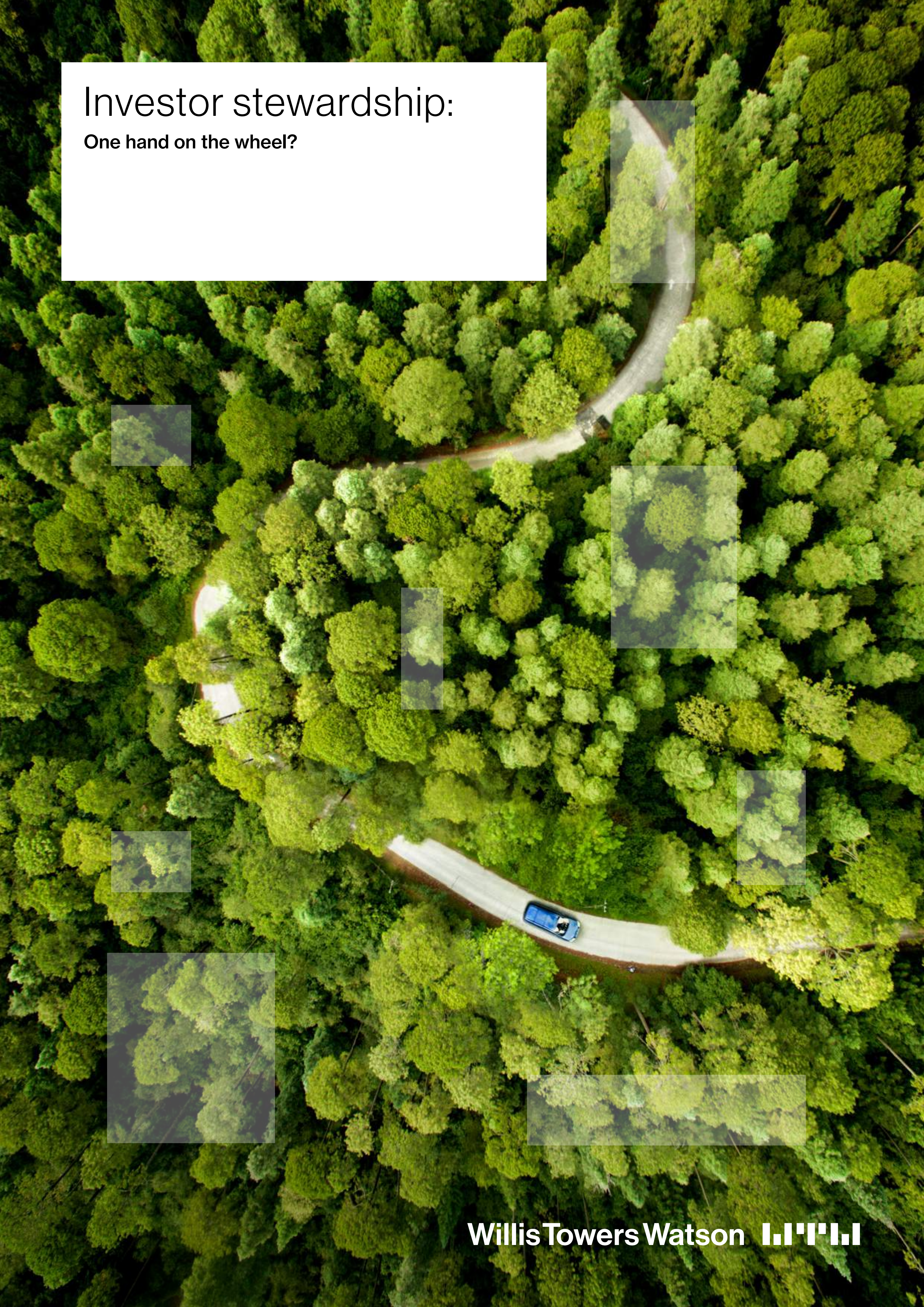
Investor stewardship:

One hand on the the wheel?



Willis Towers Watson

Investor stewardship: one hand on the wheel?

What investment activity, when done well, means improved outcomes for everyone: better returns for investors, better run companies, better controlled societal and environmental footprints – all while being cost-effective?

The answer: Stewardship, where asset managers or asset owners engage and vote to positively influence assets they invest in.

