The Four Dialogues

The need to improve how Investors and Companies engage on Governance
Key Points

Conclusions

- Substantive discussions on longer-term, strategic Governance are crowded out by the emphasis placed on short term reporting, modelling and checklists for AGM voting
- There is an apparent disconnect between the way that companies and investors view engagement on Governance
- Interactions between companies and investors can be divided into Four Dialogues, based on whether they are focussed on Governance or Execution, and their timeframe. Each of the dialogues has different participants, subject matter and objectives

Recommendations

- There is scope to make significant improvements in the effectiveness of this dialogue through managing time and resources more effectively to optimise the outcome for all parties
- Greater clarity from Investors on how Governance is taken into account in investment and stewardship decisions, including the role of advisers, would facilitate more meaningful dialogues
- More effective dialogue with Chairs and NEDs should provide investors with increased insight and confidence in the long term, sustainable creation of value for all stakeholders

Proposed Actions

- Companies and investors could consider the true focus of their dialogues and whether they need to clarify priorities and re-allocate their resources to make them more effective
- Investors should be clearer about how they integrate Governance factors into their investment decisions and stewardship responsibilities
- Companies should provide regular, structured access for investors to key Board members, including the Chair and heads of key Board committees
- The role of the intermediaries involved in Governance discussions needs to be clarified. Companies and Investors should own the dialogues
The proposed framework

The overarching role of Governance

- This is a framework showing the relationship between the various areas of corporate activity
- **Governance leads** as the Board has accountability and oversight for all company activities
- This defines how the company **executes** its business
- Then the company **reports** on its activities and results, both for internal management and for external stakeholders
- Governance and Reporting are common to all companies; execution activities will vary by company and sector.

The Four Dialogues

<table>
<thead>
<tr>
<th></th>
<th>Transactional</th>
<th>Strategic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>AGM Voting</td>
<td>Board effectiveness</td>
</tr>
<tr>
<td>Execution</td>
<td>Results and modelling</td>
<td>Forecasts and targets</td>
</tr>
</tbody>
</table>

This framework identifies the four distinct forms of dialogue that occur between companies and investors:

- **Transactional / Governance – AGM Voting**: Short term discussions on Governance matters, usually focussed on the AGM and voting, often following checklists
- **Strategic / Governance – Board composition and effectiveness**: More substantive discussions regarding Governance, seeking an understanding of the effectiveness of the Board. Typically covering strategy, board composition and succession, risk management, key priorities etc
- **Transactional / Execution – Results and modelling**: Short term performance and financial modelling to support company valuation, driven by quarterly or half yearly results. Tend to focus on 2 to 3 year outlook based on specific actions and trends in company results
- **Strategic / Execution – Forecasts and operational targets**: Longer term discussion to build out forecasts of company performance, grounded in reported results, but with 3-5 year outlook, based on market trends, declared targets and management actions.
1. Introduction
Background and Purpose

• This document presents the initial findings of a project looking into how Investors and Companies engage on the topic of Governance and considers how the interaction may be improved. It is very much focussed on a practical review of what actually happens on a day to day basis and how such engagement works in practice.
• It was commissioned by the Investor Forum, which manages collective engagements with companies on behalf of its members, which are leading investors and asset owners.
• The research has been carried out through a series of over 30 interviews (which were conducted on an unattributable basis), attendance at relevant conferences and peer-group meetings, as well as a review of public literature and research.
• Interviewees included;
  • Company: Chairs, Company Secretary, Investor Relations, Corporate Affairs
  • 16 corporates, of which 13 FTSE100 and 3 FTSE250
  • Investors: Portfolio Managers, Governance and ESG specialists, and Asset Owners
  • Advisers: Corporate Brokers, IR and Financial PR, Recruitment, Proxy Solicitation
• This document represents a summary and interpretation of the information gathered. The views presented are those of the author.
• It presents a model of how the dialogue is currently structured and considers where there may be deficiencies
  • Much of the material of necessity presents broad generalisations behind which a very broad range of realities exist

The purpose of this document is to provide a basis for debate on the effectiveness of current practices.
It raises some key questions and provides a framework for reflection and evaluation.
2. Value and Governance
ESG perspectives are growing in importance and increasingly recognised as a value driver

- ESG investment has rapidly grown in importance over the last few years as most stakeholders become more interested in Environmental, Social and Governance issues.
- Opinions differ as to the relative importance of each of the three topics, and it certainly appears that sustainability and climate change have come to dominate much of the debate.
- However, there seems to be a broad consensus that of the three main topics, Governance is the most universal, key driver:
  - ‘Governance’ was defined by Sir Adrian Cadbury as “the system by which companies are directed and controlled” (Cadbury Committee, 1992).
  - All companies need good Governance, but Environmental and Social factors will be more driven by the specifics of the company and its industry.
  - If a company has good Governance, this will be a driver of good performance in Social and Environmental issues as well.
  - This is increasingly viewed in the context of the company’s purpose.

