads as follows:

> *"The Commission is aware that this problem does not affect only financial institutions. More generally, it raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders. As a result of this situation, the Commission will launch a broader review covering listed companies in general. (p.8)"*

The Commission indicated during a meeting in January 2011 that, while there had been a wide-ranging response to the section on shareholders in the green paper, any legislative response is unlikely at this stage. However, this is not ruled out following the results of the broader review covering all listed companies.

6.2.2 Green Paper on "The EU corporate governance framework"[16] (issued April 2011)

This broader review and second green paper, directed at all listed companies, is focused on board composition, shareholders, and the 'comply or explain' framework.

Shareholders' shortcomings in holding boards of listed companies to account is a major theme, with a lack of appropriate shareholder engagement cited as a concern needing attention. This green paper questions the effectiveness of the current shareholder model and seeks ways to make it more robust. It asks:

> *"Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how? (p.13)"*

In summary, at the EU level strengthening oversight by shareholders in the companies in which they invest is a legitimate concern. Failure to achieve a satisfactory outcome would have serious implications for the existing corporate governance model which is central to the capitalist system.

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[14] DBIS, 'A Long-term Focus for Corporate Britain—A Call for Evidence', (October 2010): http://www.bis.gov.uk/Consultations/a-long-term-focus-for-corporate-britain?cat=closedawaitingresponse

[15] Corporate Governance in financial institutions and remuneration policies (June 2010): http://ec.europa.eu/internal_market/company/docs/modern/com2010_284_en.pdf

[16] The EU corporate governance framework (April 2011): http://ec.europa.eu/internal_market/company/docs/modern/com2011-164_en.pdf

7. Solutions

7.1 The investment chain and fiduciary duty

This project has focussed on four principal-agent relationships in the investment chain, namely:

i) Ultimate beneficiary – asset owner
ii) Asset owner (trustee) – investment consultant
iii) Asset owner – asset manager (institutional shareholder)
iv) Investee company (issuer) – asset manager

The project has acknowledged the primacy of beneficiaries' interests and this, in turn, highlights the crucial role of asset owners whose fiduciary duty is principally owed to the beneficiaries. The scope of that duty and how that duty is applied along the chain of the principal-agent relationships under consideration in this project are both important.

It has already been pointed out that the interpretation of that duty by trustees of pension funds – which make up the largest proportion of investment funds – limits the inclusion in investment mandates of a stewardship requirement for investment managers. This limited application of fiduciary duty has become common practice; however, nothing is written in trust law to support that interpretation.

This project therefore supports the proposal by FairPensions that would require a review of fiduciary duty, with the goal of clarifying its understanding and application along the investment chain. In particular the question of the duty owed by investment consultants to asset owners, and the extent of the duty owed by asset managers, requires review and clarification.

(Note: Fiduciary duty, while a recognised construct under English law, is not common to all other European jurisdictions where civil law prevails.)

7.2 Clarifying asset owners duties

This project concludes that the principles underpinning Section 172 of the Companies Act 2006 could be applied in the context of beneficiaries (shareholders) and trustees and members of investment fund boards (directors). The 'enlightened shareholder value' concept was a main tenet of the Company Law Review[17], and the ensuing 2006 Companies Act[18] enshrined directors' general duties in statute, using the concept as a guiding principle in formulating those duties. The general duties are set out in Part 10 of the Act, in Sections 170 – 180, but it is Section 172(1) which is worthy of consideration in the light of trustees' duties.

<u>Section 172(1):</u>

"A director of a company must act in the way he/she considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to –

i) the likely consequences 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, and
vi) the need to act fairly as between members of the company."

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[17] See http://www.bis.gov.uk/policies/business-law/company-and-partnership-law/company-law/publications-archive

[18] See http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf

Accepting that the duties and responsibilities of directors of companies are not strictly comparable with those of trustees and other investment fund board members, the roles have sufficient in common to justify their respective duties being on a comparable basis. In the same way that directors of companies, as part of their general duties in statute, are required to have regard to the factors listed in 172(1), then it seems only reasonable to suggest that trustees and other investment fund board members should take into account a range of appropriate factors, including non-financial considerations (indicated in section 5) and engagement with company boards.

The over-riding duty in 172(1) is that a director is required to act in the way he or she considers, in good faith, will most likely 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 six factors outlined in Section 172(1).

Section 172(1) provides a starting point for constructing an equivalent set of duties for trustees and other investment fund board members. In particular, such a set of duties would include having regard to non-financial matters (indicated in section 5) and engagement. With these duties clarified, trustees and other board members would be required to fulfil these duties in constructing and awarding investment mandates for fund managers. They would need to be ready to explain when certain factors, which might include engagement, are not deemed relevant after due consideration.