Arguably, good stewardship is the most useful function the asset management industry performs. Unlike trying to outperform a benchmark, where there are winners and losers, evidence suggests that effective stewardship has broad benefits.[1] Stewardship is expected by regulators to offset potential conflicts where there is separation of ownership and control. We have seen past examples of what can happen when there is too little oversight: accounting scandals; excessive executive compensation; value destructive acquisitions; environmental damage; loss of customer trust. Of course, this does not all lie at the feet of shareholders, but shareholders do have a responsibility as one of the key checks within the system – alongside boards and regulators.

Unfortunately stewardship activities account for only a very small fraction of asset management industry activity.

Why? It is tricky to measure, can involve uncomfortable conversations with company management and it is difficult for asset managers to monetise given the free rider problem that stems from fragmented ownership interests.

In 2009, referring to the global financial crisis, Lord Myners suggested institutional investors were "asleep at the wheel" when it came to stewardship. Perhaps it is now fair to say investors have one hand on the wheel, at least amongst some of the biggest asset managers and asset owners.

But there is still lots more to do. This note is a call to action for the investment community to redouble its stewardship efforts.

[1]Dimson, Karakas, Li. Active Ownership, Review of Financial Studies, 2015.
Junkin. Update to the "CalPERS Effect" on Targeted Company Share Prices, Wilshire Associate, 2013.
Hoepner, Oikonomou, Zhou. ESG Engagement in Extractive Industries: return and risk, 2015.
Gond, O'Sullivan, Slager, Homanen, Viehs, Mosony. How ESG engagement creates value for investors and companies, 2018.

To bring the subject to life, this paper is based on our research of six large asset managers emphasising index tracking who collectively manage assets in excess of US$ 17 trillion: BlackRock, Legal & General Investment Management (LGIM), Northern Trust Asset Management, State Street Global Advisors (SSGA), UBS Asset Management (UBS) and Vanguard.

Index managers play a critical role in company stewardship given increasingly large, and growing, ownership levels.

Over the last ten years the six managers above grew total assets by 144% on average compared to 35% across the largest 500 asset managers globally.[2]

Improving practice

"Passive management" is a misleading label when it comes to stewardship. More and more, index managers actively seek to improve the basket of securities within an index by acting as long-term owners.

All the managers in our sample acknowledge their responsibility and opportunity to create value in this area. They contribute to stewardship both at the company level and to various policy initiatives. All are signatories to numerous local stewardship codes.

It is good to see that approaches are progressing from a more rules-based corporate governance function into a broader stewardship approach that looks to address key drivers of long-term value creation. The processes and areas of strength differ between managers which adds diversity – there is no single 'right way'.

[2]Source: Thinking Ahead Institute and Pensions & Investments "The World's largest 500 asset managers", 2018. Index manager sample includes all assets managed by those managers.

Here we highlight positive examples from each of the managers:

BlackRock: Voice from the top

BlackRock has clear 'tone from the top' from Larry Fink's well known public annual letters to company CEOs. This has included a public commitment to double resourcing for the stewardship team which, at the time, was already the largest across the group of managers.

LARRY FINK'S ANNUAL LETTER TO CEOS

A Sense of Purpose

LGIM: Climate Impact Pledge

This is a well signposted multi-year campaign to encourage companies to manage their exposure to climate risk. Launched in 2016, LGIM issued a 2018 progress report naming leaders and laggards. While others note climate risk as a priority, the difference here is the level of coordinated effort and strong communication around a particular theme.

LGIM's Climate Impact Pledge: The results so far

We are publicising the global corporate leaders and laggards on climate change.

Northern Trust Asset Management: Hermes EOS

To augment its internal team Northern Trust Asset Management partners with Hermes EOS – a longstanding and high quality third party stewardship provider – to undertake company engagement in EMEA. They have worked together on policy and other initiatives. This approach complements the internal engagement platform in the US. One solution to the ownership fragmentation challenge is for different asset owners and asset managers to pool resources and use a group such as Hermes EOS.

NORTHERN TRUST   HERMES EOS

(Continued overleaf...)