- It is also widely accepted that good Governance does add value....
- ...and that investor engagement is specifically a driver of better Governance and therefore, of value creation.
- So there is a real value basis for a focus on Governance.
The Role of Governance

Governance and Reporting are not company specific

- This is a framework showing the relationship between the various areas of corporate activity
- All of the key activities take place within the environment set by the company’s Purpose and Culture, which may have an important impact on their effectiveness
- The framework shows that the Company has a Governance structure that defines how it Executes its business, and how the output of its execution is Reported
- Every company needs Governance to oversee its activities and set its strategy, and every company must also Report on its results and activities
- So both of these are key activities that are common to all companies
- On the other hand, many aspects of how the business manages its Execution, such as its Operational, Environmental, and Social activities, will be company or sector specific
- Thus Governance is a generic topic for all companies and if done well it will drive positive behaviours in all the other areas, which will be visible if the Reporting is appropriate and thorough
Purpose, Culture and Governance

• Governance, Execution and Reporting are all ‘process’ related, defining the way that the company is run
• These must be viewed within the context of the company’s Culture and Purpose

• In parallel to the increased focus on responsible investment and ESG issues, there is a greater focus on the company’s Purpose
• A clear Purpose helps to position a company within society, and is distinct from traditional descriptions of Mission, Values and Vision which emphasise how the company acts and are more operationally focussed
• So the Purpose is relevant to the Governance, which should align the company’s oversight and execution to the Purpose.
• It also important that the Culture of the company is aligned to both of these
• If all these factors are authentic and aligned, then the Governance structure might be expected to ensure good Execution and Reporting
3. The Apparent Disconnect
The apparent disconnect

There appears to be a fundamental disconnect between the way that investors and companies view engagement on Governance:

<table>
<thead>
<tr>
<th>Investors</th>
<th>Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Committed to Governance Engagement</td>
<td>Generally willing to engage on Governance</td>
</tr>
<tr>
<td>Signatory to UNPRI, subject to FRC Stewardship Code</td>
<td>NEDs less experienced and concerned to raise profile unnecessarily</td>
</tr>
<tr>
<td>Analysis informed by, or delegated to, proxy advisers and ESG ratings</td>
<td>Frustrated by box-ticking and questionnaires</td>
</tr>
<tr>
<td>Tend to engage only when there is an issue</td>
<td>Lack visibility over relevance to investment decision and who key decision makers are</td>
</tr>
<tr>
<td>Not fully transparent on how decisions are made</td>
<td>Pro-active approaches are often not accepted</td>
</tr>
<tr>
<td>Limited resources and capacity for ongoing, NED engagement</td>
<td>Tend to focus on short term results cycle with operational management</td>
</tr>
</tbody>
</table>
4. The Four Dialogues
Introducing the Four Dialogues

- This disconnect between investors and companies seems to be rooted in the way that they interact, and how this interaction has evolved.
- It seems that engagement between the two parties has become largely separated into several distinct dialogues, with the first main division being the two main topics of the dialogue: Execution and Governance:

<table>
<thead>
<tr>
<th>Dialogue Topic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Execution</td>
<td>Based on the results and delivery of the business. Usually focussed on Operational matters, but also including Environmental and Societal matters, as specific to the company</td>
</tr>
<tr>
<td>Governance</td>
<td>Based on Board oversight, how the company is run and stewardship</td>
</tr>
</tbody>
</table>

- Societal pressure has created a strong trend towards more focus on Stewardship and responsible investment, within which the Governance stream is key, but:
  - Not all investors have fully embraced this trend
  - Traditional investment models may not yet have fully evolved to accommodate it
  - The environment is continuing to evolve and there are many implications of which cost and available resources are a significant constraint
  - Companies are often further behind, although still demonstrating positive intent

As a result, the Governance dialogue is less well developed than the Execution dialogue
Two distinct topics
Who is primarily involved in each dialogue, from the investor and the company?

<table>
<thead>
<tr>
<th>Dialogue topic</th>
<th>Investor</th>
<th>Intermediaries or Advisers</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>Governance specialists</td>
<td>Proxy and Remuneration advisers, ESG raters, investor associations</td>
<td>Chairs, NEDs, Company secretary, IRO</td>
</tr>
<tr>
<td>Execution</td>
<td>Portfolio managers Sector Analysts</td>
<td>Corporate brokers, sell-side analysts, IR and Financial PR advisers</td>
<td>CEO and CFO, IROs, Senior management</td>
</tr>
</tbody>
</table>
The nature of the discussion........

So not only has the dialogue been separated into two different topics, there is also a significant difference in the participants and the routines of each of them:

**Governance**
- Often limited to AGM related decisions and voting
- Tendency to focus on topical matters such as remuneration, share issues and board appointments
- Mechanistic, box ticking approach via proxy advisers; onerous form filling for raters
- Rarely face to face; often not with the real decision makers or accountable NEDs

**Execution**
- Financial results and quarterly reporting
- Targets for KPIs, such as EPS, returns, margins, top-line growth
- Regular, ongoing investor roadshows and other events with the CEO and CFO
- Strategy and operational reviews
- Possibly with a 3 to 5 year view
Contrast Sell-side and ESG raters

An important point of differentiation in the processes is the role of the ESG raters, which can be contrasted with the sell-side analysts.

