Governance
for Owners

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Dear Mr Gray

BIS – A long-term focus for corporate Britain

Thank you for the opportunity to submit comments in relation to the above-mentioned consultation. By way of background, and to put our comments in context, Governance for Owners (GO) is an independent partnership dedicated to adding long-term value to clients' equity holdings through relational investing and active share ownership.

We believe strongly in ensuring that corporate Britain is able to focus on the long-term and therefore support the objectives and focus of this inquiry. We provide our response to the questions posed in the consultation paper below.

Board of directors

The degree in which UK companies and their boards maintain a long-term focus depends to a certain extent on the industry in which they operate. For instance, companies whose products require substantial, long-term capital investments or enjoy extended life cycles, such as those in the extractive, defence, and pharmaceutical sectors, may employ planning and strategies measured in decades. By contrast, firms offering products that experience rapid obsolescence or changes in consumer preferences, such as consumer electronics, may need to operate on a shorter timeframe.

Notwithstanding industry differences, drawing from our experience as an investment manager and advisor, we believe that boards and management generally endeavour to think long-term. However, we worry that short-term remuneration schemes for directors and the increasing presence of short-term oriented investors in the capital markets may be exerting pressure on them to focus unduly on delivering short-term performance. Additionally, sell-side research analysts' focus on near-term developments at the companies they cover may put boards and management in a similar bind. To illustrate, a 2006 study of US companies showed that 55.3% of the

400 CFOs surveyed would delay commencing a value-creating project in order to meet short-term (quarterly) analyst earning targets.

We are somewhat encouraged by the steps that a few companies have taken to foster longer-term thinking among their executive ranks, such as by extending the vesting period of long-term incentive schemes from the standard 3 years to 4 years or longer. Similarly, we are hopeful that requiring financial institutions to spread compensation payments over longer time periods will compel management to operate with a long-term mindset.

Just as shareholders are entitled to know the backgrounds of directors and senior management of firms in which they invest, we believe that companies have a legitimate interest in knowing the identities of their significant shareholders in order to understand their investment and voting behaviour and to discharge their Corporate Governance Code obligations to communicate and engage with them. To this end, we are highly supportive of Part 22 of the Companies Act 2006, which enables boards of listed companies to compel disclosure of beneficial ownership.

We note, however, that the shareholder register of a company during a takeover bid can change rapidly and companies have experienced difficulty keeping on top of these changes.

Furthermore, the ability of companies to identify the beneficial ownership of their shares is complicated by the increasing prevalence of nominee accounts and pooled funds. While these mechanisms may be administratively efficient and cost-effective, they are a source of frustration to both companies and investors. Beneficial owners such as pension funds are sometimes impeded from communicating and engaging with investee companies because they do not appear on the shareholder register.

We would therefore encourage the development of mechanisms to improve the ability of companies to identify their shareholders at all times, and better enable companies and their beneficial owners to communicate and engage with one another. We also believe it would be helpful to explore amending disclosure requirements to permit companies to better understand the investment and stewardship intentions of their shareholders – for example, through a designation in the shareholder register.

Shareholders and their role in equity markets – voting and engagement

We believe that the changing nature of UK share ownership can yield benefits as well as costs. On the one hand, some institutional investors from continental Europe are highly concerned with environmental and social matters and their presence on the shareholder registers of UK companies may prompt these firms to devote greater attention to such issues. On the other hand, due to sheer physical distance, differences in market practices and other factors, many foreign institutions have not been willing to play an active part to ensure the continuing effectiveness of the UK "comply or explain" corporate governance regime.

Accordingly, we believe it is imperative that the UK government explore ways – for example, by clarifying concert party rules with respect to corporate governance-

related activities or by providing incentives – to encourage foreign institutional investors to assume a more prominent role in engaging with UK companies. The provision of incentives is especially important with respect to overseas shareholders because these investors often sit outside the UK government's regulatory purview. Achieving a critical mass of institutional investor support for both the Corporate Governance and Stewardship Codes is absolutely essential to maintaining the relevance and effectiveness of the UK corporate governance regime.

