The Four Dialogues

The need to improve how Investors and Companies engage on Governance

Prepared for

THE INVESTOR FORUM

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Background and Purpose

This report has been prepared to examine the way in which companies and investors engage on Governance matters and to consider how the interaction may be improved. It is very much focused 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 facilitates collective engagements with UK listed companies on behalf of its Members, which are leading investors and asset owners.

Following a series of discussions with company Chairs and senior investors, the Investor Forum asked Jonathan Atack to carry out this research, focussing initially on the perspectives of the companies.

Jonathan is a very experienced Investor Relations professional, having been head of Investor Relations at six large companies across a variety of sectors and having received recognition with a number of IR awards and nominations. In addition to several other relevant finance roles he was also the global CFO of ING Investment Management, with almost EUR 400 billion under management in over 30 countries.

The preparation of this report has been done on the basis of desk research and almost 40 interviews with representatives from across the investment chain:

- 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

The interviews were carried out on an unattributable basis and we are grateful to those that gave their time and insights.

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 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.

Contents

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:**

	Transactional	Strategic
Governance	**AGM Voting**	**Board effectiveness**
Execution	**Results and modelling**	**Forecasts and targets**

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**

Executive Summary

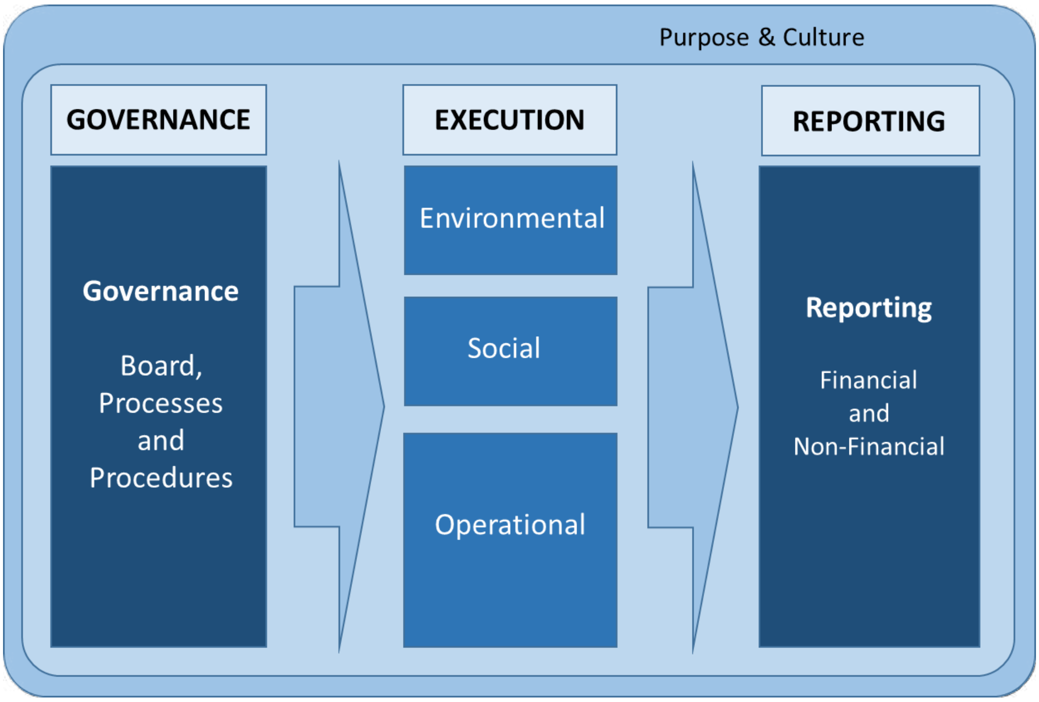
<u>Background</u>

The nature of company/investor engagement is beginning to change due to increased focus on responsible and non-financial factors, often encapsulated in terms such as Environmental, Social and Governance ('ESG'). Pressure for change is coming from society, beneficiaries, regulators and asset owners.

Many investors have made positive commitments to taking full account of ESG factors and engaging actively with investee companies, **but there appears to be some doubt as to how widespread, or effective this engagement is**.

This report has been commissioned by the Investor Forum to look into how effectively companies and investors engage on the matter of Governance. It is based on interviews with almost 40 individuals actively involved in the discussions as well a review of other publicly available information.

<u>The Company context</u>



As a key objective of investors is to increase value through investment returns, **the importance of ESG engagement is to ensure the long term sustainability of value creation**.

There is a particular focus on Governance as many investors regard this as an essential discipline for all companies which, if done well, will have a positive impact on all areas of the company's activities. The **Execution** of the company's activities would then include Environmental and Social factors, as well as the ongoing Operations of the company. Many of these factors will be company or sector specific and would be well managed if the overall Governance of the company is good. All companies must then **Report** on their activities and results.

Overarching all these processes and actions is the company's **Purpose and Culture**, which will be fundamentally important in defining their effectiveness

The Disconnect

Many companies have found that it is harder to have meaningful discussions with investors on Governance matters, particularly when compared to regular discussions on short term results. Many reasons are given for this, but there does appear to be **a fundamental disconnect** between the way that investors explain their level of interest in long-term Governance, and the experience of companies in their dialogues with the investors. A recurring theme is that there is only downside from bad Governance, with limited or no upside from demonstrating good Governance.

The Four Dialogues

	Transactional	Strategic
Governance	Transactional / Governance **AGM Voting**	Strategic / Governance **Board composition and effectiveness**
Execution	Transactional / Execution **Results and modelling**	Strategic / Execution **Forecasts and operational targets**

This report considers **the different types of dialogue** that take place between investors and companies. It finds that there are several distinct dialogues that vary in terms of subject matter, participants and time-horizon, as well as in the nature of the data used, the purpose of the dialogue and the intermediaries that are involved.

The dialogues can first be considered in terms of **the subject under discussion**. There are ongoing discussions about the way that the company is **executing its business**, as opposed to other dialogues that are based on the **Governance** of the company. The latter dialogues are more driven by the company secretary and the Non-Executive Directors ('NED's), whereas the execution discussions tend to involve the CEO, the CFO and the Head of Investor Relations. Similarly, the investors tend to be represented by sector analysts and Portfolio Managers for the execution dialogues, whereas specialists in Governance will be more likely to lead in Governance meetings.

Each of these dialogues also has a short-term element, more focussed on **transactional** matters, and a longer-term element, with a more forward looking and **strategic** emphasis. This further segregates the Governance/Execution dialogues into short/long term elements – giving **the Four Dialogues that tend to dominate the Company/Investor interaction**:

Each of these Four Dialogues tends to have different participants, with different content and base data used to inform and underpin them.

The Effectiveness of the Four Dialogues

It is also clear that **very different levels of resources** are deployed for each of these dialogues, with the Transactional/Execution dialogue dominating. It is focussed on dealing with short-term or quarterly reporting and updating investors' valuation models. This is followed by the Strategic/Execution dialogue, which is structured around managing the medium term expectations of delivery by senior management. Most companies that we consulted estimated that they spend more than 50% of their time on the former and closer to 30% of their time on the later.

	Transactional/Short term	Strategic/Medium - Long term
Governance	2% to 20%	1% to 7%
Execution	45% to 70%	20% to 45%

This leaves relatively little, only 15% to 25%, of their time for the Governance dialogues, which are also generally thought to be more biased to the short term Transactional discussions. These are primarily focussed on the AGM and voting by the investors. Lastly, **the Strategic/Governance dialogue seems to be the one with the least time and resources committed to it**. This might seem surprising given the importance of ensuring the company is well managed.

This therefore raises the concern that too much time is spent on dialogues that are more short term focussed and which are **crowding out** the Strategic Governance dialogue, which probably should be given a higher priority.