<table>
<thead>
<tr>
<th>Sell-side analysts</th>
<th>ESG raters</th>
</tr>
</thead>
<tbody>
<tr>
<td>Produce objective independent research</td>
<td>Produce objective independent research</td>
</tr>
<tr>
<td>Regular company contact</td>
<td>Generally less frequent – annually, or remote</td>
</tr>
<tr>
<td>Relationship directly with key accountable directors</td>
<td>Possibly meet Company Secretary, but also often rely on public sources</td>
</tr>
<tr>
<td>Company IRO knows who the key analysts are</td>
<td>Company IRO probably does not know who the key raters are</td>
</tr>
<tr>
<td>Very transparent (subject to MIFID II)</td>
<td>Lack transparency and accountability</td>
</tr>
<tr>
<td>Highly regulated</td>
<td>Not regulated</td>
</tr>
<tr>
<td>Taken as an input by investors, who then use in-house analysts to interpret and factor into their investment decisions</td>
<td>Often taken directly by investors and used to decide voting without significant review</td>
</tr>
</tbody>
</table>
Adding an additional dimension

- Having asserted that there are two main topics to the dialogue between investors and companies, we can now add an additional dimension into each of them – related to the relevant time horizon.
- For each dialogue topic there is a **primarily short term, transactional part**, as well as a more **strategic, medium to longer term part**:  

<table>
<thead>
<tr>
<th>Dialogue</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactional/Short term</td>
<td>Focussed on dealing with immediate reporting and actions</td>
</tr>
<tr>
<td>Strategic/Medium - Long term</td>
<td>Focussed on more forward looking matters and issues</td>
</tr>
</tbody>
</table>

- ➢This gives us four different dialogues to consider...............
The Four Dialogues

<table>
<thead>
<tr>
<th>Topic</th>
<th>Transactional</th>
<th>Strategic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governance</strong></td>
<td>1. Transactional / Governance</td>
<td>2. Strategic / Governance</td>
</tr>
<tr>
<td></td>
<td>AGM Voting</td>
<td>Board composition and effectiveness</td>
</tr>
<tr>
<td><strong>Execution</strong></td>
<td>3. Transactional / Execution</td>
<td>4. Strategic / Execution</td>
</tr>
<tr>
<td></td>
<td>Results and modelling</td>
<td>Forecasts and operational targets</td>
</tr>
</tbody>
</table>

1. **Transactional / Governance – AGM Voting:**
   - Short term discussions on Governance matters, usually focussed on the AGM and voting, often following checklists

2. **Strategic / Governance – Board composition and effectiveness:**
   - More substantive discussions regarding Governance, seeking an understanding of the effectiveness of the Board. Typically covering strategy, board composition and succession, risk management, key priorities etc.

3. **Transactional / Execution – Results and modelling:**
   - Short term performance and financial modelling to support company valuation, driven by quarterly or half yearly results. Tend to focus on 2 to 3 year outlook based on specific and actions and trends in company results

4. **Strategic / Execution – Forecasts and operational targets:**
   - Longer term discussion to build out forecasts of company performance, grounded in reported results, but with 3-5 year outlook, based on market trends, declared targets and management actions.
# The Four Dialogues

## The key characteristics of each dialogue

This chart sets out the four separate dialogues that have been identified, in terms of its focus and content, as well as identifying the key parties involved, representing the company and the investor:

<table>
<thead>
<tr>
<th></th>
<th><strong>Transactional/Short term</strong></th>
<th><strong>Strategic/Medium - Long term</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governance</strong></td>
<td>Focus: AGM Voting</td>
<td>Focus: Board composition and effectiveness</td>
</tr>
<tr>
<td></td>
<td>Content: Checklists</td>
<td>Content: Strategy oversight, remuneration, etc</td>
</tr>
<tr>
<td></td>
<td>Investor: Proxy adviser</td>
<td>Investor: Governance specialist</td>
</tr>
<tr>
<td></td>
<td>Company: Company Secretary</td>
<td>Company: Chairman, SID, NEDs</td>
</tr>
<tr>
<td><strong>Execution</strong></td>
<td>Focus: Results, modelling</td>
<td>Focus: Forecasts and operational targets</td>
</tr>
<tr>
<td></td>
<td>Content: Numbers</td>
<td>Content: Strategy and operations</td>
</tr>
<tr>
<td></td>
<td>Investor: Sector Analyst</td>
<td>Investor: Portfolio manager</td>
</tr>
<tr>
<td></td>
<td>Company: IRO</td>
<td>Company: CEO and CFO</td>
</tr>
</tbody>
</table>
The quality of the four dialogues

This model begs the question as to how well each of the four dialogues is working in practice, and where is the disconnect identified above most prevalent. It is a challenge for companies and investors to make them fully aligned:

<table>
<thead>
<tr>
<th></th>
<th>Transactional/Short term</th>
<th>Strategic/Medium - Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Governance</strong></td>
<td>There is room for a better dialogue here, perhaps with more direct contact and less reliance on third parties</td>
<td>Potentially the most important and yet the least efficient of the dialogues</td>
</tr>
<tr>
<td><strong>Execution</strong></td>
<td>The general view is that the Execution dialogue has really professionalised over the last few decades and works well. Perhaps there is now too much emphasis on the transactional rather than the strategic.</td>
<td></td>
</tr>
</tbody>
</table>
The four dialogues
- Corporate time allocation

In some initial discussions with corporates, we derived an indication of how they feel that they allocate time between the four dialogues.

