THE INVESTOR FORUM

Defining Stewardship and Engagement

April 2019

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This document sets out our thoughts on the important areas of stewardship and engagement, based on our observations and experience since the Investor Forum was established in 2014.

Definitions of stewardship and engagement

We believe that **stewardship** is preserving and enhancing the value of assets with which one has been entrusted on behalf of others. It reflects the fact that any investment intermediary looking after assets on behalf of a beneficiary or client has obligations of a fiduciary nature.

Engagement is active dialogue with a specific and targeted objective. It is intended to put the stewardship role into effect. The underlying aim of the engagement dialogue should always be to preserve and enhance the value of assets on behalf of beneficiaries and clients.

We have summarised the perspectives of the Investor Forum on the key characteristics and desired outcomes of stewardship in Table 1.

Characteristics of good engagement

Effective engagement requires a process that:

- is set in an appropriate context of long-term ownership and has a focus on long-term value preservation and creation, so that the engagement is aligned with the investment thesis
- is framed by a close understanding of the nature of the company and the drivers of its business model and long-term opportunity to prosper
- is based on clear objectives, focused on effecting change
- recognises that change is a process and that, while haste may at times be necessary, change should not be inappropriately rushed
- employs consistent, direct and honest messages and dialogue
- is appropriately resourced so that it can be delivered professionally in the context of a full understanding of the individual company
- uses resources efficiently so that engagement coverage is as broad as possible whilst using all the tools available, including collective engagement
- involves reflection so that lessons are learned in order to improve future engagement activity

These elements are necessary in order for engagement to receive the most favourable response from the engaged company and to give the best chance of delivering value-enhancing change through engagement.

To be impactful, engagement requires clear objectives, professional resource and persistency. There are no short-cuts to the delivery of effective engagement, and most complex situations require bespoke strategies rather than a more generic “one size fits all” approach.

Barriers to engagement

One context for understanding the delivery of effective stewardship outcomes is to consider how the key barriers to engagement and how they can be overcome. Through our work we have identified 5 key barriers to engagement, which are:

1. **Resourcing** – even the largest stewardship functions will always be resource-constrained and must overcome this to deliver across the breadth of companies in which the institution invests.
2. **Consensus** – it can be a challenge to reach consensus within an organisation, including between individual portfolio managers and between portfolio managers and the stewardship team; consensus between different investment institutions is still harder.
3. **Visibility** – companies and other investors may not know about the investment exposure that an investor has, and may not understand the drivers for an investment position, making dialogue and trust harder to achieve.
4. **Conflicts** –conflicts of interest may limit the scope of action of investors; it is important they have mechanisms for ensuring that client interests are always put first.
5. **Competition** – as stewardship becomes more of a differentiating factor for fund managers, more may sense they have a competitive interest in acting alone.

Overcoming barriers to engagement

A discussion among Investor Forum members in late 2018 revealed that investors perceive two main solutions to these barriers and to ensuring that engagement is effective:

- reinforcing the close integration of stewardship with the fund management activity; and
- making full use of all available resources, including collective engagement.

The decision to engage should always be closely linked to investment decision-making. For many, engagement success is about enhancing value and being able to stay invested; exit must always be an option for an active house. Thus ideally, engagement should be part of the role of every fund manager and every analyst. Where this is done, issues around resourcing significantly reduce as there is no longer the same dependence on specialist stewardship staff.

In order to reach consensus internally as much as externally – and certainly for collective engagement with other institutions – it is often necessary to focus on areas of agreement not of disagreement, which may mean directing attention to the problems at companies rather than over-emphasising specific solutions to those problems.

What matters most to clients is delivering change at the companies of highest significance – both in terms of large investment positions and in terms of sizeable exposures to risks that are of the greatest concern to those clients. Investors should therefore use the most appropriate tool available to achieve their desired outcome.

Collective engagement

The Investor Forum has built a track record over the last four years in conjunction with its members. We believe this practical approach, supported by academic evidence, and the recommendations of the Kay Review, illustrates the value of collective engagement as part of an investor's stewardship activity.

There are many practical challenges involved in encouraging collective engagement. It requires a large number of, often global, investors employing a wide variety of investment strategies to work together, in a complex legal and regulatory environment. If done effectively it helps company chairs understand the underlying reasons for investors' concerns, while respecting that it is their duty to run the company, and therefore puts them in a much stronger position to take action, rebuild trust and hopefully develop their long-term strategy on behalf of all stakeholders more effectively

For collective engagement to work effectively, participants need to be clear about the objectives, the boundaries of engagement, and to feel comfortable that they are operating in a safe and secure environment. This is why it was critically important that we create a comprehensive framework. We believe that the establishment of the Forum's Collective Engagement Framework has made an important contribution to the development of engagement practice.

Table 1: The components of Stewardship

<table>
<tr><td></td><td colspan="2">Stewardship
Preserving and enhancing the value of assets with which one has been entrusted</td></tr>
<tr><td rowspan="3">…delivered through…</td><td colspan="2">Investment approach and decision
Allocation of capital in accordance with investment purpose, mandate and client interests, at portfolio and individual asset levels</td></tr>
<tr><td colspan="2">Dialogue
Active discussions between companies and investors, of which there are two principal forms:</td></tr>
<tr><td>Monitoring
Dialogue for investment purposes: to understand the company, its stakeholders and performance.
Informs incremental buy/sell/hold decisions</td><td>Engagement
Purposeful dialogue with a specific and targeted objective to achieve change
Individual or collective basis as appropriate</td></tr>
<tr><td>…typified by…</td><td>Detailed and specific questioning; investors seeking insights</td><td>Two-way dialogue; investors expressing opinions</td></tr>
<tr><td rowspan="2">…characteristics of high quality delivery…</td><td colspan="2">• Framed by close understanding of nature of company and drivers of its business model and long-term opportunity to prosper
• Appropriately resourced so dialogue can be delivered professionally in the context of full understanding of individual company
• Dialogue must be consistent, direct and honest
• Dialogue is respectful and seeks to build mutual trust</td></tr>
<tr><td>• Set in a context of mutual understanding of fund manager’s investment style and approach
• Recognises that change within companies is a process and sometimes takes time to be reflected in external indicators of performance
• Resources are used efficiently so that neither party’s time is wasted
• Fuller insight leads to better informed decisions
• Includes feedback so that mutual understanding can be reinforced over time</td><td>• Set in a context of long-term ownership and focus on long-term value preservation and creation, so that engagement is aligned with investment thesis
• Recognises that change is a process; while haste may at times be needed, change cannot be inappropriately rushed
• Overall resources used efficiently so engagement coverage is as broad as possible whilst also proving effective
• Clear and specific objective leads to effective change
• Involves reflection so lessons are learned and taken fully into account in future</td></tr>
<tr><td>…resulting in…</td><td>• Changed investor decision-making
• Efficient capital allocation by investors
• Appropriate risk-adjusted returns for clients
• Preserved/enhanced value
• Delivery of client objectives and investment purpose</td><td>• Changed company behaviours
• Efficient capital allocation by companies
• Appropriate risk management by companies
• Preserved/enhanced value
• Delivery of corporate purpose and culture, through effective oversight</td></tr>
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