One potential explanation for this is that the **Execution dialogues are clearly linked to the modelling and valuation of the company**, which is essential for the investor to monitor the performance of the company and assess its value creation – usually captured in some form of financial model, based on audited information. This gives a robust basis for the meeting as well as a clear purpose to the dialogue.

On the other hand, **Governance based dialogues often lack a comparable focus on value** and the grounding in assured, quality data. **Often the effectiveness of this dialogue is diminished when it is effectively outsourced to advisers and ESG analysts** who take a checklist approach. This limits the direct dialogue, but also diminishes the opportunity to explain deviations from the checklists.

Even when there is a chance for meaningful dialogue, it can be rendered less effective if the purpose of the conversation does not have a clear link to the long-term value creation of the company. **There is clearly scope for more transparently integrating Governance factors into the valuation**.

Key questions

This report asks the reader to consider these key questions:

- **Does good Governance add value?**

  There is a generally accepted view that it does, but it is not always clear how it is taken into account by asset managers. Clearly for some it is a given that Governance is adequate unless there is a known problem. Many investors screen negatively, but there are relatively few clear examples of how positive recognition adds value.

- **How are Governance factors incorporated into valuations and investment decisions?**

  If investors can clearly articulate how they take governance factors into account, then companies would be able to provide the right information and steer behaviour to support value creation.

- **Is the nature of the dialogue between companies and investors optimal?**

  The report describes the Four Dialogues framework. Considering market practice, is it the case that resources are being directed optimally, or is too much time and effort spent on the Execution and Transactional dialogues – at the expense of time for the longer term Strategic Governance dialogue?

- **How should approaches change to make Governance engagement more effective?**

  If the time and resources of companies and investors are not being allocated optimally, what changes can be made to the processes of engagement, the content of the discussions and the types of meetings to rebalance activities towards the Strategic/Governance dialogue, so as to focus more on long term, sustainable value creation.

It is hoped that consideration of these questions, based on the Four Dialogues framework, will help to stimulate discussion and potentially create a consensus for how to improve the situation, leading to further action towards improvement.

1. Introduction

The nature of the dialogue between investors and companies regarding Governance is starting to evolve rapidly. Directors of public companies know that they are increasingly in the spotlight, especially when things go wrong. Meanwhile investors are increasingly under pressure to take their Governance responsibilities towards the companies that they own more seriously as the focus extends from financial returns to place more emphasis on stewardship. This pressure is coming from many directions – not least regulators and standards setters, but also broader society and their own customers. Some now see increased Governance insight as a potential competitive advantage and there is general acceptance that good Governance should lead to better long term value creation.

However, the track record of engagement is not so impressive. In reality the dialogue is often limited and principally revolves around AGMs and box-ticking checklists that measure the form of the Governance structures over the substance of their effectiveness. Engagement only really steps up when something goes wrong, and even then it is frequently dominated by relatively short to medium term considerations such as remuneration and board succession.

It is often not clear how, even if, Governance matters are integrated into the investment process and without this common understanding it is hard for companies to know how to communicate about it. Contrast this with the dialogue on operational matters and execution, which is usually well structured, ongoing and value focussed. Over the last twenty years or so companies have learnt how to communicate based on financial results and value drivers; this is now recognised as a core competence for CEOs and CFOs, backed by professional investor relations staff and advisers.

This document looks at how the nature of Governance engagement between investors and companies is changing and seeks to offer some suggestions for how it might be improved in the future.

'We believe that ESG is financially material.
It does add value – Especially G – it is a necessary condition to get ESG right. Good G drives the ES.'
Asset Owner

2. Value and Governance

The Nature of Value

A key factor underlying many of the points raised in this document is that of value. Indeed, it is a core, underlying assumption that the relationship between companies and investors is founded on value. The reason for the investor investing in the company is in the hope and expectation that the investment will grow in value, including distributions of profit. This may be a view taken in order to provide an investment return for a client of the investor, or as principal. It is also generally accepted that one of the objectives of a company's management is to create value – primarily for the shareholders.

This view of value creation may generally be considered to be most effective when applied to long term, sustainable value creation. In this case it is also much more likely that value will also accrue to other stakeholders, such as employees, customers, suppliers and society as a whole. If a company takes a longer term view and aims to create sustainable value growth it is much more likely to invest in its employees and try to keep its customers happy through service quality and value. In this way it may be possible to drive a virtuous circle of happy, engaged employees providing a great service to customers that are willing to pay a fair price and return for more, which then generates a growing and profitable revenue stream. This provides good returns for shareholders as well as enabling further investment in employees and the business.

If the management of the company is tempted to take a shorter term view of profit generation, they may seek to maximise it through such measures as under paying employees, overcharging customers, or perhaps avoiding other costs such as tax or efficient waste disposal. This may indeed boost profits in the short term, but is likely to lead to damage to the business in the medium to longer term, which would therefore imply a destruction of value. So it may be that a true focus on long term value creation should override a temptation for short term profits.

Ideally we should look through short term volatility and fluctuations in profits and encourage greater confidence in long term, sustainable growth.

The Role of Governance

Some observers have tended to take the view that institutional investors are only focussed on short term gains and that they have no regard for the company that they are investing in, its other stakeholders, or anything beyond a near point in time at which they will take profits and sell out. This view has of course been exacerbated by certain high profile investors, such as some hedge funds, and activities such as short selling which are often perceived in a negative way. However, this all tends to hide the fact that a very large proportion of investors do take a longer term view and that they are increasingly taking a broader view of factors other than the short term financial results. Some of the largest investors are managing money for pension funds, which by their very nature have a 30 to 40 year view, a timescale that far exceeds the impact of current operational actions.

When investors engage with companies there can be many topics for consideration, but underlying the relationship there is most likely to be some view of value, how the company is creating it, and how it will be recognised in the share price. As investors and society increasingly take a broader view of business it is highly likely that companies should see some economic value accruing from good citizenship and thus it is appropriate to look through short term volatility in valuation metrics and focus on long term, sustainable growth, for the benefit of all stakeholders.

There is now a dramatic increase in the awareness of broader and longer term factors that can be taken into account in making investment decisions and there is equally a strong increase in pressure from society as a whole encouraging investors to do so.

This trend comes with many labels of which the most important is perhaps ESG – standing for Environmental, Social and Governance. Other popular terms include Responsible Investment, Corporate Social Responsibility 'CSR', and Impact Investing – which seeks investments that deliver some positive 'impact' in addition to financial returns. One problem that besets analysis of this area is the differing nature of these labels and the lack of consistency in how they are applied. In many cases the discussion is dominated by considerations of climate change and sustainability, which are large and important topics in themselves, but by no means exclusive concerns in the broader context. This review will focus on the term ESG as it is perhaps the most broadly accepted and interpreted and, within that, on the 'G', for Governance. A generally accepted definition of Governance is that given by the Cadbury Committee in 1992. 'Governance' was defined as "the system by which companies are directed and controlled".