SSGA – Gender diversity on boards

Stewardship activity has in the past largely been kept behind closed doors. But if the objective is to achieve broad-based change then sometimes a creative public campaign is powerful. The Fearless Girl sculpture commissioned by SSGA in 2017 got people talking. SSGA identified over 1,200 companies across the United States, Australia, Canada, EMEA and Japan without a single woman on their board. They voted against the Chair for over 500 companies each year – in 2017 and 2018 – that failed to take adequate steps to address this issue. Partly in response to these efforts, 423 companies added a female director.

'Fearless Girl' sculpture
by Kristen Visbal

UBS – Solutions

UBS has created bespoke investment solutions which integrate stewardship, particularly in the areas of climate change and impact. These have been developed through leveraging partnerships with leading asset owners, academics, top universities as well as in-house intellectual capital.

Vanguard: Team construction

Vanguard's team has been established and grown significantly over the last few years including new joiners with diverse functional experience from a variety of backgrounds. This helps them to engage credibly with directors on relevant topics (such as risk, audit, human capital, finance, legal, investments) to assess board strength and quality of process. Vanguard also appears to effectively leverage its relationship with certain active managers.

Call to action

We recognise the efforts made by stewardship teams and acknowledge encouraging momentum in both resources and activities. That said, we think there is a long way for the industry to go given the commitment so far has been limited and the opportunities to add value seem so significant.

Below we set out topics where progress seems slow and discuss how stewardship tools might be better applied.

Some may view the list as stretching but we would argue that large indexation managers have a major opportunity and responsibility to bring robust stewardship with deeper engagement models – leveraging their long horizons, breadth of influence and sizable stakes – rather than allowing a stewardship gap to exist following the diminishing interests of traditional active managers.

Topics:

Board quality: Boards of corporate or non-corporate entities provide critical oversight. Each of the asset managers considers this area but we typically see limited emphasis on:

- the effectiveness of the nominations process
- the processes of independent directors: skill diversity; time commitment; resources available to them; range of duties; level of vigilance; how independent they are
- having meaningful input on the appropriateness of individuals for board positions

Executive compensation: An area that consistently takes up significant bandwidth and with strong shareholder rights but evolution seems gradual.

Smaller companies: Tend to receive relatively limited attention, particularly companies based in markets away from the domestic base of the index managers (such as Asia).

Capital structure: Deterioration in corporate balance sheets, for example due to share buybacks is rarely discussed. Related, the challenge of balancing interests of bondholders and shareholders.

Climate risk: On everyone's priority list but, in our view, many progress initiatives lack sufficient urgency and depth.

Local market norms: We understand that cultural nuances across markets can make pushing against the status quo challenging, however, areas such as limited gender diversity of boards in Asia or lack of auditor rotation in the US are often placed in the 'too difficult box'.

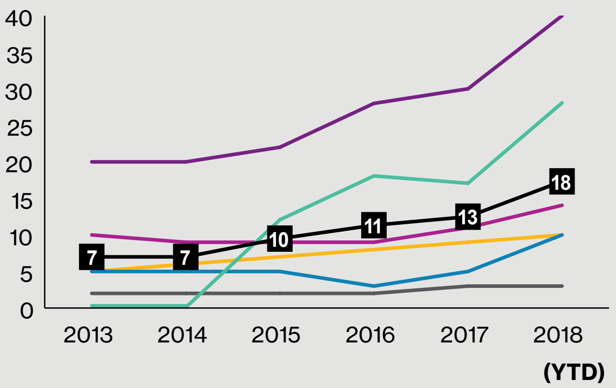
Sensitive subjects: Areas where personal or political values meet financial value – remain underdone, for example transparency on corporate lobbying activities. Without full transparency it is difficult for shareholders to understand potential financial and reputational risks or determine if the board is adequately overseeing those risks.

Tools:

Resources

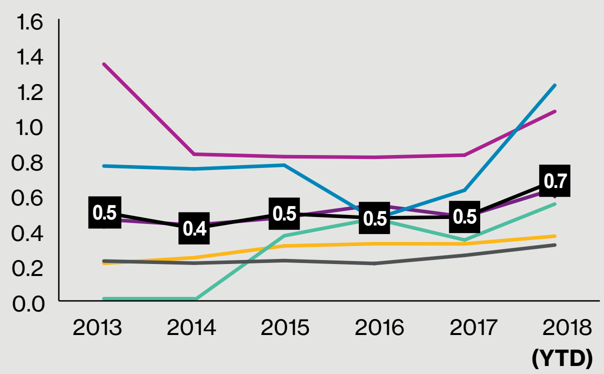
It is encouraging to see that the majority of firms have increased internal stewardship resources over time (see *Figure 1*). However, this upward trend is less obvious when compared to total firm assets under management (see *Figure 2*) and compared to the total number of investment professionals employed.