At times the factors included in this section, and any others under consideration, may be in conflict. In these cases, trustees or investment fund board members should use their independent judgement as to what actions are in the best interests of beneficiaries as a whole.

Section 172(1) was written with the aim of changing directors' behaviour to be more inclusive in considering factors with a bearing on shareholder value, and also to take a longer term view without diluting the primacy of shareholders. In the case of pension and other investment funds, beneficiaries take the place of shareholders.

Proposing a Section 172(1) equivalent for trustees and other investment fund board members is also aimed at changing the behaviour of asset owners to have regard to non-financial matters (indicated in section 5), the longer term, and engagement in investment mandates. But such a section would also be likely to break down the prevailing defensive attitude toward fiduciary duty by making transparent the range of factors taken into account by trustees in fulfilment of that important duty.

Inserting a Section 172(1) equivalent would have the effect of making more explicit in trust law a trustee's duty to have regard to non-financial matters and engagement when, in the trustee's independent judgement, it is in the best interests of beneficiaries to include this in investment mandates.

The matters for engagement could include –

- Corporate strategy
- Board composition and effectiveness
- Remuneration
- Risk management
- Environmental and societal impact

as essential for consideration, with additional matters on a case-by-case basis depending on an investee company's individual circumstances.

7.3 Shareholder engagement

Constructive dialogue is at the heart of engagement. This project has revealed, through discussions with our selected group of experienced chairmen, that there is a need to raise the standards of dialogue between institutional shareholders and company boards. The currently low standard of dialogue is an important factor standing in the way of effective engagement and stewardship.

Improving the quality of dialogue and engagement between shareholders and boards requires the following to be addressed:

i) A framework for dialogue

ii) A clearer understanding on the part of issuers and shareholders on expectations

iii) Enhancement of the skills of those engaging from the investment side which recognises the qualities required to conduct dialogue at the most senior levels within companies

iv) Guidelines for asset owners

It has already been made clear that this level of dialogue goes beyond discussing financials alone.

7.4 Investment management practice

Fund managers with fiduciary obligations should address the following question, "Do my business processes clearly reflect that my client's interests come first?" This should precipitate a review of the following areas of business practice:

- Portfolio construction
- Research and engagement
- Portfolio turnover

The collective actions of fund managers through the buying and selling of equity securities determines the cost of equity capital. In a market dominated by institutional investors, these actors carry the responsibility of supplying and recycling scarce capital for investment in the production of goods and services. Fund managers hold a fiduciary duty to act for the benefit of their clients, to act in favour of their present and future interests. That is not to say that fund managers must be long-term holders of securities, but, where stewardship is an explicit interest of the asset owner, it does place an obligation on them to value securities with a long-term perspective. Hence, the work of fund managers in pricing and supplying capital is instrumental to employment, economic growth, and prosperity. Conversely, short-term traders provide the valuable economic service of adding liquidity to the market, which enables investors to accumulate and dispose of securities inside the issuer's capital investment cycle.

The emergence of certain practices over the last 25 years gives cause for concern that the fund management business is losing sight of its macroeconomic purpose. These practices are:

- A shift from fundamental to relative analysis
- A trend from balanced to specialist management

The consequences of these trends are a weakening in the price discovery process and the efficient allocation of capital, a focus on short-term dynamics, and a lack of interest in corporate governance. While the underlying forces that are driving these trends originate from the asset owners and their immediate advisers, it is the professional duty of the fund management industry to reflect upon these issues and enter the debate in seeking and applying solutions.

7.4.1 Portfolio construction

Over the last 40 years there has been a shift from balanced to specialist investment management mandates. The shift has its roots in the passage of the Employee Retirement Income Security Act (ERISA) of the United States in 1974. The ERISA legislation was a powerful catalyst to the development of the investment consulting business and the evolution of what has become today's best practice in pensions fund management. Under balanced management, the asset owner allocates funds to the fund manager who undertakes to invest the money across a range of asset classes in order to maximise the customer's risk adjusted return. The balanced fund manager's added value is in asset allocation and security selection. The specialist manager only manages a specific asset class; hence several specialist asset managers are required to manage the client's total portfolio. The specialist manager should be a better stock picker than the balanced manager.