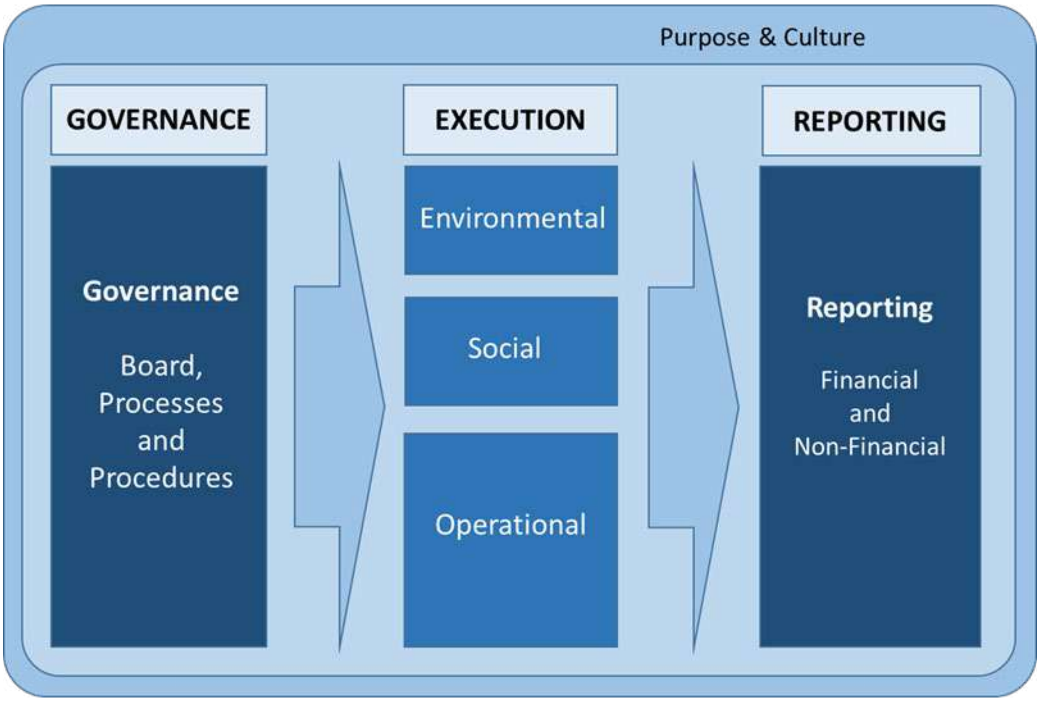


Figure 1 Governance is a leading factor

A number of investors and asset owners specifically made the point that Governance is a lead indicator, and applies equally to all companies. This contrasts with other factors such as Environmental and Social factors which, like the business Operations, are more specific to the company or sector. Hence, the focus is on Governance as, if that is strong and appropriate, then it would imply that the other aspects of the company are also being overseen, planned and managed well.

As a consequence, some investors very specifically focus on Board composition, as the Directors are the leaders of the company's Governance and they have oversight of all other company activities.

Similarly Reporting is a universal factor, as all companies should be reporting accurately and appropriately to enable stakeholders to analyse and understand the company. This, of course, would include both financial and non-financial data.

> *'Governance is really important – it's the lens through which E & S is viewed.'*
> *ESG Recruiter*

All of these activities take place within the environment of the company's Purpose and Culture, which are two key factors which will define the appropriateness and effectiveness of the Governance, Execution and Reporting. It is self-evident that a poor culture, lacking accountability and transparency, will render any Governance process ineffective. So Purpose and Culture must be taken into account in assessing the effectiveness of the Governance – to ensure that they are authentic and aligned.

Key stakeholders – asset owners and asset managers

There are many important stakeholders, but key amongst these is the asset owner. In a typical structure, asset owners have capital to invest, which they place with asset managers. The Asset Owner may well be a pension fund, a life insurance fund or some other form of collective investment vehicle. The Asset Owner places its capital with one or more Asset Managers to invest the capital on its behalf.

The Asset Owner will also put in place a mandate, or a contract, with the Asset Manager, specifying how the capital is to be invested. This may place restrictions on risks to be taken, but may also enable the Asset Owner to specify a particular approach to ESG criteria for its investments – if it believes that this will lead to better returns over the time horizon of the investment.

The Asset Owner will also be mindful of its duty to its customers or beneficiaries, and to its regulators and broader society. It now appears that Asset Owners are increasingly asking Asset Managers to take more account of ESG factors in managing their capital and they acknowledge that this may lead to higher costs. However, they would expect to offset this cost with higher returns.

There is now much positive pressure for enhanced ESG engagement from society and regulators, but as the Asset Owners pay the fees of the Asset Managers, it seems that this channel is well placed to influence meaningful progress.

3. The Apparent Disconnect

It seems that there is a disconnect between the position taken by many investors, regarding their commitment to ESG engagement, and the practical experience of companies.

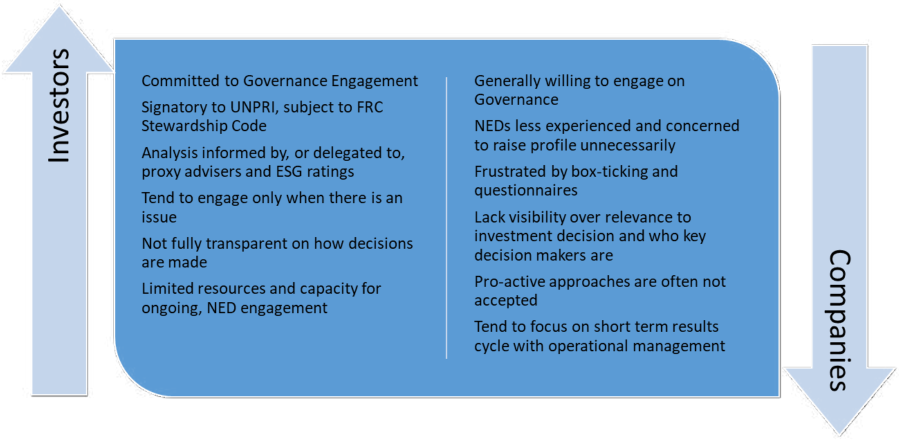


Figure 2 The disconnect between investors and companies

Whilst companies are generally willing to engage and explain or discuss their Governance, their pro-active attempts to do so are often rebuffed. Where there is engagement, it is often formulaic and checklist based, managed by advisers, without meaningful direct interaction between directors and investors.

It was almost universally felt that analysis was very short term and financially driven. Companies felt that there is excessive focus on short term factors such as quarterly reports and share price movements. Companies have generally become very adept at managing these short term interactions over results and announcements, with active investor relations functions which have become very professional and serve their audiences well.

Discussions revealed many related areas of concern, suggesting that investor behaviour was not always consistent with the high level of public commitment. Such examples include comments by regulators and journalists

4. The Four Dialogues

The current engagement dialogue

In order to understand how the apparent disconnect has arisen, it is helpful to breakdown how the current engagement dialogue happens. It seems that the current dialogue between companies and investors has become largely separated into several distinct dialogues. These can be described as Governance and Execution, but each has very different characteristics.

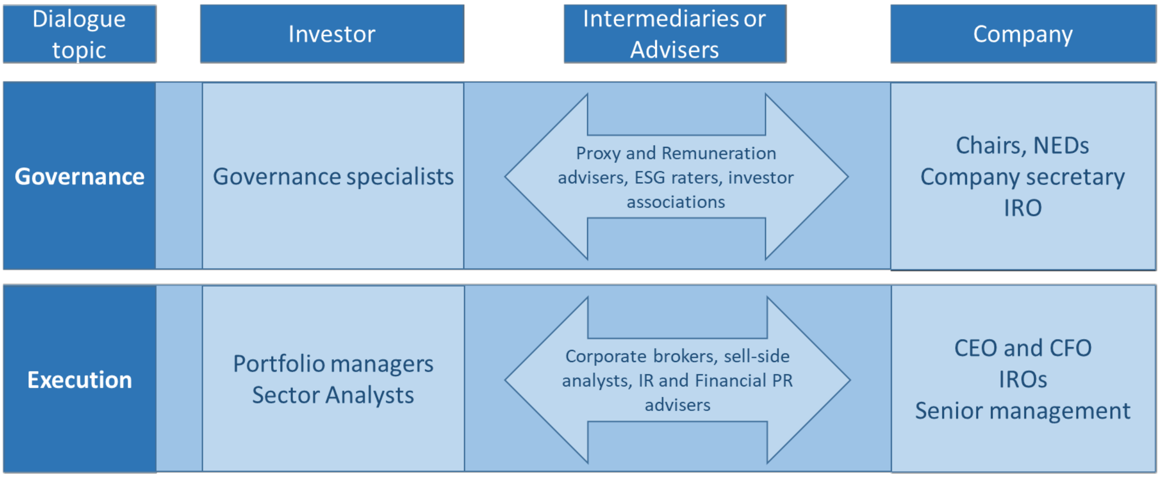


Figure 3 The two main types of dialogue between companies and investors

The Execution Dialogue

The main dialogue between investors and companies is driven by the ongoing execution of the company's business operations and is heavily dependent on the short-term financial results.