While there is no one-size-fits-all approach to engagements, we believe – in terms of general principles – that engagements are most effective when undertaken in private (i.e., out of the glare of the media and public) between parties that are well-prepared, willing to engage candidly and constructively, and adopt a principled but pragmatic approach to resolving any dispute. In this regard, we would advise against promulgating regulations to require institutional investors to publicly disclose the fine details of their engagement activities.

Furthermore, representatives of institutional investors must be credible to boards in terms of possessing sufficient seniority, relevant experience and understanding of business dynamics.

From our experience, some institutional investors in the UK devote substantial resources to discharging their stewardship obligations and are held in high regard by peer investment firms and investee companies alike. Unfortunately, other institutional investors have tended to "tick the box" and "go through the motion." At these firms, there appears to be insufficient senior management support for meaningful and thoughtful voting and engagement, resulting in inadequate resources allocated to these activities.

We bring to your attention a recent study[1] by academic Paul Cox, who found that, in the UK, responsible investment fund managers and specialist voting and engagement firms allocated the greatest resources to stewardship activities, as measured by the ratio of number of stocks held to size of dedicated staff. At the opposite end of this spectrum lie index fund management firms.

It is also important to recognise that different investment styles often yield different engagement approaches. For example, large mainstream institutional investors with broad portfolios (numbering in the hundreds) typically focus on regular, "low intensity" engagement with investee companies – covering such governance matters as board structure, succession planning and executive pay – while "focus" funds with concentrated holdings tend to probe investee companies on the intricacies of strategy and performance.

We believe voting is an important tool, as it provides shareholders with a formal recourse if informal dialogue proves unsatisfactory or unsuccessful. In our view, the strong voting rights of UK shareholders have contributed to the comparatively greater willingness of UK boards and management to engage meaningfully with their shareholders.

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[1] Paul Cox, Responsible Investment in Fund Management: It Works, But When? (October 2009)

Voting has the greatest impact and relevance when it is connected to engagement activities, particularly when a shareholder has lodged a vote against management, because it enables companies to understand the views and decisions of their shareholders.

We believe that disclosing voting records publicly is a matter for asset owners, although we caution that actual voting decisions may not be a good reflection of an institutional investor's effort to discharge its stewardship responsibilities. On this point, there appears to be a belief among policymakers, the media and the public that high levels of "votes against" attest to the diligence and independence of an institutional investor.

The reality, however, is more nuanced. For example, if an institutional investor is truly successful in conveying its concerns through *ex-ante* engagement with a company's board and management, it is unlikely that matters brought before the shareholders meeting would warrant a dissenting vote. By contrast, some institutional investors have adopted voting policies that are implemented in an overly rigid manner (without considering individual contexts), resulting in a high proportion of "votes against."

Shareholders and their role in equity markets – short-termism and agency problems

In our view, the short-termism that pervades the investment industry – due to agency issues in the investment chain, financial incentives, performance measurement metrics, and other factors – poses a serious impediment to the ability of institutional investor to serve as stewards. We enclose for your reference an article authored by Simon Wong[2] discussing how modern investment management practices and characteristics (including those mentioned above) hamper the ability of institutional investors to serve as active, long-term oriented stewards, and suggesting potential solutions.

In addition, we would urge the Government to consider ways to develop mechanisms to reward shareowners – domestic and foreign – who are both loyal shareholders and good stewards. Loyalty can be defined as a minimum of say two years on the share register with shares that have not been lent. Good stewardship can be defined by reference to the UK Stewardship Code. The loyalty awards for good stewards could include enhanced dividends, voting rights, bonus shares, and reduced capital gains tax.

We believe that pension funds and other asset owners should take due care when negotiating mandate terms with their investment managers, particularly relating to voting and engagement activities, incorporation of environmental, social and governance (ESG) matters in investment decision-making, and performance measurement metrics and financial incentives.

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[2] Simon Wong, Why stewardship is proving elusive for institutional investors, Journal of International Banking and Financial Law (July-August 2010)

For example, we believe that it is imprudent for pension funds to agree to pay no management fees – usually expressed as a percentage of assets under management – for passive funds but allow investment managers to earn a financial return via share lending revenues. From an alignment of interest perspective, this arrangement is highly problematic because it removes the incentive for the asset manager to maximise portfolio value. Moreover, with no management fees to depend on, the investment manager may be reluctant to recall lent shares to vote them because it would then be deprived of its primary source of revenue.