<table>
<thead>
<tr>
<th></th>
<th>Transactional/Short term</th>
<th>Strategic/Medium - Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance</td>
<td>2% to 20%</td>
<td>1% to 7%</td>
</tr>
<tr>
<td>Execution</td>
<td>45% to 70%</td>
<td>20% to 45%</td>
</tr>
</tbody>
</table>

- The limited sample of corporates was very consistent
- There is a clear majority of time spent on Execution dialogues, with that heavily inclined towards the shorter term, modelling, discussions
- This leaves relatively little time for Governance dialogues, which are again generally more likely to be short term focused
- It is clear that this balance does shift quickly if there is a particular issue or event
Crowding out.....
- an opportunity to rebalance supply and demand?

This analysis would seem to suggest that a heavy focus on traditional, executional dialogues are crowding out time and resource that might usefully be spent on Governance dialogues

- So much time spent on short term numbers......
- So much time on AGM box-ticking......
- So many reporting requirements and layers of questionnaires......

Given the general expectation that Governance should be a part of a company evaluation, this might imply that there could be some benefit from re-balancing the dialogues.....

Which would make most sense if it reflected the way that value is decided
5. Proposed Actions
Investors
– potential actions to consider

• Commit to moving the balance away from short term and execution focussed dialogues
  • Less quarterly modelling meetings; less reliance on ESG ratings and proxy agents
  • More, regular meetings with Chairs and NEDs to understand how governance works and how effective it is
  • Clearer alignment and integration of their internal views of a company
  • This may mean adding resources or redeploying them from other short term, executional activities

• Be clear about how Governance factors are integrated into the investment decision and stewardship responsibilities
  • Explain what information they therefore require, preferably in an objective, thematic sense, rather than a checklist.
  • Particular help on how they can understand the effectiveness of the Board and its Governance would be highly beneficial
  • Actively engage with the ‘comply or explain’ approach, rather than a mechanistic application of checklists. Greater clarity on how ratings information is used would reassure companies and enable them to focus their efforts appropriately.

• A commitment to a regular, ongoing dialogue on strategic, long term Governance
  • This might best be separated from the formality of the AGM and should involve the Chairman and other key Non-Executive Directors rather than the company secretary and executive management.
  • A ‘joined-up’ internal approach where Governance specialists work closely with the Portfolio Managers and other analysts so that the company receives a consistent message and the voting follows.

• The quality of the dialogue would be improved by personal interaction which provides better context to the essential facts.
• Exercise stronger stewardship through communicating their views on the company and the key issues that they are concerned about to the company, beyond AGM voting
ESG ratings and intermediaries
- Clarifying their role

• The matter of the proliferation of ESG raters and how they gather information from companies is increasingly an issue and a concern for companies
• It might be better if the way ESG data is disclosed and used could be more aligned to the way that financial data is treated for the Execution dialogues:
  • A standardised data set – like a report and accounts
    • So that companies know what to disclose and users have a base data set to access and rely on
  • Third party raters could also gather and use the data
    • The company would not be obliged to complete surveys
  • A preferred set of raters would emerge that investors and companies could rely on
    • Akin to the sell-side analysts that support the Execution dialogues
  • Governance engagement between investors and companies can then be informed by more insightful analysis
    • Discussions might then be less reliant on the check-list approach
Companies
– thoughts on building Governance engagement

- The Board should take active ownership of Governance and its communication
  - Ensure appropriate and aligned disclosures are available and easily accessed
    - Identify key messages as well as core data; integrate key messages in other investor messages
    - Consider a video message on the website, from the Chair and Committee chairs
    - Seek opportunities to reduce other areas of communication to free up resources
    - Identify key people and clarify their roles in communicating Governance
    - Decide on an annual or three year programme and review it regularly
- Identify large shareholders and their key Governance contacts
  - Build relationships with them as you would with a sector analyst or PM
  - Ask them what information they want and how they use it, which other information sources they use
- Identify key ESG raters and their key contacts for your company
  - Get to know them and build relationships
  - Have a policy on disclosure and ensure the info is available, but the workload is manageable
  - Review and challenge their reports and recommendations

- Be proactive
  - Offer regular Governance meetings to key investors; include the sector analyst and PMs as well as Governance contacts
  - Group meetings are very efficient and an annual or bi-annual meeting should be at the heart of the programme
  - You might also consider some 1-1s for large investors, at least offer
  - Try to avoid AGM season as investors will be busy and voting may dominate any meeting
- Face to face contact builds credibility and confidence
  - Build reputation before there is a problem; you should then have more goodwill and time to address it.
- Internal alignment
  - Ensure the IRO and Company Secretary are close; also involve media teams and senior management
  - The IRO should have an open line to the Chair and regularly attend Board meetings
- The Board should seek independent, objective feedback on Governance and its communication
  - A regular perception study should evaluate the views of stakeholders and be reported to the Board
  - Independent advice for the Board may be appropriate to avoid the risk of internal silos or agendas
Appendix
Jonathan Atack