This dialogue is now generally well established and efficient. It takes place between the company CEO/CFO and the investors, who usually rely on in-house analysts with a sector specialisation, and the Portfolio Managers of the individual funds that have invested in the company.

The company directors are supported by professional in-house Investor Relations ('IR') teams as well as a range of external advisers including investment bankers and corporate brokers – who have a particular role to play in the UK market. There are also research intermediaries, most particularly sell-side analysts, who provide independent research and contribute to market efficiency and transparency.

The nature of the dialogue is driven by financial metrics, such as sales, costs, advertising spend, profit margins, profits, tax rates, cashflow, capital investment and returns. Key drivers of these metrics, such as pricing, market share, economic growth, product mix, volumes, outlet numbers, numbers of customers and capacity are also very much part of the dialogue as they directly impact the delivery of the financial results.

The quarterly reporting of the results gives regular updates to investors and this data is then the basis for updating their views on the company's prospects. In essence this is summed up in some form of valuation model, which enables the investor to make decisions around the attractiveness, or otherwise, of the shares that they hold. The degree of confidence that the investor has in the delivery of these future results is vital to the credibility of the valuation and companies will often seek to reinforce this by publishing their own targets or forecasts – but usually only on a one to three or possibly five year view. The discussions are based on reported financial numbers which are ultimately audited and assured.

The engagement with investors usually takes the form of regular one-to-one meetings, or collectively in conferences and seminars, which enables investors to quiz management over their results and future strategy. A key element of these interactions is that it enables the investors to look the management in the eye and to form their own assessment of their credibility and competence. This underpins their confidence in the delivery of the forecasts.

Furthermore, the content of the discussion will vary from investor to investor. Each will tend to have their own views around what are the key metrics and sensitivities for each company. There is no 'standard' approach so the discussions are very much driven by the perspectives of the individual investor. This can lead to a very dynamic interaction and executive management often learn from the meetings.

There may be some discussion of Environmental and Social factors, and indeed there is a stream of engagements that focus more on sustainability and climate change. These should be regarded as a subset of the execution discussions, as they will tend to be company or sector specific and are closely dependent on how the company executes, within the larger Governance framework.

The Governance Dialogue

The dialogue between investors and companies on the matter of Governance is generally very different in almost every respect and primarily focussed on box-ticking in relation to a standard set of topics.

The dialogue is often only between the Company Secretary and the investor, usually represented by an intermediary that advises on voting at the Annual General Meeting of the company. This adviser will report to the Governance team of the investor which executes the voting at the AGM. The Governance team will engage directly with the company much less often and will have significantly less resources than the in-house sector analysts. The company IR function may be involved in the meetings but it appears to be very rare for any NEDs or Chairs to be involved in the normal cycle of such meetings.

A recent study by Citigate Dewe Rogerson[1] found that 49% of companies do not proactively offer any opportunities for investors to engage with NEDs and 37% of Chairmen do not meet investors outside of the AGM. This seems sub-optimal, as these are the individuals who are accountable for delivering good Governance.

The nature of the dialogue is generally limited to standard items that are either on the agenda for the AGM, or relate to established checklists – such as the FRC Governance Code. Such topics include Board remuneration, succession planning and the ability to issue shares. They rarely go into more subjective matters such as the company culture and strategy, and their implications for the future development of the business.

The AGM then passes and in another year the process is repeated.

[1] The evolving landscape; 10th annual Investor relations Survey, September 2018

It is often not clear how and to what extent investors really use ESG information, particularly Governance information, in their investment process and decision making. As a result there is less opportunity to engage in broader discussions around metrics whereby the company can seek to build confidence in its delivery and improve its valuation. Similarly there is limited opportunity for investors to look the relevant directors – the Chair, heads of board committees, the Senior Independent Director – in the eye and form a view on their competence.

> *'Comply or explain is not working. It only feeds the ratings so 'Explain' has no value. There is no nuance; investors do not add to the box-ticking.'*
> *IR Adviser*

It is also very much the case that active engagement on Governance often only happens after a significant issue has arisen. So whilst the Execution dialogue is forward looking the Governance dialogue is more typically focussed on ex post problem resolution.

Comparing the Execution and the Governance Dialogues

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

Figure 4 Comparing the Execution and Governance dialogues

It seems, therefore, that the Governance and Execution dialogues are carried on in two entirely different ways.

The Execution dialogue is thorough and value based, with clear metrics enabling a detailed and mutually beneficial engagement. Meanwhile, the Governance dialogue is much more mechanistic and is more of a process that has to be gone through, rather than an opportunity to really share thoughts and learning.

Comparing the two, the problem seems to be that the Governance dialogue is not rooted in the value consideration in the way that the execution dialogue is. Without clear metrics or an understanding of the how ESG metrics impact value, there is no currency for the discussion and no real grounding in value creation.

All participants seem to agree that good Governance is a strong contributor to long term value, but they fail to be able to quantify it and so there is no basis or incentive for meaningful debate.

There is no doubt that the dialogue and the analysis that does go on over Governance must generate data – but is this in fact limited to some form of rating that is not strongly linked to value creation?

There are certainly cases where perceptions of poor Governance leads to a refusal to invest – so there is clearly some element of a 'hygiene' factor at the negative extremes, but limited evidence of any positive benefit from engagement over ESG.

It is also clearly the case that a failure of Governance can lead to sudden and catastrophic value destruction. A case in point is Carillion plc which fell rapidly from a market capitalisation over one billion pounds Sterling to zero, by way of a series of profit warnings. This has led to much on-going agonising over what went wrong and why, but there is certainly much discussion about how a desire to support the share price in the short term led to dysfunctional decisions that led to the collapse. This clearly is contrary to the desire to support long term value and even despite around 40 pages of Governance reporting in Carillion's 2017 report and accounts.

It is also important to point out that there is one area of interest that might be perceived to straddle the Execution and Governance topics – and that is Sustainability. Indeed, the ESG space is often dominated by environmental and sustainability matters and as a result there is often a better dialogue in this area. As climate change is such a high profile megatrend it is on the agenda of the CEO/CFO and companies are keen to advertise their green credentials. It is also such a major driver of real trends in the global economy and the markets that it can have a more direct impact on valuation through the normal course of business. There is, therefore, a much better established round of conferences and analysts that do look into how companies are performing in this area and it is perhaps this that means the value impact is more real and taken seriously.

Given the earlier assertion that Governance leads, whilst Environmental, Social and Operational factors are more company specific, there is no real mis-match here. The sustainability discussion belongs in the Execution dialogue, where its relevance and importance will depend on the specifics of the company.

The Four Dialogues defined

Having set out above an argument that the engagement dialogue between investors and companies can be viewed as being split into Execution and Governance dialogues, we can now further break this down by adding an additional dimension. This dimension is to split each of the dialogue types into those with a more short term, transactional focus, and those with a more medium to longer term, strategic focus.

The transactional dialogues will be primarily focussed on dealing with short term, immediate reporting and actions, such as AGM voting for the Governance dialogue and Quarterly results for the Execution dialogue.

The strategic dialogues will be more forward looking, such as targets and investment plans for the execution dialogue and succession planning or risk management for the Governance dialogue.

This, in effect, enables us to consider four distinct types of dialogue that might exist between a company and its investors, with Governance and Execution further subdivided into Transactional and Strategic. This seems to be valid, as there is a general differentiation in the subject matter for each, further supported by the reality that each dialogue tends to involve different participants, as set out in Figure 6.