To ameliorate agency problems in the investment chain, it is critically important that asset owners monitor and evaluate the stewardship activities of their investment managers diligently. Many UK pension funds, however, appear to give cursory attention to this area.

Directors' remuneration

In our view, several factors have contributed to the rapid growth of executive pay at UK companies over the past decade. First, the relevant market for executive talent at large UK companies is increasingly global. This development means that firms in this segment must often match the compensation level of their global peers (often those from the US) in order to recruit and retain senior executives. Second, the growth in remuneration at large UK companies has rippled downward to smaller enterprises through the use of peer benchmarking to set executive remuneration. Frequently, the peer group selected as comparators include firms that are larger – sometimes substantially – than the company undertaking the benchmarking. Third, it has been widely acknowledged – including by remuneration consultants – that disclosure of executive remuneration on an individualised basis has contributed to an upward ratchet of pay. Lastly, the remuneration committees at some UK firms may have been insufficiently involved in structuring executive remuneration arrangements or failed to resist unreasonable demands by executives.

While information on executive compensation is intended for shareholder use, executives also access it to compare themselves against peers inside and outside of the company. According to a veteran remuneration consultant, "Many executives want to be the top dog and, if someone gets a certain amount, then he wants to get the same, if not more." The remuneration committee chair of a major FTSE 100 company told us recently that "negotiation on pay is increasingly adversarial because of its highly personal nature – many executives interpret the amount of pay received as an indication of how much the board values them. In fact, remuneration doesn't motivate a senior executive but it can de-motivate."

Even though there are continuing issues with executive remuneration at UK companies, we do not believe that it is necessary to widen the membership of the remuneration committee. We believe that reforms to the remuneration setting process as well as to the structure of compensation arrangements could help to improve the link between executive pay and company performance. We provide several suggestions below for your consideration:

- The remuneration committee should be actively involved in setting executive remuneration, including responsibility for the initial screening and ultimate selection of the remuneration adviser, and should limit the delegation of decision-making to the human resources department or senior executives

- Use peer benchmarking sparingly (perhaps once every 4-5 years) and select peer groups carefully

- Require top executives to hold meaningful amounts (up to several times annual salary) in company shares, including by investing personal funds, and impose restrictions on selling the shares acquired

- Extend the vesting period for long-term incentive schemes from the standard 3 years to 5 years or longer. Where feasible, allow departing executives to retain unvested LTI awards (which would vest according to the original terms). This would encourage all executives – even those who may be retiring or departing in the near to medium term – to focus on their companies' long-term performance. Moreover, it would obviate the need for an executive's new employer to offer a "golden hello" to compensate for any forfeited share awards.

We believe that the introduction of a non-binding vote on remuneration has facilitated engagement between companies and their top shareholders. Furthermore, increased shareholder involvement on executive remuneration over the past decade has improved the structure pay arrangements but it has not impacted the quantum of payouts. However, analysing executive pay proposals is extremely time-consuming for many institutional investors in the UK, particularly given the extensive consultation process that takes place each time a company proposes to amend its executive remuneration schemes.

Furthermore, because many institutional investors do not fully trust remuneration committees, they have tended to oppose schemes that propose to employ non-standard performance metrics. As a result, many companies feel compelled to adopt total shareholder return and earnings per share as performance metrics, even when one or both of them may be inappropriate for a particular firm. For instance, a medium-size UK high technology company believed it was required to use EPS as a performance metric even though firms in its industry experienced recurring "boom and bust" cycles.

Some institutional shareholders also employ overly simplistic criteria to evaluate the appropriateness of executive remuneration arrangements. For example, some investors are willing to approve higher proposed payouts so long as the performance targets are raised commensurately, and do not consider the possibility that this approach may encourage the executive team to take inordinate risks.