Under both balanced and specialist mandates the customer's strategic asset allocation is determined through consultation with a third party, normally a pension fund consultant. Whereas the balanced manager can switch between asset classes to deliver value through tactical asset allocation, the specialist manager cannot. There is concern (as yet untested but worthy of further analysis) that, due to the difficulties of coordinating several specialist asset managers, the strategic asset allocation for a specialist mandate is relatively fixed and this may interfere with the efficient allocation of capital between asset classes. To respond to the asset owner's requirements, the specialist manager must closely mimic the client's benchmark and adopt a relative trading strategy. In many cases the ensuing equity portfolio holds so many securities that stewardship becomes impractical and ultimately of limited value to the investment process. This issue is not exclusive to specialist mandates, balanced mandates compete for client business on similar terms and may craft their portfolios to closely match the client's benchmark.

The specialisation model also creates another problem in the principal-agency relationship. Some firms may only focus on small-cap stocks, others only on technology; likewise, some managers may only invest in equities and not in any other asset class. At some stage in the market cycle, small-caps, tech stocks, and equities will either separately or together trade above a value that justifies liquidating the investments and turning away new client money. This creates a conflict where the firm should reduce the client's exposure to certain areas of the market, yet does not want to incur the operational loss or lose skilled staff if the funds and the managers cannot be deployed equally productively elsewhere in the firm. Hence, under the specialist model, it is commercially difficult for the manager to signal to the client that he should not be exposed to a particular sector of the market. Investor behavioural issues make the situation more complex; the dot-com boom presents a classic example of investor hysteria and of commercial necessity 'to make hay while the sun shines'.

Passive and active fund management characterise each end of the market in fund manager services. In between these two points there is a substantial portion of assets which are actively managed under tight constraints. Aside from the question as to whether these funds can meet their objectives after fees of outperforming passive strategies (performance records seem to be quite episodic), there is an issue with their portfolio construction. Passive strategies accept that, ex-post, they will have over-weighted expensive stocks or markets, and under-weighted cheap assets. They do this in the belief that either they cannot identify, ex-ante, cheap from expensive, or cannot do so sufficiently effectively to come out ahead net of higher costs. Full active strategies believe that it is possible to separate the expensive from the cheap. Enhanced strategies, by looking very much like the index, are prone, like passive funds, to over-weighting the expensive and under-weighting the cheap. Such funds also tend to own large numbers of stocks. As with passive funds, fundamental analysis and stewardship are not economically viable, except for the largest holdings. Further, such strategies do not focus on absolute intrinsic value but only on relative value, thus limiting their role in the price discovery and capital allocation process.

7.4.2 Research and engagement

This report strongly endorses fundamental equity analysis because this is the only approach that seeks to identify the intrinsic value of a security. Through this approach funds migrate to and from securities depending on whether they are cheap or dear and help smooth oscillations through the stock market cycle. This process contributes to the greater public good through pricing risk and directing risk capital towards the most productive opportunities.

An integral part of fundamental analysis concerns engagement. Frank and full discussion on an issuer's strategy, risks, management, and governance within an atmosphere of mutual respect helps fund managers value securities and provides an external challenge to the activities of management. It should be noted that investment has two sources of return: a return 'on' investment and a return 'of' investment. The return of investment through dividends represents an important recycling of capital. There is a concern that too much emphasis has been placed on the former (stock price appreciation) and too little on the latter. A lack of constructive engagement can lead issuers to hoard cash and pursue suboptimal strategies, such as value-destroying acquisitions. It is incumbent on fund managers to challenge the boards of issuers to demonstrate that they are directing the funds at their disposal towards projects that will earn at least their cost of capital. If not, these funds should be returned to investors for use elsewhere.

The presence of free riders on stewardship presents a concern. The argument is that stewardship is not a cost free process yet its benefits accrue to all investors. While this report believes that the individual costs of stewardship are outweighed by the benefits of better price discovery, there is a population of investors who do not hold this opinion and choose not to engage in stewardship for this reason. This raises the dilemma observed in CFA Institute's response to the FRC's consultation on stewardship that under the current circumstances:

> *"the [Stewardship] Code would only apply to a rather small and exclusive part of the investment management industry, thereby placing the burden of improving corporate governance on a disproportionately small minority of investors. (p.6)"*

This report's view is that the argument not to engage because of the free rider issue is unhelpful to the interests of beneficiaries and society at large and calls upon investors who hold this view to reconsider their position.

7.4.3 Portfolio turnover

Trading activity in institutional portfolios accelerated with the narrowing of trading spreads and the introduction of technology in the late 1980s. It is an illusion to believe that all investors can consistently outperform the market by engaging in short-term trading strategies (although this is not to deny that some active managers trade profitably). Not only are they trading against themselves, a zero-sum-gain situation; they also incur frictional trading costs. Further, there is an argument that they are less informed than their agents – the investment banks and brokers – when it comes to market timing activities because they have a less complete view of the market. Hence, on average, they are likely to lose money when they trade against these intermediaries.