	Transactional/Short term	Strategic/Medium - Long term
Governance	Focus: AGM - Voting Content: Checklists Investor: Proxy adviser Company: Company Secretary Short term discussions on Governance, typically held between the proxy/ESG rating agencies and the Company Secretary. Usually focussed on the AGM and voting, often following checklists.	Focus: Board composition and effectiveness Content: Strategy oversight, remuneration, etc Investor: Governance specialist Company: Chairman, SID, NEDs More substantive discussions regarding Governance, probably with the Chairman or other NEDs and committee chairs and the Governance specialists at the investor. Covering strategy, board composition and succession, risk management, key priorities etc.
Execution	Focus: Quarterly results, modelling Content: Numbers Investor: Sector Analyst Company: IRO Short term performance and modelling to support company valuation, driven by quarterly results. Held with IRO and investor sector analyst. Sell-side provide more input.	Focus: Targets and tactics Content: Strategy and operations Investor: Portfolio manager Company: CEO and CFO Longer term discussion held with CEO/CFO and Portfolio Manager. Grounded in reported results, but with 3-5 year outlook, based on trends, targets and management actions.

Figure 5 The Four Dialogues

In meetings with company representatives this model has been a helpful basis for discussion and has been generally accepted as a useful way to view the types of engagement. Naturally the table shows a very distinct set of boxes, but there will of course be some overlap in practice and this really represents a broad segregation of what will be more of a continuum in practice.

We can see that the Execution dialogue has a transactional element that is very much driven by short term results, in particular quarterly results as a basis for updating and revising financial models. In these discussions the company IRO will take the lead and they will interact with the investors' sector analysts and the sell-side as a route to market for the investors. Typically the IRO will then take the CEO and CFO on the road to meet investors on a one-to-one or collective basis, or at conferences and other events. The dialogue here will still be execution based, but is more likely to be forward looking – the impact of current plans and actions, expected capex, new products launches, geographic expansion and KPI targets.

> *'We talk too much about numbers and not enough about strategy.'*
> *Asset Manager*

For the Governance engagement, the short term is typically focussed on the AGM and is very much defined by voting intentions. The Company Secretary may well take the lead and the IRO could be involved, but it is most likely that they will be talking to a proxy adviser or other third party rather than directly to an investor. In some cases there may be meetings with the Governance specialist of the major investors, but in either scenario the dialogue will be driven by the AGM agenda and often by standard checklists. For the longer term, strategic discussion, this will be with the Chair of the board or other NEDs and will involve the Governance specialists of the investor – possibly accompanied by relevant PMs. However, even with these it is likely that the emphasis is on 'hot' topics such as remuneration and succession planning, with a focus on short term actions, rather than genuinely strategic matters and board effectiveness.

Crowding out – short term considerations dominate

When we consider the balance of the four dialogues the reality seems to be that the major focus is on the short term Execution/Transactional discussions, with slightly less but still a significant focus on the longer term Execution/Strategic dialogues. Most companies that we consulted estimated that they spend 45% to 70% of their time on the former and something like 20% to 45% of their time on the later. This is based on a small number of observations, but they were remarkably consistent in the overall pattern of how they thought their company's time was allocated.

	Transactional/Short term	Strategic/Medium - Long term
Governance	2% to 20%	1% to 7%
Execution	45% to 70%	20% to 45%

Figure 6 Indicative time allocation by companies to the Four Dialogues

This leaves relatively little time for the Governance dialogues, which are also generally thought to be more biased to the short term Transactional discussions. The companies indicated that between 2% and 20% of their time was spent on Governance /Transactional matters, and only 1% to 7% on Governance/Strategic dialogues.

Overall the view is that the Execution dialogue is efficient well managed, whilst the Governance dialogues are somewhat lagging in quality and effectiveness.

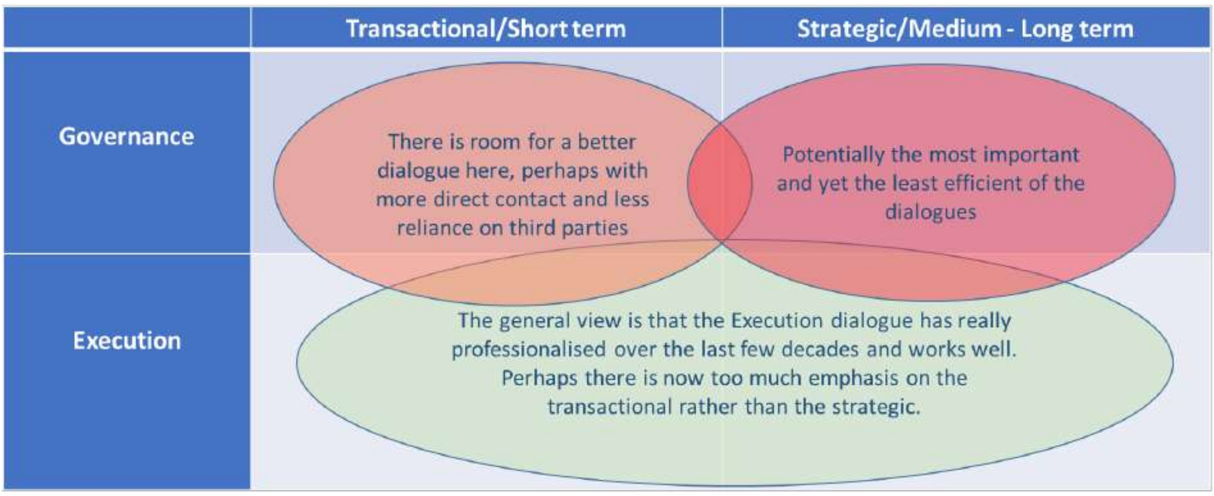


Figure 7 The effectiveness of the different dialogues

The net result of this is that the amount of time and effort spent on the Execution dialogues is crowding out the Governance dialogues, particularly the longer term, strategic dialogue that should be happening between investors and Boards. Given the supposed focus on stewardship and the role of the Directors in running the company for the long term, acting as the elected agents of the investors, this may seem surprising, or at least sub-optimal.

One possible explanation for this is that the Execution dialogues are more closely aligned to how investors value companies. The content of the discussions directly drives valuation models and therefore buy/sell decisions and share values.

On the other hand, therefore, the Governance dialogues are possibly too far removed from the valuation process and so not so strongly grounded. The result of this is that the content of the discussions is not so well defined and the discussions themselves are not taken so seriously.

5. The Investor perspective

The importance of Governance

The increased focus on Governance, within the broader concern about the nature of companies' stakeholder responsibilities, has been taken up by a number of important bodies. Perhaps two of the most prominent are the Principles for Responsible Investment ('PRI') and the Financial Reporting Council ('FRC') in the United Kingdom.

The United Nations has partnered with the PRI which sets out six principles that have been prepared by investors, for investors, to enable them to act in the best long term interests of their beneficiaries. The UK's FRC has a mission to promote transparency and integrity in business and produces both The UK Corporate Governance Code[2], which sets out the Governance obligations of UK corporates, and The UK Stewardship Code, which sets out how investors may best assist companies in doing this. Engagement is a core element of this and it specifically states 'For investors, stewardship is more than just voting'.[3]

The United Nations Principles for Responsible Investment ('UNPRI')

The UNPRI are important, given their global reach and relatively long history. It was founded in 2006 with 63 members and has since grown to have 1,961 signatories, being investors with almost USD 82 trillion of Assets Under Management.[4] Of these over 1,000 are in Europe and 456 are in North America, but there are significant numbers in South America, Africa, the Middle East and Asia.

Each of the signatories has signed up to the six principles of the UNPRI, 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.

Taking this at face value, it would seem that a very significant amount of assets are being managed on the basis that ESG is incorporated into decision making, they are being good, active owners and they are seeking ESG disclosure from their investee companies.

Furthermore, 373 Asset Owners have also signed up to the UNPRI, which demonstrates that the customers of the Asset Managers are also increasingly putting pressure on them to ensure good ESG practice.