Rather than shareholders micro-managing remuneration matters, we believe that remuneration committees should be given greater discretion to put in place remuneration arrangements that would best meet their companies' needs and then be judged on the results in terms of company performance. In our view, shareholders

should be prepared to remove remuneration committee chairmen who fail to do their job.

We do not believe that UK shareholders require additional rights. They simply need to exercise the existing ones more diligently and rigorously.

Takeovers

Despite the fact that most mergers fail to create value for the acquiring shareholders, we have heard complaints from directors that advisers sometimes pressure boards – by invoking the latter's fiduciary obligations – into pursuing acquisitions. We would urge the UK government to assess whether this is a widespread concern among directors. If so, the government should clarify or restate the board's obligations in this area.

We would also recommend consideration of measures to encourage company advisers to think long-term, such as through a compensation structure whereby a significant proportion of an adviser's fees is paid in the form of the acquiring company's shares and which are subject to a multi-year lock up.

We believe that the "Class Tests" – and the 25% materiality threshold requiring companies to obtain shareholder approval – under the Listing Rules of the UK Listing Authority provide adequate safeguards to shareholders of acquiring companies. To empower shareholders of overseas offerors who are not granted equivalent "Class Tests" rights, the UK government may wish to consider reserving the authority in certain situations to block or delay a takeover unless an overseas offeror obtains the consent of its shareholders.

We hope you find these comments helpful. Please contact Simon Wong in the first instance if you would like to discuss any of the points made above.

Yours sincerely,

Peter Butler
Founder Partner and CEO

Simon Wong
Partner

Feature

KEY POINTS

- Institutional investors have been under increasing pressure to act as responsible shareholders but efforts to convince them to be active, long-term oriented 'stewards' have fallen short.
- Modern investment management practices and characteristics – such as financial arrangements that promote trading, excessive portfolio diversification, and a lengthening share ownership chain – make genuine stewardship challenging for institutional investors.
- These deficiencies may be remedied by eliminating unnecessary intermediation, revamping performance metrics, rationalising portfolio holdings, and other actions.

Author [illegible]

Why stewardship is proving elusive for institutional investors

This article discusses how modern investment management practices and characteristics hamper the ability of institutional investors to serve as active, long-term oriented stewards – as envisioned by the stewardship codes in the UK and other markets – and suggests remedial measures.

As the dominant owners of listed companies in many developed markets, institutional investors have been under increasing pressure to act as responsible shareholders. In the UK, where institutions own more than 70 per cent of the stock market, a Stewardship Code has been developed to encourage pension funds, insurance companies, and their asset managers to monitor and engage investee companies actively with the view to protect and enhance shareholder value (see Figure 1). Similar efforts are under way in Canada, France, the Netherlands, and other markets.

However, attempts in recent decades to convince institutional investors to act as active, long-term oriented 'stewards' have fallen short. A recent examination by the Organisation for Economic Co-operation and Development of the contributing causes of the global financial crisis concluded that institutional investors were generally not effective in monitoring investee companies.

FIVE UNDERLYING STRUCTURAL DEFICIENCIES

Why is it so difficult for institutional investors to act as stewards? In essence, it is because stewardship is not in their genetic makeup. Modern investment management practices and characteristics make it extremely hard for an active, long-term ownership mindset to take hold. These include:

- inappropriate performance metrics and financial arrangements that promote trading and short-term returns;
- excessive portfolio diversification that makes monitoring difficult;
- lengthening share ownership chain that weakens an 'owner' mindset;
- misguided interpretation of fiduciary duty that accords excessive deference to quantifiable data at the expense of qualitative factors;
- flawed business model and governance approach of passive funds.

Inappropriate performance metrics and financial arrangements

Many asset managers are evaluated and compensated based on short-term, relative performance. Unsurprisingly, investment managers focus on delivering short-term returns, including by pressuring investee companies to maximise their near-term profits.