Figure 1. **Size of stewardship teams over time – the black line shows the average**

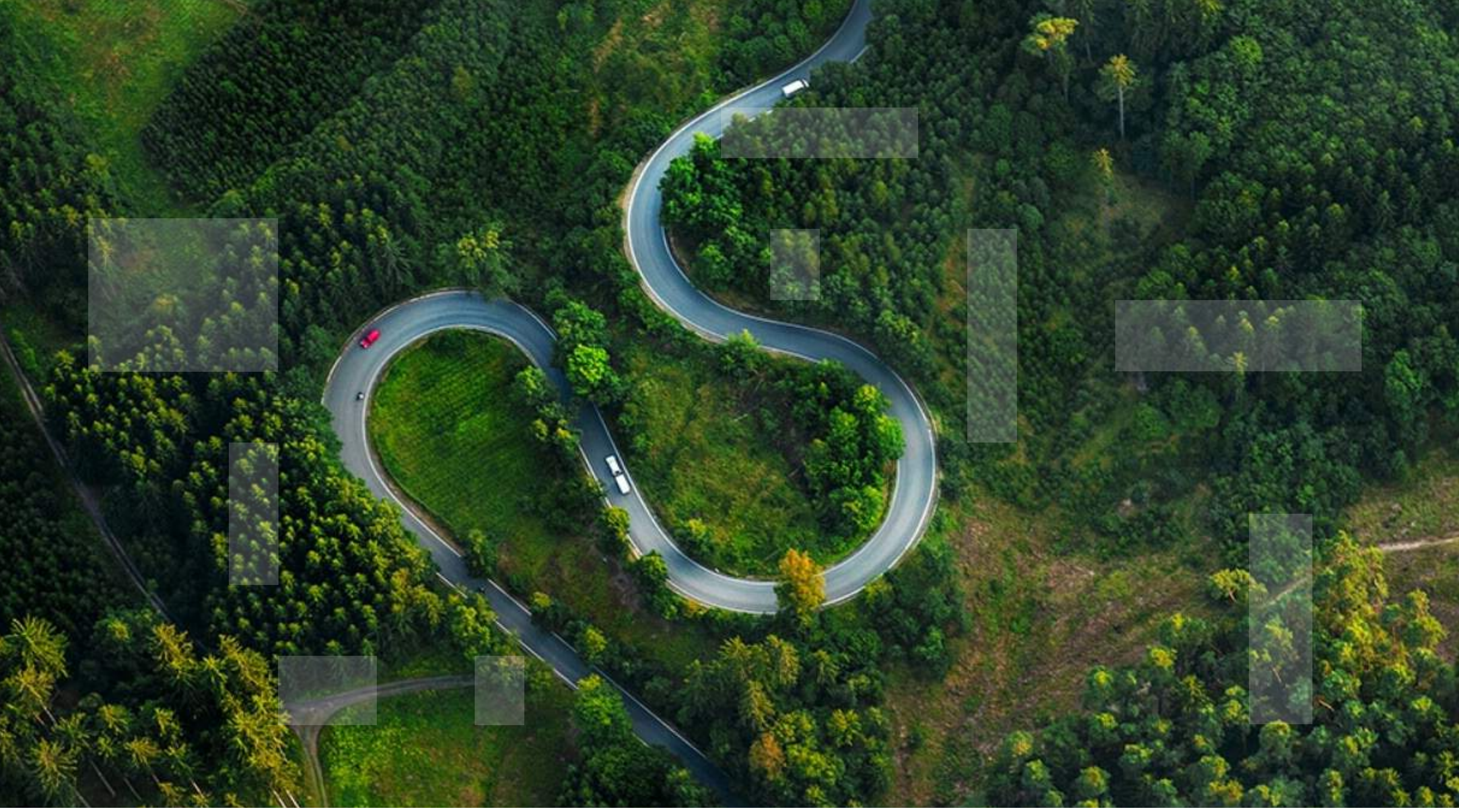


Note: Figures supplied by managers; excludes wider firm resources that may contribute to stewardship activities such as internal active investment teams

Figure 2. **Size of stewardship team per $100 billion assets under management – the black line shows the average**



Note: For 2018 YTD, data is as at Q2 or Q3 depending on latest availability; assets data sourced from eVestment



So what's the right number?