In its study on how engagement creates value, the UNPRI states that 'There is clear evidence that engagement by investors with companies on …. ESG issues can create shareholder value.'[5] However,

[2] Financial Reporting Council, The UK Corporate Governance Code, July 2018
[3] UK Stewardship Code, September 2012, p1 Stewardship and the Code
[4] As of April 2018, UNPRI website https://www.unpri.org/about-the-pri
[5] How ESG engagement creates value for investors and companies, PRI, 2018

it acknowledges that how this creates value is poorly understood. It largely attributes the value creation to the benefits derived from the related communication, learning and the development of relationships.

UK Financial Reporting Council

The FRC regulates auditors, accountants and actuaries in the UK and has a mission to promote transparency and integrity in business. It also sets and publishes the UK's Corporate Governance and Stewardship Codes.

The Governance Code was born out of the Cadbury Committee recommendations in 1992 and was most recently updated in 2018. It now includes 18 Principles, supported by 41 Provisions covering topics such as leadership, division of responsibilities, board composition succession and evaluation, audit and remuneration.

The FRC emphasises the value of good corporate Governance to long-term sustainable success.

Compliance with the Governance code is not mandatory, but The Listing Rules do require companies to make a statement of how they have applied the principles. This 'comply or explain' regime carries significant moral authority, but by its nature does tend to lead to a tick-box approach by companies reporting. This has been explicitly recognised by the FRC, and with the launch of the new code in 2018 Sir Win Bischoff, chairman of the FRC, wrote to company Chairs and investors asking them to 'avoid a tick-box approach' and stating that 'explanations should not be evaluated in a mechanistic way.'[6]

The Stewardship Code complements and supports the Governance Code by setting out seven Principles that institutional investors should follow in order to better exercise their stewardship responsibilities. It makes it clear that stewardship extends beyond voting at AGMs and specifically encourages engagement with companies and reporting on their activities. UK authorised asset managers are required by the FCA to report on the nature of their commitment to the code.

The Stewardship Code was most recently published in September 2012 and is currently being reviewed, with a revised code expected in 2019.

Other drivers of increased attention to Governance

As investors increase their interest in ESG criteria, we will see a corresponding increase in the number of specific funds and indices that are constructed around these metrics. This will therefore drive a corresponding increase in the focus of the investors and the companies. This mirrors an increased focus on requiring and monitoring ESG factors from clients, most importantly the Asset Owners.

[6] Letters from Sir Win Bischoff, to Company Chairs and investors, July 2018

Investors: two aspects of shareholding – investment return and stewardship

It is important to understand that investors have a dual interest in their investments – both the financial returns that they make and their responsibility for good stewardship as owners of the company. The balance is shifting noticeably towards the latter and this has implications for how engagement happens. Ultimately the two are mutually supportive as good stewardship should promote value creation that boosts investment returns, particularly over the longer term.

Investment returns

This is the aspect of ownership that is the most obvious and has historically been the primary focus of investor engagement. Investors are primarily driven by the financial returns made as a result of the share price appreciation and any cash distribution, such as dividends. This is measured in the short term and the decision to buy, sell or hold is taken on the basis of expectations of future movements.

Measurement of the fund managers' performance is therefore predominantly financial and encourages a short term view, based on a financial view of the short term delivery. There is some incentive to engage over better operational management, as this may directly affect the share price, but there is also a significant incentive to simply exit and sell the shares if they underperform.

Stewardship

However, shareholders are the owners of the company and they appoint the directors, as their agents, to run it for them. There is therefore, an implicit responsibility to see that it is run well and properly. Shareholders do have the chance to vote at the AGM each year and some do use this opportunity to engage proactively, but until recently it has been rare to see significant votes cast against the recommendation of the Board.

There is a belief that good stewardship should involve a strong dialogue with the company that would in turn lead to improved understanding and ultimately better performance in the long term. Thus good stewardship is increasingly seen as an obligation of a shareholder, which may also serve to promote better value creation by the company.

6. The Company perspective

With all this pressure for engagement on Governance, then we might expect to find that corporates are feeling the pressure, with building demands for engagement and disclosure. However, having spoken to representatives of many corporates – from Chairs of Boards through company secretaries, investor relations heads and corporate affairs, as well as many advisers to corporates, it is not quite as clear cut as we might expect.

Whilst all companies were willing to engage on Governance, and many felt that they were pro-active in reaching out to investors, the response from investors was not uniformly enthusiastic. It was common practice for the Chairs of those companies interviewed to write to major shareholders each year to offer meetings. Generally the response rate was very low.

> *'Every year I write to my top 25 shareholders offering a meeting. Very few even respond.'*
> *FTSE 100 Chair*

Consequently there was a view among companies that investors were only really interested if there was already a problem and that they did not have the resources for ongoing, routine engagement. Furthermore, it was often felt that Governance engagement was limited to AGM voting, when it was delegated to intermediaries, and it was also happening independently of the Portfolio Managers or sector analysts covering the company. The conversations that did occur were frequently dominated by remuneration, and it was not clear how Governance matters impacted the investment decision, beyond negative screening and a decision to divest or not invest.

There were a number of common themes in the conversations with corporates explaining why the dialogue with investors on Governance seemed to be limited. These are summarised in Figure 2.

One theme was simply a lack of time to spend on Governance matters due to **conflicting priorities**, but as mentioned above, there were often cases where **Investors were not responsive** when offered meetings on Governance, or their routine **meetings had a different focus**. For some companies, it was not always clear who were **the right counter parts** at the investor to discuss Governance with, or if they were aligned with the Portfolio Managers and analysts. Companies were not sure what exactly **the content** of Governance disclosure should be, and in any case **intermediaries tended to dominate** the interactions. Companies felt that they did **not have the resources** necessary to answer all the questions that they were asked, particularly questionnaires from intermediaries on ESG issues. Finally, in an environment where directors feel under increased pressure and scrutiny, there was a concern expressed by a few that holding additional Governance meetings when there was no evident existing issue might only serve to **create a new issue**.

Notwithstanding all these barriers to engagement, companies were generally aware that there are many good reasons to engage on Governance. These include fiduciary and regulatory requirements, a desire for a positive and supportive relationship with investors as well as the opportunity to facilitate AGM voting and to improve the share price.

Barrier	Explanation
Other priorities	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
Investors not responsive	It is sometimes felt that investors' commitment to ESG is more superficial or that they are under-resourced in this area; meetings are often not taken when offered
Intermediaries dominate	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
Unsure on content	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?
Fear of creating an issue – no upside potential	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.
Different focus of investor dialogue	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.
Visibility of counterparts	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.
Resources	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.

Figure 8 Barriers to engagement - Corporate perspective

One particular concern was the role of the ESG analysts and rating agencies, and other intermediaries such as proxy agents. There was a generally negative perception, largely based on their lack of transparency and accountability. Companies felt that the work was often of poor quality and that they had little opportunity to address issues. Another key concern was the large number of related surveys and questions, which meant that it was hard to know which were really important or influential.

7. The Value of Governance

How is Governance taken into account by Investors?

Given the general requirements for increased stewardship and ESG engagement, it should be the case that ESG criteria are featuring more prominently in investment decisions and valuations.

It is clear that there are a broad range of methodologies being employed by investors and this spans a range from simple inclusion/exclusion criteria to very sophisticated modelling adjustments. In addition there are also varying operational models being employed within investors as to how they integrate ESG factors and resources.