7.4.4 Fund manager selection

Where asset owners decide to integrate stewardship as part of their investment mandate, they need to select fund managers who are able to execute that requirement. These managers are likely to demonstrate the following characteristics:

- Their investment process depends heavily on fundamental analysis.
- They run a limited stock portfolio, taking significant positions against the security's weighting in the index.
- They have low portfolio turnover relative to current industry practice.

In order to support stewardship, asset owners should put more emphasis on longer-term performance rather than quarterly, and increase their tolerance to tracking error. Asset owners can gain greater assurance between measurement periods by defining the quality of securities held in the portfolio, using criteria such as balance sheet strength, the size of revenues, and other income statement measures. With regards to tracking error, asset owners can either set a wider range or alternatively construct a portfolio which uses a combination of active and passive funds to control for this factor.

7.4.5 Stewardship and long-term ownership

Stewardship implies a long-term perspective on investment, this should not to be confused with long-term ownership. Investors who incorporate stewardship into their investment process will value securities on the sum of the present value of their cash flows until the businesses cease trading. This does not mean that the investor who buys a security has the intention of holding it until it ceases trading. The virtue of publicly traded securities is that they can change hands between investors, and that ability makes public securities more valuable than private securities. The liquidity of the public markets has a value that reduces the overall cost of capital.

If the efficient allocation of capital is price determined, then when an investor buys a stock cheaply he should want to sell it when it becomes expensive. The investor may have a price target set at a one-year horizon; if that horizon is met and exceeded within 12 months at a level beyond 'reasonable' valuation, then the rational action is to sell the security. Similarly, an investor could buy a security that is trading above current fair value, if he seeks to change some aspect of the business that will increase its value. For example, if the management is not maximising the opportunities presented to the business, then an investor could lobby the management to change direction to maximise the value of the assets. The investor may have to wait a long time before he can convince the management to effect change. Hence, the investor is a long-term holder seeking extraordinary returns, but may accept the market return while he is waiting.

In some European markets, issuers are able to offer inducements to encourage long-term ownership. These inducements can take the form of extra voting rights and additional dividends. Such inducements do not of themselves encourage stewardship but merely encourage longer-term ownership. The secondary effects are to interfere with the price discovery process and to create two classes of ownership in the same underlying security. Further such inducements could restrict the flow of capital to other more productive uses.

8. Recommendations and Next Steps

To make progress on stewardship will require further work and debate of solutions amongst the various parties involved. This report aims to stimulate those actions on the basis of the following recommendations.

1. To encourage professional advisers, especially lawyers, to reappraise how the principles of fiduciary duty should be applied as part of the investment process. A first step could be to convene a group of legal experts, principally current practitioners, to confirm that, under the existing law, asset owners discharging their fiduciary duty may have regard to a broader range of factors than current practice encourages. This would remove some of the perceived restrictions on what asset owners may properly consider when making decisions on investment strategy and investment mandates.

2. To follow up with a meeting of legal experts (drawn from above), a small selected group of trustees, and other investment fund board members, to give a lead to endorsing the wider interpretation of fiduciary duty under the existing law.

3. To initiate and continue further debate on solutions by convening meetings with relevant parties including:

   i) UK DBIS
   ii) European Commission
   iii) Asset owners
   iv) Investment consultants
   v) Asset managers
   vi) Company directors

4. To agree and resource the further work needed to initiate the solutions proposed. To:

   i) Review and clarify the fiduciary duties of principals (asset owners) and agents (asset managers and investment consultants) in the investment chain, and their respective roles.

   ii) Develop a duty equivalent to Section 172 (1) of the Companies Act 2006 for trustees and other investment fund board members regarding engagement on a definitive range of matters (amongst others) in their investment strategies and instruct their fund managers accordingly.

   iii) Review and clarify the technical skills and other attributes required of those from the fund management industry to engage constructively with corporate boards, and establish a framework to guide the content of dialogue for engagement.

   iv) Create a set of standards to ensure effective and constructive engagement, and a set of principles for asset owners to consider when deciding a requirement for engagement by their fund managers.

   v) Investigate communication with ultimate beneficiaries to raise awareness of the investment process and build trust in the system.

Appendix I

Investment management practice

The art of investment management is to invest a pool of funds so as to deliver the greatest return subject to a specified risk constraint over a defined investment horizon, to meet a future liability. The investment portfolio is usually subject to one or more other investment constraints, such as liquidity requirements, tax circumstances, legal situation, and unique circumstances, which could include environmental and societal issues. In most cases, investment professionals called investment managers[19] conduct investment management[20]. They are the agents of the person or people who own the pool of funds.