• Investor Relations experience, Head of IR at:

<table>
<thead>
<tr>
<th>Company</th>
<th>Market cap, index</th>
<th>Sector</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bass PLC</td>
<td>£12bn, Mid FTSE 100</td>
<td>Leisure, hotels and drinks</td>
<td>UK</td>
</tr>
<tr>
<td>RBS plc</td>
<td>£40bn, top 10 FTSE 100</td>
<td>Banking</td>
<td>UK</td>
</tr>
<tr>
<td>easyJet plc</td>
<td>£1bn, FTSE 250</td>
<td>Airlines</td>
<td>UK</td>
</tr>
<tr>
<td>ING Group NV</td>
<td>Eur 60bn, AEX</td>
<td>Banking, insurance and asset management</td>
<td>Netherlands</td>
</tr>
<tr>
<td>AkzoNobel NV</td>
<td>Eur 15bn, AEX</td>
<td>Chemicals and coatings</td>
<td>Netherlands</td>
</tr>
<tr>
<td>SES SA</td>
<td>Eur 6bn, CAC</td>
<td>Telecomms and Media, Satellite comms</td>
<td>Luxembourg</td>
</tr>
</tbody>
</table>

• Complementary experience in senior finance roles, asset management and investment banking.
  • CFO of ING Asset Management, Eur 400 billion AUM, and member of the investment committee
  • Group Treasurer of AkzoNobel NV and member of the Group Pensions Executive Committee
Key questions to be considered:

• Does good Governance add value?

• How are Governance factors incorporated into valuations and investment decisions?

• Is the nature of the dialogue between companies and investors optimal?

• How should approaches change to make Governance engagement more strategic and meaningful?
The nature of Value

• A core, underlying assumption, is that the relationship between companies and investors is founded on ‘value’ – but what does this really mean?

• How is quality of Governance reflected in investment and stewardship decisions and does this really impact value?

• Value is primarily considered in terms of the value of the shares
  • Preferably taking into account long term, sustainable value creation
  • It may also consider value created in society as a whole, for which the company/investor should be economically rewarded

• Financial markets are often considered to be very short term
  • There is a risk that short term value can be created at the expense of other stakeholders
  • True, sustainable value creation should drive a virtuous circle of value for all stakeholders

• Ideally we should look through short term volatility and encourage confidence in long term, sustainable growth
Stakeholders and drivers of change

**Society**
- The public
- Government
- Regulators
- Customers
- Employees
- Pensioners
- Public bodies
- Media

**Asset owners**
- Pension funds
- Trustees
- Funds
- Individuals
- Charities

**Investment managers**
- Passive and active managers
- Hedge funds

**Companies**
- Listed companies

Advisers

Asset Owners are increasingly expecting Investors to take more account of ESG and Stewardship. There is pressure to clarify mandates, activities and reporting.
The investor perspective –
Committed to engagement on Governance and incorporating it into investment analysis

**FRC Stewardship Code:** all UK-authorised Asset Managers are required under the FCA’s Conduct of Business Rules to produce a statement of commitment to the UK Stewardship Code or explain why it is not appropriate to their business model. The code states:

- For investors, stewardship is more than just voting. Activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.

**UNPRI:** Each of the signatories has signed up to six principles of which the first three are:

- **Principle 1:** We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3:** We will seek appropriate disclosure on ESG issues by the entities in which we invest.

• Many investors are actively committed to engaging on Governance and ESG and have dedicated governance teams.

• Many are signatories to the UN PRI and, if UK–authorised, they have to explain how they apply the FRC Stewardship code.

• Some 2,000 investors have now signed up to the UNPRI, representing around US$ 90 trillion of AUM.
There are two key topics of meetings: Investment and Stewardship

Investor/Company meetings

Investment

The objective is to decide on a buy/hold/sell decision
Focus is on potential for investment return, often relative to set indices or alternative investment opportunities. This reflects the fiduciary duty to the asset owner and should be aligned to the investment mandate.

Stewardship

The objective is to influence the company positively and encourage good Governance and business practices
Focus is on how the company is managed and exercising the rights and obligations of the shareholder as owner, including voting at general meetings

• Meetings between companies and investors can involve two apparently very different objectives
• Investors’ primary concerns will generally involve either Investment decisions or practising good Stewardship, or possibly a combination of the two, but the buy/sell decision has tended to dominate. This may be determined by the investment mandate
• However, both are ultimately intended to support the creation of value
• The Stewardship aspect produces a dilemma for Index and Quant investors, which do not rely on company knowledge for investment decisions and are often driven by economies of scale and cost minimisation, whereas effective Stewardship requires company specific knowledge and resources for engagement
• Each approach is very different and Stewardship is important
  • Not just voting at AGMs; it can include proposing motions but ideally it can add long term value by routinely engaging with the company on issues
  • Index and quant funds can be less involved and may delegate to intermediaries
• There is increasing pressure from Society for more engagement on Governance – this is seen coming from Asset Owners, regulators and customers and applies in the retail and institutional markets
Company concerns