Figure 1: UK Stewardship Code

Best practice guidance for UK institutional investors* on engagement

Overall objective

To enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders, reduce the risk of catastrophic outcomes due to bad strategic decisions, and help with the efficient exercise of governance responsibilities

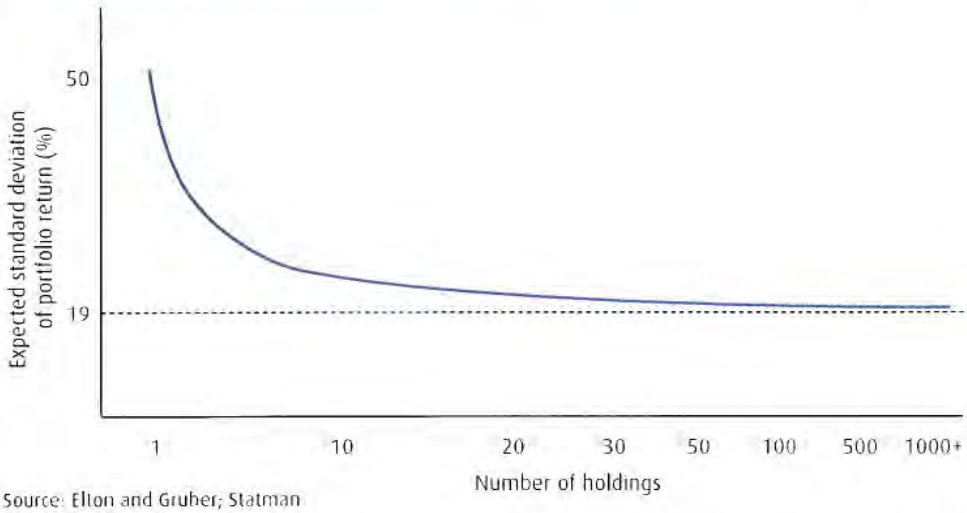
Key elements of code

- *Principle 1:* Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities
- *Principle 2:* Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
- *Principle 3:* Institutional investors should monitor their investee companies
- *Principle 4:* Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
- *Principle 5:* Institutional investors should be willing to act collectively with other investors where appropriate
- *Principle 6:* Institutional investors should have a clear policy on voting and disclosure of voting activity
- *Principle 7:* Institutional investors should report periodically on their stewardship and voting activities

* Pension funds, insurance companies, and investment trusts and other collective investment vehicles and any agents appointed to act on their behalf.

Electronic copy available at: http://ssrn.com/abstract=1635662

Figure 2: Declining benefit of diversification in terms of reducing volatility of returns



Source: Elton and Gruber; Statman

One UK local authority pension scheme, for instance, reviews the performance of fund managers quarterly and focuses on the deviation of portfolio returns from established benchmarks and anticipated range of returns for future quarters. While evaluating the performance of investment managers on a relative basis – that is, the extent to which they outperform or underperform a market index such as the FTSE 100, S&P 500, or MSCI World Index – can help ensure that they are not rewarded undeservingly in a bull market or punished inequitably in a market downturn, it can also encourage herd behaviour and a short-term focus, particularly if a narrow time interval is utilised to measure performance.

According to the Marathon Club, an organisation that promotes long-term investing, 'The quarterly monitoring process, with a focus on performance relative to an index, has become the norm in the investment industry and has been blamed for promoting short-term behaviour by investment managers'. A veteran UK money manager complains that 'fund managers – even seasoned ones – are under intense pressure from colleagues and clients if they experience a string of two to three quarters of underperformance'.

In terms of compensation, a 2009 survey by investment consultant Mercer revealed that bonuses for individual fund managers are, to varying degrees, 'linked to performance versus a benchmark or manager rankings table in any given year'. Some asset manager respondents stated that 'incentive systems are often devised to pay fund managers to be aggressive over shorter time periods, especially pronounced for mutual funds, where managers are often incentivised against quarterly performance versus a market benchmark or quartile rankings'.

Furthermore, the widely used *ad valorem* approach – where fees are calculated based on assets under management rather than outperformance – has been criticised for encouraging investment managers to grow by attracting inflows of new money rather than by expanding existing assets through superior investment performance.

Excessive portfolio diversification

The techniques employed by many institutional investors to manage risk – such as pension funds appointing multiple investment managers and fund managers constructing portfolios around the market benchmarks against which their performance is measured – often result in excessive diversification, with equity portfolios containing hundreds or even thousands of stocks.