Investment management mandate

The investment management mandate is a formal agreement between the owner of the funds and the manager. It describes how the funds should be managed, defines the various portfolio constraints, and the remuneration of the manager. In trust-style situations, such as pension funds, these agreements can be complex and often require the input of other agents (pension fund consultants and lawyers). In simple collective schemes, such as unit trusts, these agreements are less complex; the asset owner makes a choice from a range of products, largely based on the description of the investment strategy. In all cases, the opportunity for the asset owner to require that the investment manager conduct stewardship as part of the investment process is either prescribed or selected through the investment management mandate. The investment manager constructs a portfolio of assets that is consistent with the investment mandate. The portfolio's risk constraints influence the choice of assets held in the portfolio, which in turn govern its targeted return. Low-risk portfolios hold assets such as short-term government bonds and, as a consequence, will deliver lower returns than high-risk portfolios that could contain equities or alternative assets.

Diversification

A key aspect of investment management is diversification of risk through holding many individual investments, as opposed to a few. Diversification reduces risk on the basis that during normal market activity, not all stocks move in the same direction or in the same order of magnitude at once. In mathematical terms, the securities are not perfectly correlated with each other. Hence, the fund manager can reduce the overall risk characteristics of the portfolio by selecting lowly correlated stocks. In reality, there are limits to diversification because all securities have a link to the performance of the economy. Evans and Archer[21] conducted the original academic analysis of diversification as a method to reduce dispersion of portfolio returns. Fisher and Lorie[22] and Elton and Gruber[23] conducted follow up studies. All these studies recognised that the gains from diversification diminish with each additional holding. Academic consensus suggested that holding between 30 and 40 securities achieves nearly all the benefits of diversification (see the following table and chart). In abnormal market conditions characterised by financial panics or periods of excess liquidity, the correlation of all assets commonly trends to one, extinguishing benefits of diversification.

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[19] Investment managers are frequently called asset managers

[20] The terms investment management and asset management are interchangeable

[21] Evans & Archer "Diversification and the Reduction of Dispersion: An empirical Analysis" (Dec 1968)

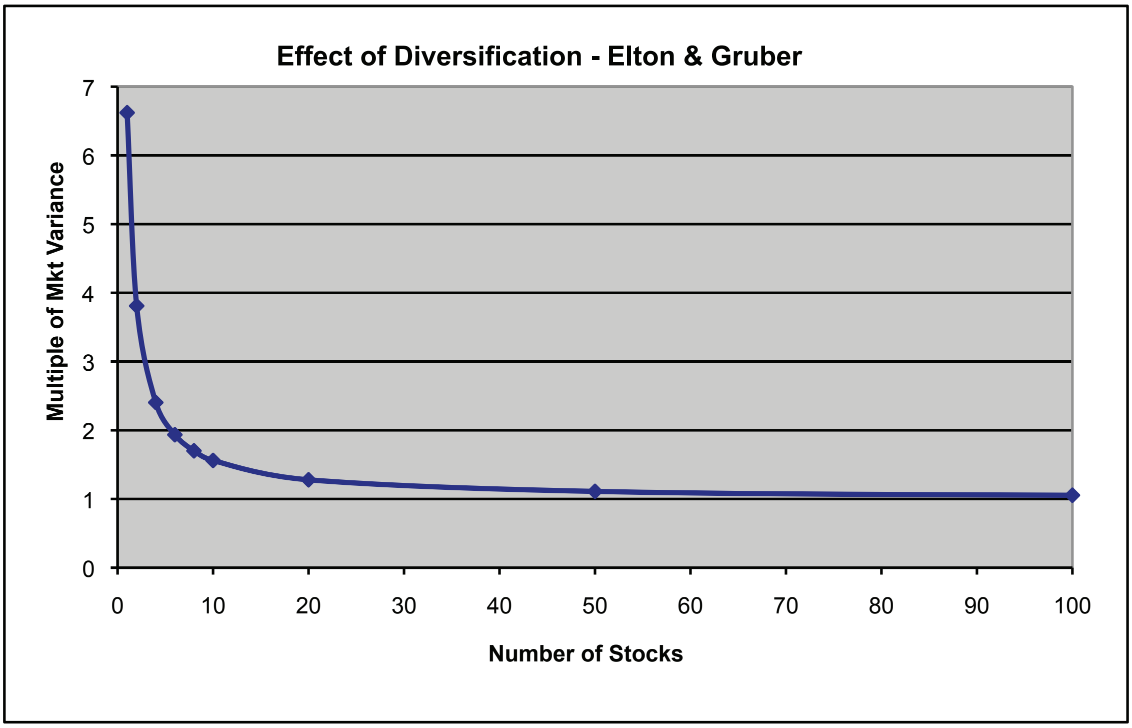
[22] Fisher & Lorie "Some Studies of Variability of Returns on Investments in Common Stocks" (Apr 1970)

[23] Elton & Gruber "Risk Reduction and Portfolio Size: An Analytical Solution" (Oct 1977)

The following table is an abridged version of Table 8 in the Elton and Gruber paper, with the addition of a column to illustrate the multiple of portfolio variance (controlled by the number of securities) to the variance on the market portfolio.