Most companies believe that they are willing to engage on Governance, and that they are proactive in reaching out to investors, but the investors do not engage with them effectively

- Chairmen write to investors offering meetings annually and receive a very low response rate and even lower take-up
- Their impression was that there is only a negative aspect to Governance – it is assumed to be ok until there is an issue
- Investors do not have the resources to engage on Governance
- Too much is outsourced or delegated to intermediaries, such as AGM voting and ESG evaluations
- This leads to box-ticking and no opportunity to ‘explain’ if not complying, or to discuss real, long term issues
- Lack of integration within the investors - issues discussed with the PM, and agreed, are then voted against by the proxy advisers
- Companies receive contradictory signals from different parts of the investor organisation
- There is too much focus on remuneration rather than, say, board effectiveness
- There are huge reporting requirements and multiple ratings and questionnaires, some of dubious quality and limited transparency
- It is not clear how Governance impacts the investment decision

There was some suggestion that the size of the company was a factor in whether they could win investor time. Other factors included business complexity, regulatory context and concentration of holdings
Reasons for companies to engage

Given all the concerns that companies have, we should remember the reasons for them to engage:

• A requirement of the Governance code
• An obligation to the owners of the company – directors are the agents of the shareholders – they should regularly consult their owners
• Opportunity to explain matters relevant to the company
• ….. and to receive feedback from the investors, which may impact on company decisions
• Establish a good relationship and reputation
• Identify potential issues in advance
• Establish goodwill to permit time to address emerging issues
• Facilitate better informed voting at general meetings
• Improve the share price and reduce the cost of capital; enhance value
Proliferation of ESG advisers
- a major concern for companies

A key concern raised by many corporates was the role played by the ESG advisers, raters and proxy agents.

This stems from:

- Focus on checklists, not understanding
- Barrier between the company and its investors
- Lack of accuracy, even misleading information
- Lack of transparency
- Unwillingness to permit corrections
- Lack of accountability

- Perceived conflicts of interest
- Proliferation of different parties
  - Hard to know which matters
- Threat of a bad rating if you do not engage
- Inconsistent with PM view

Examples:
- Proxy agents: Glass Lewis, ISS
- Indices and raw data providers: Bloomberg, MSCI ESG research, Thomson Reuters
- Raters: Hermes EOS, Sustainalytics, VigeoEiris
- NGOs/Questionnaires: CDP, RobecoSAM

Companies do not know which ones to take most seriously, but fear that they will be disadvantaged if they do not engage, or if they are mis-represented.
Barriers to Governance engagement  
- from the Corporate perspective

Many perceived barriers impede how companies engage regarding Governance:

<table>
<thead>
<tr>
<th>Barriers</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other priorities</td>
<td>There are so many calls on the corporates’ time that proactive engagement on Governance rarely reaches the top of the list. It will often only be escalated when there is an issue, or perceived issue, raised by large shareholders.</td>
</tr>
<tr>
<td>Investors not responsive</td>
<td>It is sometimes felt that investors’ commitment to ESG is more superficial or that they are under-resourced in this area; meetings are not taken when offered.</td>
</tr>
<tr>
<td>Intermediaries dominate</td>
<td>Engagement on Governance topics is often done via intermediaries such as proxy advisers and ESG rating agents; this often serves short term objectives (AGM votes) or may lack transparency and focus. It can lead to a box-ticking approach (more ‘comply’ than ‘explain’) and outcomes that are at variance to direct dialogues.</td>
</tr>
<tr>
<td>Unsure on content</td>
<td>Companies are not clear how Governance is taken into account in the investment decision, or how a stewardship dialogue will help performance. How do you frame a discussion of board effectiveness for long term value creation, rather than focussing on, say, narrow decisions about remuneration?</td>
</tr>
<tr>
<td>Fear of creating an issue – no upside potential</td>
<td>There is a concern, particularly with NEDs, that dialogue with investors is more likely to raise an issue which will cause reputational damage. This is exacerbated by the view that there is no upside from good Governance – only a downside to poor Governance. If there is no problem, there is no need to engage.</td>
</tr>
<tr>
<td>Different focus of investor dialogue</td>
<td>The dialogue with investors is heavily focussed on the short term delivery of results and modelling, based on quarterly results, and led by CEO/CFO. This rarely includes Governance and crowds out those responsible for it. Different investors also have different views.</td>
</tr>
<tr>
<td>Visibility of counterparts</td>
<td>It is often not clear who to engage with at the major funds. Reliance on intermediaries increases the distance between the parties. Does the PM or sector analyst have responsibility, or is it just the Governance specialist; which funds or PMs are actually holding the shares, what are their mandates? Companies frequently express concerns about whether the individuals are aligned within the investors and regarding continuity as people move.</td>
</tr>
<tr>
<td>Resources</td>
<td>The company may not have adequate resources to deal with all the information requests and opportunities to engage. The NEDs may not have the capacity.</td>
</tr>
</tbody>
</table>
Governance engagement  
- additional perspectives on the disconnect

