THE INVESTOR FORUM

Barriers to engagement

December 2018

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What are the barriers to high quality engagement – including collective engagement – between investors and companies? We suggest that there are 5 crucial blockages in the system, and a further emerging one:

1. Resourcing

The numbers are striking. The largest investment houses hold tens of thousands of companies. Even many moderate sized firms own a few thousand. Rare is the investment firm with a genuinely concentrated portfolio across all its investment mandates – even where individual portfolios are concentrated, the aggregate is a rather more diffuse exposure. Having sufficient resource to engage effectively across a firm-wide portfolio is a significant challenge.

Thus it is no surprise that resourcing poses a real challenge to effective engagement. As a recent study by ICSA (*Shareholder engagement: The state of play*, July 2018) states: "One factor mentioned by both issuers and investors were investors' resource constraints. With many major investors often holding thousands of firms in their portfolios it is only natural that their resources are stretched to engage meaningfully with all companies." Even with recent growth, and plans for further additions to teams, the resourcing levels may not be sufficient to cover such a broad waterfront. Certainly, this is the experience of UK chairs; at the Investor Forum's breakfast meetings between directors and investors, the question of limited investor resources was a repeated theme, and a repeated frustration.

The ICSA study suggests that there has been an increase in the quantity of engagement but companies perceive that this growth in activity was "not always accompanied by an increase in the quality of engagement". In part into the gap in resourcing come the proxy advisors, which facilitate investors to take better decisions. However, they cause frustration on both sides when these advisors become substitutes for direct dialogue between the parties.

2. Consensus

The investment community is proud to operate in an open marketplace, and an active market requires different opinions. In this lies the crucial main behavioural barrier to collective engagement: investors are trained that they are most effective when they do not share a perspective collectively with others. And that is not sharing in the sense both of not telling others what their view is, and in almost deliberately not having the same view as others. The investors that are most widely feted are those who are or were contrarians in their thoughts and actions.

Consensus is not in investors' DNA. While stewardship teams do have somewhat more of a habit of dialogue and cooperation with each other, portfolio managers do not – in many fund management houses even within the firm, not just externally. Thus getting portfolio managers to agree that there is a problem to be addressed, let alone that action should be taken, and let alone that there should be collective action, can be a significant challenge. Furthermore, some investors can be concerned that seeking to engage collectively might in some way signal possible future portfolio investment decisions which might expose them to the market moving against them.

3. Problems not solutions

One of the particular challenges with consensus-seeking is that investors have a tendency (as do human beings generally) to concentrate on areas of disagreement rather than areas of agreement. Often, investors can identify that there is a problem at a company, or at least that they share concerns about a company. But finding scope for agreement about a sensible way forwards, about what needs to change, is much harder. And so, too often, collective discussions stop. Whereas, the strength of collective concern could in itself be a sufficient trigger to engagement and to catalysing a change at the company. After all, the board may be less responsive to outside assertions of the way things ought to be, but might listen to a concerted call for unspecified change, to which the directors themselves can develop an appropriate response.

By combining to present the concerns and the problem to the board, investors may learn more about what solutions may make sense. The way in which a board responds to a collective call for change can often indicate appropriate ways forward.

4. Visibility

In markets other than the UK, there can be limited transparency of shareholdings. Indeed, in some markets investors seek to preserve their anonymity with real vigour, and while larger positions in contracts for difference (CfDs) are disclosable in the UK, smaller position remain private. This can prove a barrier to engagement, because companies do not know which investors to seek dialogue with and even when investors do approach them for discussions, companies may not be fully confident that they have clear insight into the investors' overall position in relation to the company, including short as well as long positions. An assertion of holdings will be less convincing than a formal disclosure, limiting trust and perhaps openness. Similarly, unless holdings are public, investors may not know who their fellow shareholders are with whom they might wish to collaborate; the shareholding lists compiled by data providers are often not wholly accurate.

5. Conflicts

Conflicts of interest are the financial industry's dirty little secret. Investors are no better than other financial institutions at acknowledging the existence of conflicts – open acknowledgement being the first step to building trust among clients and beneficiaries that the firm will do the right thing notwithstanding the conflict of interest. Many stewardship codes call for transparency around conflicts which might impinge on stewardship activities, yet a number of investors fail to rise to this challenge. Very few institutions state, simply and directly, that they will put client and beneficiary interests first.

In this context we should not be surprised if on occasions conflicts may get in the way of doing the right thing for clients and delivering effective stewardship. This will not be overt, but it may play a part in a decision that this particular engagement may not be the right one for the investor to make a big deal of, or simply to participate in a collective engagement, preferring to plough a lone furrow.

6. Competition

Stewardship professionals have historically been content to work together, both informally and in more formal collaborations, recognising that in many cases that is the best way to deliver change on behalf of clients. However, as stewardship is becoming more of a focus for clients and for investment consultants, and more of a differentiator between the services offered by fund management houses, there are signs that some teams are beginning to believe that they should keep some activities to themselves so as to be able to claim full credit for the change.

This is still an unusual mindset, and need not happen. The best questions from clients and consultants should explore how the fund manager takes the judgement as to how best it can generate change of behalf of clients, not whether it believes it was unique in seeking that change. But over time should this mindset take hold, the competitive spirit will prove a significant barrier to collective engagement – and will also at times prove a barrier to delivering needed change.

Client interest

Those client and consultant questions are key – what change is in client and beneficiary interest, and how can it best be delivered. Being honest and clear about what are the answers to those questions will on occasions sweep away all of the barriers to effective engagement and enable institutional investors to deliver fully on the promise of stewardship.

Contact Us

The Investor Forum
183 Euston Road
5th Floor
London NW1 2BE

Telephone +44 (0) 207 611 2223
info@investorforum.org.uk
www.investorforum.org.uk