Number of Securities	Total Risk	Risk as a Multiple of the Market Portfolio
1	46.81%	6.6211
2	26.93%	3.8096
4	17.00%	2.4040
6	13.68%	1.9354
8	12.03%	1.7011
10	11.03%	1.5605
20	9.05%	1.2793
50	7.85%	1.1107
100	7.46%	1.0545
200	7.26%	1.0263
500	7.14%	1.0095
1000	7.10%	1.0038
Minimum	7.07%	= Variance of market portfolio

Source: Based on Elton and Gruber (1977).



Source: Based on Elton and Gruber (1977).

The Undertakings for Collective Investment in Transferable Securities (UCITS) directive of the European Union seeks to protect retail investors from excessive diversifiable risk by requiring investment managers to diversify their portfolios. In an equity fund, no single security can exceed 10 percent of the value of the fund, and holdings between 5 percent and 10 percent can not exceed 40 percent of the aggregate value of the fund[24].

Security valuation

Security valuation seeks to discover the intrinsic or present value of an asset. Intrinsic value reflects all of the asset's expected cash flows, including the terminal cash flow, discounted by the cost of capital. The sum of these discounted cash flows equals the present value of the asset. This process is readily applied to assets of finite duration, such as bonds, but becomes more complex where the life of the asset is infinite, as in equities[25]. In the absence of pre-determined cash flows and consensus on the cost of capital, the analyst has to use his judgement. By inference, the best equity analyst makes the most accurate forecasts of the issuer's cash flows. Hence the most accurate forecasters will thoroughly understand the issuer's business. Only through management dialogue and other external enquiries will the critically minded analyst be able to develop reliable forecasts. Whilst assembling his analytical model, the analyst is likely to run into what if scenarios. When discussing these 'what ifs' with the board of an issuer, the analyst is likely to share his opinion on what decision might produce the more value-creating outcome. Such a discussion amounts to active engagement through 'thoughtful ownership', a core attribute of good stewardship.

The valuation process that seeks the intrinsic value of a security is known as fundamental analysis. In addition to fundamental analysis, there are other forms of analysis: relative, quantitative, and technical. As the title suggests, relative analysis compares the market prices of assets. Quantitative analysis is often a more sophisticated form of relative analysis. Technical analysis uses past stock price movements to predict the future. These alternative forms of analysis raise one significant issue. These methods rarely consider the business or the human factors that manage the business. It is therefore reasonable to suggest that these forms of analysis separate the underlying business of the security from its perceived value by market participants. Securities analysed by these methods will not gravitate towards intrinsic value. It would become a serious concern if these methods of analysis dominated stock selection, because the market would fail to accurately price risk. Flows of funds would dictate the direction of the markets rather than the pursuit of fair value. This would have implications on the allocation of new capital and possibly have a pro-cyclical effect on the normal market cycle, by both heightening market peaks and deepening market troughs.

Big Bang, the narrowing of trading spreads and the influence of technology

The 27th October 1986 was a watershed day in the London financial markets. Popularly referred to as "Big Bang" the 27th October marked a sudden switch in process and procedure in the securities markets, through deregulation, with the aim of bolstering London's position as a major financial centre. Major elements of the deregulation were the move to single capacity, the abolition of fixed commissions, a shift to electronic trading, and foreign ownership of stock broking firms. The deregulation unlocked competitive forces in the markets, which significantly narrowed trading spreads and stimulated a substantial increase in trading activity.

The late 1980s saw the widespread adoption of technology in the financial services business, through the proliferation of desktop computers and software, which afforded spreadsheet analysis, charting and document creation. At the same time, there were significant improvements in the provision of real-time financial information and business news, from providers such as Reuters and Bloomberg. This was partly a function of deregulation, because the London Stock Exchange lost its monopoly on the distribution of financial data and news, allowing new entrants into this market. By connecting these information services with their desktop computers, fund managers were able to monitor the holdings in their portfolios in real-time, and consequently

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[24] Directive 2009/65/EC, Article 52, page 63 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:en:PDF

[25] A general assumption in equity analysis

measure the impact of news and other market movements on the value of a holding and the portfolio. The use of this technology very probably increased the propensity of fund managers to trade. During this time, it became common for stockbrokers to offer these information and news services to their clients in exchange for 'soft commission' agreements. Hence, fund managers were tempted to trade more frequently through the provision of this technology and obliged to do so in order to retain the use of the technology[26].