One UK pension fund, for example, holds shares in most of the 700-plus companies in the UK All Share Index. Meanwhile, a big US pension fund has more than 5,000 equity holdings in the US alone and a sovereign wealth fund holds shares in 8,000-plus companies globally.

Similarly, passive and active asset managers that replicate market indices can end up with hundreds of companies in their portfolios. It has also been suggested that the *ad valorem* fee structure discussed above encourages large portfolio holdings as diversified funds are more able than concentrated ones to absorb significant inflows of new money.

Large portfolios, however, give rise to difficulties in monitoring – particularly the resource-intensive engagements between institutional investors and boards of directors contemplated by stewardship codes in the UK and other markets – and weaken an 'ownership' mindset. Former UK City Minister Lord Myners complained recently that investment management today is characterised by 'portfolios with high diversification and low exhibited stock conviction'. Moreover, studies have shown that the principal benefit of diversification – reducing portfolio volatility – diminishes rapidly after 20-50 stocks (see Figure 2).

Lengthening share ownership chain

Increasing use of intermediaries – investment consultants, 'funds of funds', external asset managers, and others – in investment management has lengthened the ownership chain of companies and, in the process, lessened the sense of accountability between ultimate investor and investee company.

Electronic copy available at: http://ssrn.com/abstract=1635662

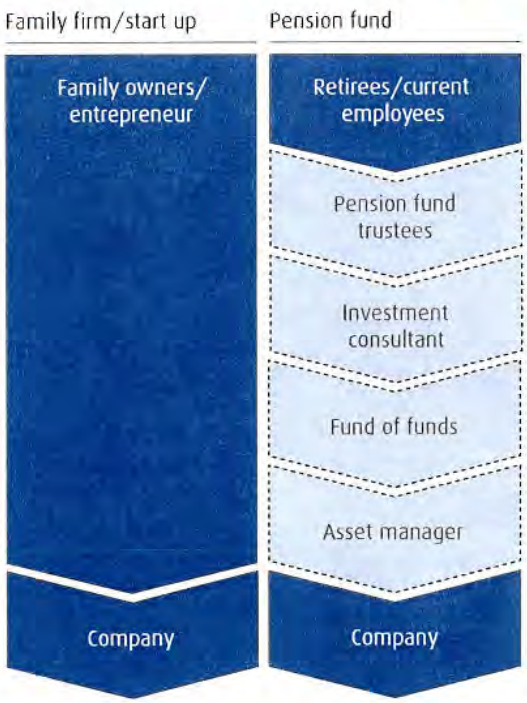
Compared to a family or founder-run firm, where direct ties often exist between ultimate owners and company management, the distance from pension beneficiaries to investee company is often bridged by several layers of intermediaries (see Figure 3). This phenomenon – termed 'separation of ownership from ownership' – has introduced serious agency problems. Delaware Chancery Court judge Leo Strine has commented that institutionalisation of ownership 'presents its own risks to both individual investors and more generally to the best interests of our nation' because fund managers may be as likely 'to exploit their agency [as] the managers of corporations that make products and deliver services'.

These agency issues have necessitated the introduction of a cascading set of performance measures to monitor intermediaries along the ownership chain. However, because short-term performance metrics are typically employed at each link in the chain, additional problems – such as misaligned time horizons and a trader mentality – have arisen.

Consequently, it is perhaps no coincidence that rising institutional ownership in the US – from 35 per cent in 1975 to 70 per cent today – has been accompanied by greater portfolio turnover (see Figure 4). Whereas the average stock holding period in the US was nearly five years in 1980, it is less than five months today. Judge Strine observed that 'institutional investors who hold stocks, on average, for a very brief period of time and are highly focused on short-term movements in stock prices have become far more influential and prevalent'.

"Asset managers believe that fulfilling fiduciary obligations requires them to evaluate investment ...