It is implicit in much of the public information and guidelines that good Governance does, or should add value. It should not, therefore, be a simple hygiene factor that can be used to screen out companies, but there should be some upside from doing it well, as well as the downside from being seen to fail. At the very least, good Governance should remove some downside risk

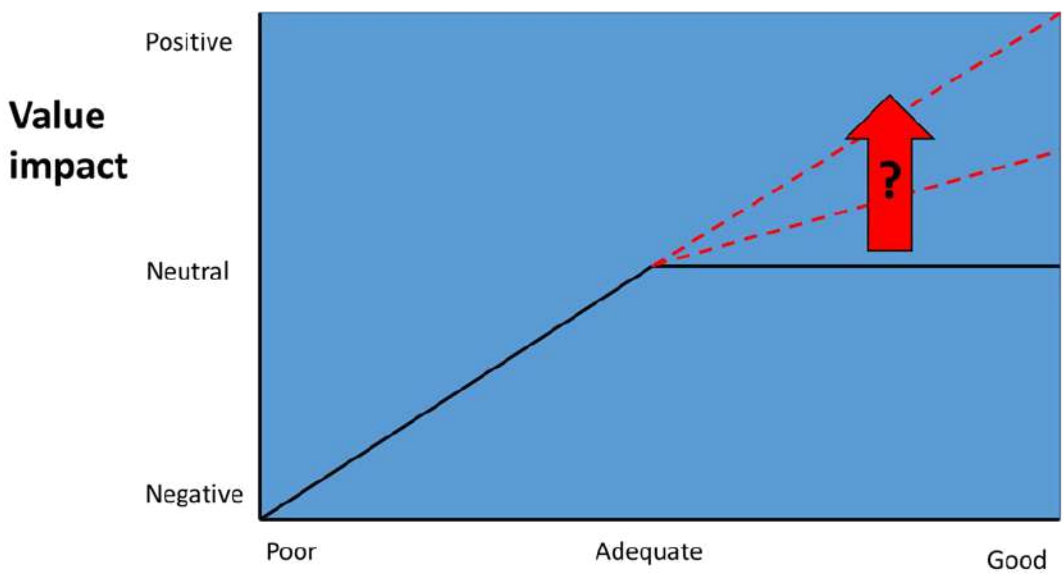


Figure 9 Does good Governance add value?

Many of the ESG factors relate to sustainability and these can have a more direct impact on a company's prospects in the medium term and are therefore easier to incorporate into financial and valuation models. For instance, changing regulation on emissions can be easily linked to manufacturers of engines and cars. It may be the case that some assumptions regarding the 'E' and 'S' factors have more of a short term impact which can be covered in the execution dialogue with management and therefore incorporated into the valuation.

> *'If the Board is demonstrably strong, it improves confidence and so it does influence active positions. Face to face meetings mean we can assess effectiveness.'*
> *Large, global investor*

Factors that fall under the Governance criteria might be less tangible, perhaps. For example a company's policy for its staff remuneration, training and development might reflect its culture of fairness. If a company looks after its staff better and promotes their personal development – does it indeed see increased staff loyalty, lower turnover, better customer service and improved innovation? This should drive revenues, but perhaps with a higher cost base and over what time scale? If this seems plausible, it should be possible to model and quantify the benefit. Even less tangible might be an assessment of the effectiveness of the company's reporting systems and audit. If it lacks transparency or has weak controls this might meaningfully impact on decision making and could lead to a serious issue with important financial consequences.

In practice therefore, we might expect that each investor should have clear criteria for how they assess the impact of the various ESG factors for each company, including Governance, and this should be visible in their modelling, valuation and investment decisions.

Passive investors

For passive owners of shares the opportunities for differentiating based on ESG criteria are more limited, as they tend to be confined to matching index weightings. They can claim that the ESG factors that are taken into account by other investors and are already reflected in the index. For some there has been the possibility to make specific ESG indices, where an objective rating of the individual companies ESG characteristics leads to an adjustment of their relative weighting against the base index.

There are specific indices and funds focussed on sustainability and ESG criteria.

Some passive investors are very large and can account for significant proportions of every company's investor base, across an entire index. Even if their percentage holdings are pre-defined, it is still important that they should take their broader stewardship duties seriously. Although they might not be following the short term operational results, they still have a responsibility to ensure that their companies are properly run and managed. Active stewardship engagement should also help to raise values across the index.

Many leading passive investors do write annual letters to investee companies to highlight their stewardship priorities and ESG teams engage with companies based on these themes.

However, this can create an implicit tension as the passive model is effectively meant to be low cost, but strong stewardship implies building and maintaining a significant team of ESG analysts and having the capability to engage with companies in a constructive and informed manner, rather than rely on third party ratings for voting decisions. In this way they should influence better outcomes for the companies, the investors and their customers – the asset owners.

There is some evidence that customer pressure from Asset Owners is encouraging investors to commit more resources in this way, whilst accepting the cost implications.

> *'We use our leverage to hold Asset Managers to account. We understand that there are costs to responsible investment but we want visibility into the investment decision as we believe it gives a good return.'*
> *Pension Fund, Chair*

Similarly, investment strategies based on quantitative analysis leave little room for understanding the nuances of the company's Governance and strategy in taking buy/sell decisions.

How is value modelled?

Generally an investor will build some sort of financial model for the company that will incorporate the key drivers and metrics that are relevant to the investor's view of the world. This will then drive a cash flow forecast which is discounted to present day values and summed to give a valuation.

Typically the model will have a short term view with very specific numbers built up quarterly or annually based on current trends and known factors that may impact in the short term. This might include, for example, new product launches, plant openings, marketing campaigns or cost reduction initiatives. This might reflect a period of three to five years and will often also be the timescale over which management gives particular targets for delivery.

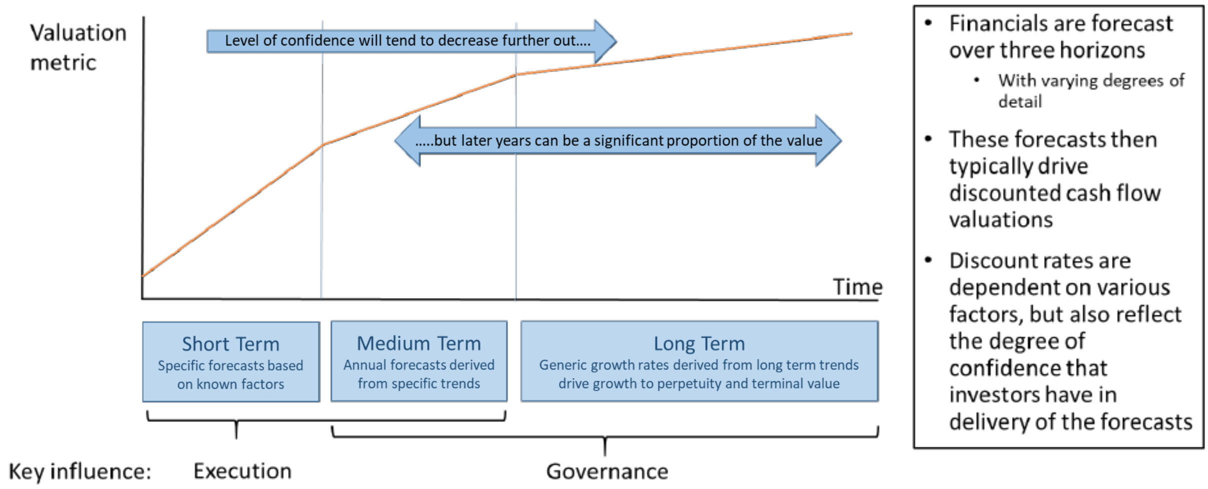


Figure 10 How forecasts drive valuation

The model may then have a medium term section where individual years are forecast, but based on simple trends for key drivers of the model with little variation by year. This might typically represent a timescale from five to ten years. We would expect the Execution dialogue to have a significant role to play in defining this part of the model, but over this timescale it is also more likely that the impact of relatively good or bad Governance will start to be more visible, with the underlying performance more heavily influenced by macro-trends.