Portfolio performance measurement and stock indices

Another effect of the introduction of technology was a growth in the speed, affordability, and sophistication of portfolio performance measurement and attribution. As a consequence, asset owners demanded more comprehensive portfolio performance presentations from their fund managers. In the early 1980s it was satisfactory to compare the portfolio with other portfolios with similar investment mandates; by the late 1990s it had become standard to measure the portfolio against an index. The technology enabled the asset owner to evaluate the fund manager's performance by asset, country, sector, and stock selection. It was at this time that tracking error across the last three evaluation criteria became a material consideration for manager selection and retention.

Standard stock indices are market-value weighted, where the weight of a stock in an index is proportionate to its capitalisation. The justification for this approach is that under modern portfolio theory, the optimal portfolio holds the market of all securities. This approach is not without its critics. The market-weighted index is silent on underlying value and prone to respond to flows of funds. The Japanese market boom of the 1980s illustrates the problem. International portfolio strategies, which focused on security selection fixed to relative country weightings in a global index, were forced to increase their exposure to the Japanese market as it increased in value in order to manage their tracking error. Eventually the Japanese bubble burst and many investors lost money because they focused on relative value within a market rather than on fundamental valuation.

Indices maintain their popularity because there is a substantial and growing interest in passive or index fund management. Passive management has a history of 'consistently' outperforming half of all investors; due to lower costs, passive management will always outperform more than half of the universe of investors. Asset owners appreciate the benefits of passive management for its consistent performance at a relatively low cost. There is certainly a place for passive management as a risk management tool, but it does not lead to price discovery or the efficient allocation of capital.

Fund management and the status of stewardship

The previous paragraphs illustrate that the events of the late 1980s had a significant impact on the way fund managers operate. The use of new technology gave asset owners greater insight into the performance of their fund managers. While greater fund manager accountability is a desirable outcome, the changes in methods of evaluating fund managers, with a focus on quarterly performance and tracking error, may have had negative secondary effects on price discovery, the allocation of capital, and interest in stewardship.

In response to customer demand fund managers offer a broad range of services from the active to the purely passive. A high proportion of funds are managed actively within tight constraints. These funds have the following characteristics:

- They hold a large number of securities,
- The size of their positions is referenced by the security's weighting in the benchmark index, and
- Security selection and the decision to trade are based on relative analysis.

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[26] A four times commission multiple was the common ratio for soft commission agreements. Hence if a Bloomberg terminal cost £1,000 per month, the fund manager would have to generate £4,000 of commission for the broker in the month to cover the cost of the terminal, before consideration of any other services that the broker may provide.

A consequence of holding many securities is that there is a limit to how closely the fund manager can follow any particular investment in detail. In order to process all the information generated by his many holdings, the fund manager must largely depend on relative analysis for the basis of his investment decisions. Whilst the fund manager may engage with the management of the companies in which he invests, his interests are to confirm short-term financial metrics, such as sales, margins, working capital, and borrowings. He is unable to process a detailed analysis of the company's strategy, nor how it relates to the market opportunity. Issues of corporate governance become a tertiary consideration, and are frequently delegated to a third party. Anecdotal evidence from the management of issuers confirms these statements; they complain that engagement is too driven by quantitative rather than qualitative considerations.

At both the active and fully passive ends of the market there are a number of fund managers who are fully engaged in stewardship activity. Active fund managers running focused and activist funds, some hedge funds, and investment trusts tend to take large positions in a limited number of securities. Their investment process demands that they closely follow their investee companies. Conversely, some passive managers see themselves as universal owners and hence have an interest in stewardship of the whole market. Whilst in most cases they do not have the resources to closely follow the majority of stocks in their portfolios, the concentrated nature of the indices allows limited monitoring and the exercise of rights in the majority of the index by value[27].

[27] The top 30 stocks of the FTSE 100 and FTSE All-Share indices respectively represent nearly 79% and 67% of the value of these indices (31st December 2010)

Appendix II

EU Green Paper on 'Corporate Governance in Financial Institutions and Remuneration Policies'

The EU's green paper, 'Corporate Governance in Financial Institutions and Remuneration Policies', is introduced as follows:

"3.5 The role of shareholders

The financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least.