This disconnect is also apparent from other interested parties. 
Further evidence of this is presented on the next three slides:

- Select Committee report into Carillion comments on investor engagement
- Independent study of investors commitment to ESG
- Financial advisers express concerns over the integrity of ESG products
Comments from the following excerpts from the report reinforce the need for engagement, and the need to improve:

51. Other issues raised are deep-seated and need much more work. The right alignment of incentives in the investment chain is a fiendishly difficult balance to strike. The economic system is predicated on strong investor engagement, yet the mechanisms and incentives to support engagement are weak and possibly weakening. The audit profession is in danger of suffering a crisis in confidence. The FRC and others have their work cut out to restore trust in the value, purpose and conduct of audits. Competition has the potential to drive improvements in quality and accountability, but it is currently severely lacking in a market carved up by four entrenched professional services giants. There are no easy solutions, but there are some bold ones. (Paragraph 217)

179. The effective governance of companies and faith in our business culture relies upon the effective stewardship of major investors. They in turn rely upon accurate financial reporting and honest, constructive engagement with company boards. The current Stewardship Code is insufficiently detailed to be effective and, as it exists on a comply or explain basis, completely unenforceable. It needs some teeth. Proposals for greater reporting and transparency in terms of investor engagement and voting records are very welcome and should be taken forward speedily. However, given the incentives governing shareholder behaviour, and the questionable quality of the financial information available to them, we are not convinced that these measures in themselves will be effective in improving engagement, still less in shifting incentives towards long-term investment and away from the focus on dividend delivery. A more active and interventionist approach is needed in the forthcoming revision of the Stewardship Code, including a more visible role for the regulators, principally the Financial Reporting Council.
Independent study
- How serious are the asset managers about ESG?

By way of an example, a recent study found limited evidence that investors’ public commitments to responsible investing are properly reflected in their company’s identity:

• The H&K Responsible Investment Brand Index, the first of its kind, has analysed all European Asset Managers ranked among the largest worldwide 400 managers with a view to validating whether good intent is also communicated at a meta level through the brand. The index evaluates actual commitment against follow-through in brand architecture.

• Over three quarters of the companies analysed (or 184 out of 239), formally commit as responsible investors.

• ‘It is however hard to distinguish between genuine long-term commitment to sustainable investments in its larger sense and companies who just ride the hype for their own benefit.’

• The majority of European asset management companies analysed (147, RI Traditionalists) actually commit to a responsible approach but miss the opportunity to share their approach and actively incorporate it into their brand.

Source: Hirschel and Kramer (H&K) Responsible Investment Brand Index; November 2018; https://www.ri-brandindex.org/
Financial advisers have expressed worry over possible mis-selling of products marketed as having strong environmental, social and governance credentials as interest surges in the responsible investment sector.

Virtually all financial advisers (97 of 100) were “very” or “fairly” concerned “about the potential for allegations of mis-selling” of ESG-badged investments, said Cicero, a market researcher.

Source: Financial Times, 20.1.19, Fears mount over mis-selling of ESG-labelled products
At the start, it was asserted that the relationship between investors and companies is founded in value.

It is possible that the Execution dialogues work better as they are closely aligned to how investors value companies

- The content of the discussions directly drives valuation models and therefore buy/sell decisions and share values

The Governance dialogues are possibly too far removed from the valuation process and, as a result, are not so strongly grounded

- The content of the discussions is not so well defined and the discussions themselves are not taken so seriously

This view relies on the assumption that good governance does add value. The following slides explore how the dialogues can influence a traditional valuation approach
A key question is whether or not good Governance adds value, or is it simply that poor Governance destroys value?

Many people believe that Governance is a hygiene factor – if its adequate, then there is no upside, as shown by the solid black line.

However, much of the rhetoric implies that good Governance should add value, implying an upside along the red dotted lines.

Depending on your view of this matter, your view of engagement would be different.
Value impact of good Governance
- engagement implications of the view taken

Potential positive impact:
Good Governance adds value, or prevents its destruction
- The view of Governance becomes a driver of the valuation of the company
- This should be taken into account in the investment process, alongside execution based meetings
- Regular meetings are held with those responsible – Chairman, NEDs – in order to assess the quality of the company’s governance and to adjust the valuation and investment decision accordingly
- Transparency on how this is taken into account improves the dialogue

Only downside risk:
Bad Governance destroys value
- You assume that Governance is at least adequate at all companies until a specific risk is identified
- There is no need for ongoing engagement, beyond routine AGM voting
- There is no value impact, so Governance is a neutral factor in the valuation and investment decision
- You then engage at the point that the risk is identified in order to drive change, or
- Exclude that company from portfolios and sell all shares

➢ Many actors seem to talk like they believe in the upside and act like they only believe in the downside risk
➢ Even then, perhaps some engagement could reduce the downside risk
How forecasts drive valuation
- A simple model

Financials are forecast over three horizons
• With varying degrees of detail

These forecasts then typically drive discounted cash flow valuations

Discount rates are dependent on various factors, but also reflect the degree of confidence that investors have in delivery of the forecasts

- Short Term
  Specific forecasts based on known factors
- Medium Term
  Annual forecasts derived from specific trends
- Long Term
  Generic growth rates derived from long term trends drive growth to perpetuity and terminal value

Key influence: Execution
Governance

Level of confidence will tend to decrease further out....