The indexation stewardship team job spec is vast given the spread of ownership interests (see *Figure 3*): corporate engagement on dozens of complex issues covering close to 10,000 companies, voting on tens of thousands of resolutions, regionally fragmented public policy engagement, research, disclosure and external communication. This practical task list alone necessitates far bigger teams and the value proposition further justifies increased resourcing.

If just a quarter of a basis point – often merely a rounding error – of every asset invested was directed to stewardship, that could mean teams orders of magnitude bigger than at present (we estimate over 10 times bigger on average).

This would also allow hiring of people with diverse and highly skilled backgrounds including:

- experienced business leaders
- technical experts in areas such as the environment or legal
- those with traditional active management experience

Currently, this type of expertise is often not present.

Figure 3. **The index manager ownership fragmentation challenge**

Clarity
We observe a lack of tangible, specific milestones around what stewardship success looks like, even on prioritised topics such as remuneration, climate risk or board quality. Perhaps related, stewardship seems to lack urgency and accountability is soft.

This may lead to the pursuit and celebration of what are inadequate initiatives – in terms of timeliness, scope or magnitude – particularly in pressing areas such as climate risk.

Policies, high-level annual voting statistics and selected anecdotal examples of company discussions are useful but can paint an incomplete picture. Clearer objectives alongside detailed activity and impact reports on key stewardship themes would allow progress to be measured and enable more engaging communication with clients.

Another useful disclosure would be explanations of voting decisions, including related engagement activity, at controversial AGMs.

Levels of transparency around stewardship activity currently differ widely by manager.

Voting
Care needs to be taken when reading into voting records. Sometimes an asset manager will be making significant engagement efforts behind the scenes with good progress on a particular issue such that a dissenting vote is then not required.

Still, we feel at times there can be too much reticence to vote against company management in order to protect relationships and perhaps to avoid being associated with an ‘activist approach’. One example is non-routine shareholder resolutions where some asset managers appear to have a strong default position of supporting company management. This may act as a barrier to change and send a false signal to other investors and peer companies about the issue in question.

Despite it being one of the tools available for stewardship, none of the asset managers in our sample has ever filed a shareholder resolution although we understand that one plans to do so in future.

Stock lending frequently occurs but it is very rare to recall stock before a vote. This does not seem ideal especially given sometimes third parties may borrow stock with the intention of gaining voting power.

Collaboration
There are pockets of excellent collaboration across the industry but inter-manager collaboration within our sample seems low. Large index managers are used to competing intensely for market share, but stewardship is an area where collaboration, not competition, is often in the interests of their clients.

Only the three smaller managers in our sample are signatories of Climate Action 100+, the world’s largest collaborative initiative around managing climate risk.

Leadership
The stewardship challenge calls for leadership-minded thinking and, particularly for large indexation managers, a universal owner mindset[3] could capture both the responsibility and opportunity. They could more proactively set out their investment beliefs and consequently the standards expected of companies across a range of issues including, and beyond, those raised in this paper.

The long and winding road ahead

Stewardship is an underappreciated but critical part of corporate oversight. It is showing encouraging momentum across the industry and indexation managers are stepping up with good signs of progress. Still, there is a lot more to reach for with structural challenges to cut through given highly fragmented ownership interests.

For asset managers to put both hands firmly on the wheel more of their clients and intermediaries need to pay close attention and call for a safe journey. Then there’s reason to be optimistic.

[3]Universal owners are large, long-horizon organisations that own a slice of the market through their portfolios, and exercise leadership-minded thinking recognising the stake they have and the role they play in the health and effective functioning of the system. See Urwin, Pension Funds as Universal Owners: Leadership Calls and Opportunity Beckons, 2011

Further information

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