The growing importance of financial markets in the economy, due in particular to the multiplication of sources of financing/capital injections, has created new categories of shareholders. Such shareholders sometimes seem to show little interest in the long-term governance objectives of the businesses/financial institutions in which they invest and may be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons. In this respect, the sought-after alignment of directors' interests with those of these new categories of shareholder has amplified risk-taking and, in many cases, contributed to excessive remuneration for directors, based on the short-term share value of the company/financial institution as the only performance criterion. Several factors can help to explain the disinterest or passivity of shareholders with regard to their financial institutions:

- *Certain profitability models, based on possession of portfolios of different shares, lead to the abstraction, or even disappearance, of the concept of ownership normally associated with holding shares.*
- *The costs which institutional investors would face if they wanted to actively engage in governance of the financial institution can dissuade them, particularly if their participation is minimal.*
- *Conflicts of interest.*
- *The lack of effective rights allowing shareholders to exercise control (such as, for example, the lack of voting rights on director remuneration in certain jurisdictions), the maintenance of certain obstacles to the exercise of cross-border voting rights, uncertainty over certain legal concepts (for example that of 'acting in concert') and financial institutions' disclosure to shareholders of information which is too complicated and unreadable, in particular with regard to risk, could all play a part, to varying degrees, in dissuading investors from playing an active role in the financial institutions in which they have invested. (p.8)"*

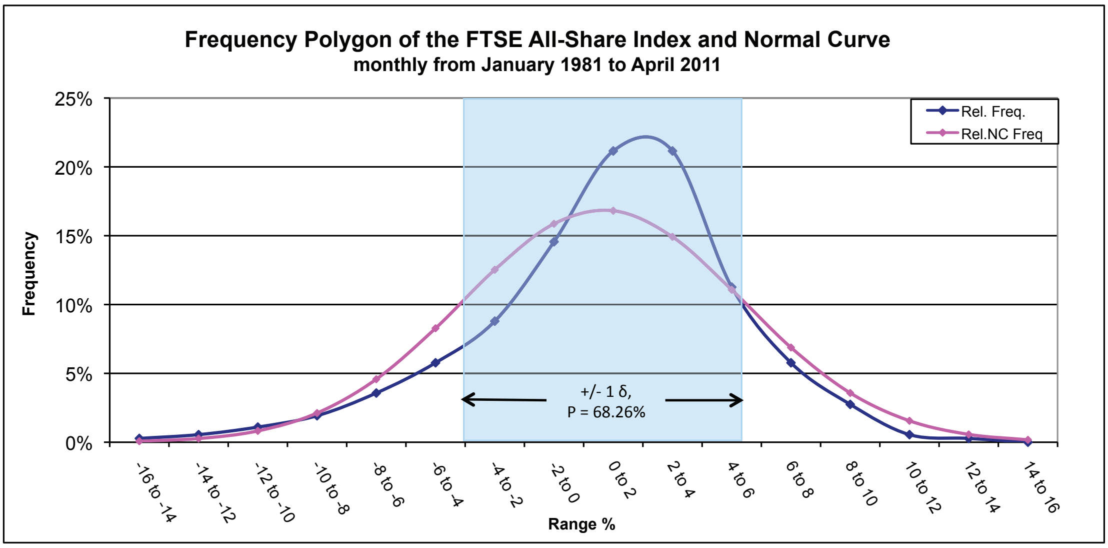
Appendix III

Statistical analysis of risk and return on the FTSE All-Share Index

Financial analysts model the distribution of returns from securities and indices through a 'normal distribution curve'. The data below provides a statistical analysis of the distribution of monthly returns on the FTSE All-Share Index from January 1981 to April 2011. The chart plots the recorded relative returns of the index and the normal curve using the same mean and standard deviation statistics. The fit is less than perfect, but it is generally acceptable for modelling purposes.

The standard deviation of return is a popular measure of risk, where statistical analysis predicts that just over two-thirds of events will occur between plus and minus one standard deviation from the mean return. The pale blue box on the chart illustrates the predication in terms of the normal curve. However, reality demonstrates that this occurs more often than expected, and in this case, nearly three-quarters of all occurrences fall between this range.

FT All-Share Index – Jan 1981 to Apr 2011	
Sample	364
Mean	0.65%
Median	1.24%
Variance	0.225%
Standard Deviation	4.74%
High	12.98%
Low	-30.92%
Range	43.90%
Skewness	-1.363
ex-Kurtosis	5.782



Annex 1

ISSUERS

Robert Beeston	*Chairman*, Elementis plc
Sir Roger Carr	*Chairman*, Centrica plc
Sir John Egan	*former Chairman*, Severn Trent plc
Lord (Michael) Grade of Yarmouth	*former Executive Chairman*, ITV plc and *Chairman*, Pinewood Shepperton plc
Lord (David) Simon of Highbury	*former CEO*, BP plc
David Tyler	*Chairman*, Sainsbury plc

Annex 2

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