Finally for the Long Term, there will not be individual annual forecasts but some very high level trends will be used to derive a growth rate to perpetuity, from which a Terminal Value is derived. This terminal value can often form a very significant part of the valuation and so it cannot be ignored, and it is explicitly the case that assumptions made here can have a major impact on the overall valuation. Over this time period it will be hard to differentiate between companies based on broad market trends or the current executive management, but it is highly likely that the importance of better Governance will be seen to have a very material impact.

> *'Good Governance leads to better financial growth.'*
> *Asset Manager*

Finally, an important component of the discounted cash flow valuation is the discount rate that is applied to the forecast cash flows. This can also have a very important impact on the total value ascribed to the shares. This rate is closely tied to the relative risks that exist in relation to the delivery of the cash flows. It is highly likely, therefore, that good Governance should have a strong bearing on the discount rate and therefore on the valuation. There are examples of investors adjusting the inputs to the discount rate calculation by plus or minus 20% based on their view of the quality of its ESG. This then directly impacts the valuation.

Even based on this simplistic view of how investors value companies there is clearly considerable scope for integrating Governance factors into the valuation and forming a view on how they are impacting the target price. It may even be possible to give a company credit now for the anticipated benefit of improving Governance, if there is confidence that this being done.

So how do investors make valuation decisions integrating Governance criteria?

If so many investors claim to have integrated Governance, and broader ESG, criteria in their decision making processes, how do they in fact do it? Each will have their own approach and methodology and there is no doubt that some do have detailed and objective processes. However, these may be limited in number, and possibly restricted to certain concentrated portfolios.

For many it seems that Governance is a hygiene issue. It is assumed to be alright until there is a problem, when it suddenly receives a great deal of focus. Thus there is only a downside from getting it wrong. Perhaps there is some implied positive as there is at least a benefit from removing some downside risk if there is a positive impression of Governance standards at a company. However, it is not clear to many how a demonstration of good Governance brings value through the investment process.

> *'We are struggling with how to integrate [ESG]*
> *with real authenticity and purpose.'*
> *Asset Manager*

There is a problem with cost effectiveness and how can limited resources be spread over many stocks in a vast investment pool. As a result, many investors effectively sub-contract a significant part of their responsibilities to third parties and other advisers – key amongst these are a number of proxy-advisers and ESG rating organisations.

This leads to many different approaches again, but it also puts the investor at arm's length from the company and limits the opportunity to interact. It also means that the approach is most likely to be driven by box-ticking against a checklist, which leaves no room for explaining divergence from the list or judging the effectiveness of the boxes that are ticked. Sustainability issues are also more dominant in some of their analyses.

It also gives rise to other problems. One of these is the accuracy and credibility of the data, which is often gathered from public sources and may result in the context being misunderstood, old data being gathered, or data simply being missed. Concerns have been raised that there may be some over reliance on unregulated intermediaries, some of which may also have competing or conflicting interests.

The variety of advisers also leads to a plethora of approaches to a company asking for data and forms or questionnaires to be completed, which is simply too much for them to manage. The International Trade Centre has identified over 230 standards initiatives, applicable to more than 80 sectors and 180 countries.

Failure to complete a survey will often default to a bad rating – regardless of the reality at the company – which is an implied threat to the management, but hardly leads to a fair basis for ratings. It also has the risk that companies may benefit from 'spinning' the story to get a better rating and there are suggestions that some may be helped in that exercise by the surveyors. There have also been complaints of serious inaccuracies in the reports and of companies being asked to pay significant sums to be able to review their own data, or of being given extremely short timeframes to review.

ESG ratings

There is a growing number of companies and organisations that provide advice and ratings of some sort relating to the ESG status of companies. These include MSCI, Bloomberg, Thomson Reuters, Sustainalytics, Hermes EOS, RobecoSAM and CDP.

Within these there are many different approaches, from the simple provision of data, to structured ratings and more tailored approaches. Some engage directly with the company, some rely more on public data, but in the end they provide information to investors which can then be used in their decision making.

Proxy advisers

Similarly there are a number of prominent proxy advisers – notably Institutional Shareholder Services ('ISS') and Glass Lewis – who can provide similar services, but focus on voting at AGMs and EGMs. They do engage with companies although most often at the level of the company secretary and IRO and inevitably their approach is more inclined towards ticking the boxes in relation to the AGM agendas.

> *'The Proxy advisers are overly powerful. Investors just vote as they are advised.'*
> *Corporate Broker*

Investors often rely heavily on their advice and it can be the case that voting is effectively outsourced by investors, with the vast majority of votes going in line with the external advice. An implication of this is that the voting may not be connected to the Portfolio Managers that understand the company best and interact with management regularly. There have been cases where an issue has been discussed and agreed with a Portfolio Manager, only for the votes to be cast against management by a separate department.

Why is the Governance dialogue not so well developed?

Ultimately then, it seems that there is general acceptance that Governance is an important part of the investment decision and ongoing stewardship responsibilities, but somehow the Strategic Governance dialogue between investors and companies is generally not happening in a way that is supportive of real engagement.

The Governance dialogue is too often more of a one-way channel, via intermediaries, constrained by a checklist approach at a transactional level. This inevitably leads to a focus more on the form than the effectiveness of the Governance and limited useful feedback to the company.

> *'Communicating on Governance is like throwing mud into the void.'*
> *FTSE 100 company, Head of Investor Relations*

Even when Chairmen of companies offer to engage with investors they often find that the response is muted and as a result the dialogue that does happen tends to be at the wrong level – not with those that are really accountable for delivering. Sadly it might only get to that level after an issue has arisen and become serious, whereas it might have been identified and dealt with earlier had there been more of a two way dialogue.

Some companies have also expressed concerns that there may not be enough resources available in the investors to enable a meaningful and regular dialogue and there is also a lack of clarity about what would be most useful to disclose. It would certainly seem that there is a risk that a dominant focus on short term Execution factors to support modelling is crowding out resources that might be committed to understanding longer term Governance matters. Perhaps if these were more overtly take into account in the valuations then they might receive more focus.

8. Proposed Actions

Returning to the Key Questions

At the start of this report, the reader was asked to consider four key questions. These might now be revisited:

- **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 it is also the fact 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.

What could be done?

In considering what might be appropriate to improve the nature of engagement between investors and companies on Governance, there are perhaps two key points to address arising from this research:

1. Do you believe that good Governance does, or should, add value? This is important, as if your position is that there is only downside from bad Governance then it would imply a very different approach – you would only engage when there is, or you believe there is, an issue. If you believe that there is an upside, then you should be willing to invest in identifying and evaluating it.

2. Do you recognise the 'Four Dialogues' model? If you see the Four Dialogues as a useful tool for analysing and understanding the ways in which companies and investors engage, it can be used to help manage time and resources more effectively to optimise the outcome for all parties.

Assuming that the response to those two questions is positive, then investors and companies could consider how to adapt the way that they interact in order to drive a more efficient set of dialogues to enable the investors to better evaluate the company from a long term, investment return point of view and to exercise their stewardship responsibilities optimally.

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

> *‘Investors need to meet companies to avoid box-ticking.’*
> *Global investor*

Clarifying the role of ESG ratings and intermediaries

The proliferation of ESG raters and how they gather information from companies, is increasingly an issue and a concern for companies. It is a rapidly evolving market that can be confusing. Possible improvements might include:

- A generally accepted 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 could be pro-active in building Governance engagement

Given that there is clearly a trend towards greater engagement on Governance matters, the Board should take active ownership of Governance and its communication. Even if they anticipate a weak response, it may be good to start to build relationships with the right investors and to run a programme of relevant events. Even if the initial response is underwhelming it may start to build momentum and experience, particularly with the more advanced investors. The best time to build a reputation is whilst things are going well.

Some initial thoughts on building Governance engagement:

- Taking active ownership of Governance and its communication
    - Ensure appropriate and aligned disclosures are available and easily accessed
    - 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

Governance

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Investors and Companies Engage

Prepared for

THE INVESTOR FORUM

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