.....but later years can be a significant proportion of the value
Growth rates and confidence
- important factors in the valuation

Short Term
Specific quarterly and annual forecasts are used to drive valuations. There is a range of possible outcomes in the market, from which it is possible to derive:
- A consensus growth rate that is important in the valuation
- A spread of forecasts – or range – that give an indication of the degree of risk in the consensus

Long Term
Long term forecasts tend to rely on broad assumptions of a sustainable growth rate driven by industry structure and mega-trends:
- This rate of growth, in relation to the discount rate is a value driver
- This impacts the Terminal Value, which can be an important part of the valuation and is very sensitive to the assumptions

Range of outcomes

Long term growth rate
If Good Governance drives value
- then the dialogues can be aligned to the valuation

<table>
<thead>
<tr>
<th>Governance</th>
<th>Transactional/Short term</th>
<th>Strategic/Medium - Long term</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The governance dialogue can drive the ultimate view of long term sustainable growth and the confidence that the investors have that the Board is building a company that will survive and compete for the long term, with a minimised risk of major upsets along the way. This can be reflected in assumed growth rates, discount rates and terminal values.</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Execution</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The execution dialogue will continue to provide the detailed building blocks for the short/medium term modelling whilst enhanced Governance insight may affect the degree of confidence due to risk mitigation and, again, discount factors.</td>
<td></td>
</tr>
</tbody>
</table>

It is clear that some investors are already doing this very explicitly.
• There are examples of ESG factors specifically impacting discount rates, or being used to adjust target prices
• But others are only using it superficially or implicitly, if at all
➢ **If it was generally more explicit, it would enhance the ability of companies to communicate accordingly**
Can good Governance contribute to value?

Based on the discussion above it seems that there is a case to be made for good governance adding value:

• Increased confidence in long term sustainable growth
• Reduced risk of short-term issues or business failure
• Reduced discount rates, lower volatility and optimal cost of capital

There is evidence that some investors are actively taking this into account, but many are clearly not really, or visibly, doing so.
Returning to the Key questions:

**Does good Governance add value?**
- There is a clearly an argument that it does, or at least should do.
- The rationale is that good governance leads in the oversight of all the company’s execution, so if that is well managed then the long term sustainability of value creation should be increased and the risk of serious issues arising should be reduced.
- Some investors have clear models and processes for taking these factors into account, but many work simply on the basis of excluding investments with clearly poor governance.

**How are Governance factors incorporated into valuations and investment decisions?**
- Most companies do not have a clear view as to how their quality of governance can affect their valuation or the investment decisions taken by asset managers.
- Generally they are happy to provide the access and information that investors require, but in the absence of that information they focus on other areas that are known to be of interest and have well established channels of communication, supportive advisers and robust disclosure.
- Much of the Governance dialogue that does take place is carried on via intermediaries which is a source of frustration to many companies.

**Is the nature of the dialogue between companies and investors optimal?**
- The report describes the Four Dialogues framework.
- It finds that the Execution dialogues are generally well run and efficient, taking up the majority of the resources on both sides, although heavily weighted towards short term and modelling discussions.
- However the Governance dialogues are generally less well regarded. The Transactional dialogue is dominated by intermediaries, focussed on AGM voting, whilst the Strategic Governance dialogues are often less frequent or less well structured.
- It seems that the Strategic Governance dialogue should be important, but it is being crowded out by the transactional and executional dialogues, particularly due to the short term focus of many.

**How should approaches change to make Governance engagement more effective?**
- If the time and resources of companies and investors are not being allocated optimally, then perhaps they could be reallocated to move the emphasis to more constructive Strategic Governance engagement.
- Less emphasis on short term engagement could increase the overall efficiency of the process.
- Greater clarity over the content and purpose of Governance discussions would also be beneficial, as would clarifying the role of the intermediaries involved.
Potential for beneficial trade-offs

If an investor wishes to benefit from greater insight into Governance,

• to understand long term value creation
• increase confidence in delivery of expected results, and
• to drive better performance through good Stewardship

.... there is the potential to re-focus activities away from short term execution.

This might include:

• Less focus on quarterly results, to allow more time for stewardship and Strategic Governance discussions
  • For example, stop quarterly reporting, or reduce to simple trading updates
• Focus dialogue on substance, not form; with Chairs/NEDs responsible for Governance
  • Placing greater emphasis on meeting Directors will enable a subjective evaluation of their competency and trustworthiness
  • More Explain than Comply; engage in a dialogue and de-emphasise box ticking
• This might enable shifting resources from short term financial modelling to more Governance insight
  • Stronger integration between Sector and ESG analysts may be beneficial
  • Better guidance to companies on how they should engage would also increase efficiency
Governance

A Practical Review of how Investors and Companies engage