Figure 3: A key issue is the lengthening ownership chain



Misguided interpretation of fiduciary duty

Across the investment chain, there is an increasing emphasis on furthering the economic – as opposed to non-financial – interests of clients and ultimate beneficiaries. A US state pension fund, for instance, declares that the 'investment board, staff and investment managers must perform their duties for the exclusive benefit and in the best economic interest of the system's members and beneficiaries'. Likewise, a UK pension scheme states that the fund's 'overriding obligation is to act in the best financial interests of its members'.

Many asset managers echo the same theme. A large US investment manager, for instance, stresses that its duty is 'to manage clients' assets in the best economic interests of the clients'.

Government has also reinforced this view. In 2008, the US Department of Labor warned that 'in the course of discharging their duties, fiduciaries may never subordinate the economic interests of the plan to unrelated objectives'.

Unfortunately, the emphasis on economic interest has contributed to asset owners and asset managers believing that fulfilling fiduciary obligations requires them to evaluate investment and other decisions principally in quantifiable financial terms. A US corporate governance expert remarked that the Labor Department's guidance implies that 'fiduciaries can only justify shareholder activism to increase immediate returns at the company involved'. Such interpretation, however, can result in flawed and harmful decisions.

When evaluating whether it is in the best interest of shareholders to recall a stock on loan in order to vote it, fund managers are required to weigh the value of voting against stock lending revenue to be foregone. Given the difficulty of valuing a vote quantitatively, some fund managers routinely assign it a zero value and, hence, conclude that shareholder interest is better served by not recalling the stock in question, even when contentious items are to be voted upon.

In takeover situations, the decision of asset managers to sell their holdings or accept a bid is guided principally by stock price – which is highly influenced by short-term considerations – rather than a thorough assessment of a company's long-term prospects. According to a senior executive at an established UK investment house, 'In a takeover context, we would typically sell if the stock price rises above our target price, as this is our fiduciary duty to our clients'.

To minimise expenditures, some pension

funds seek to pay no management fees – usually expressed as a percentage of assets under management – for passive funds but allow investment managers to earn a financial return via share lending revenues. From an alignment of interest perspective, this is highly problematic because it removes the incentive for the asset manager to maximise portfolio value while introducing severe conflicts of interest. With no management fees to depend on, the investment manager may be reluctant to recall lent shares to vote them because it would then be deprived of its primary source of revenue.

Flawed business model and governance approach of passive funds

Due to comparatively high fees and underperformance of actively managed funds, passive funds – which tend to fully replicate a broad market index such as the S&P 500 or All-Share Index and where exiting individual holdings is not an option – have enjoyed a resurgence of interest among institutional and retail investors in many markets.

In 2009, passive funds experienced inflows in excess of US$100bn while active funds suffered outflows totalling more than US$300bn. Witness also the explosive growth of largely passive exchange traded funds ('ETFs'), which had nominal amounts under management a decade ago but more than US$1trn today.

Because passive investing precludes trading in and out of individual stocks and seeks long-term gains in the broad equity market, passive funds and stewardship should be natural bedfellows.

Yet, the bulk of passive funds pay scant attention to corporate governance. Index fund marketing, for instance, focuses almost exclusively on their low cost and tracking error performance (ie, deviation from benchmark index return). Correspondingly, many passive asset managers allocate meagre resources to proxy voting and engagement with investee companies. A recent study of UK investment firms revealed that passive managers allocated the least resources to stewardship activities, as measured by the ratio of number of stocks held to size of dedicated staff.

It is particularly worrying that some ETFs have taken steps that appear to harm stewardship. One ETF provider, for instance, has decided not to charge any management fees and will instead rely on securities lending to generate income.

Although passive investing underpins the equity portfolios of a substantial proportion of pension funds – in some cases, amounting to 70-80 per cent of their equity exposure – many of them do not scrutinise the stewardship activities of passive managers. When reviewing passive manager performance, pension scheme trustees tend to focus exclusively on tracking error performance rather than the manager's voting and engagement activities. At a UK public pension scheme, passive asset managers are evaluated strictly on whether tracking errors are within 2 per cent of the relevant index.

POTENTIAL WAY FORWARD

While the structural deficiencies discussed above are indeed worrying, there are a number of potential remedies that could help to provide a more conducive setting for stewardship.

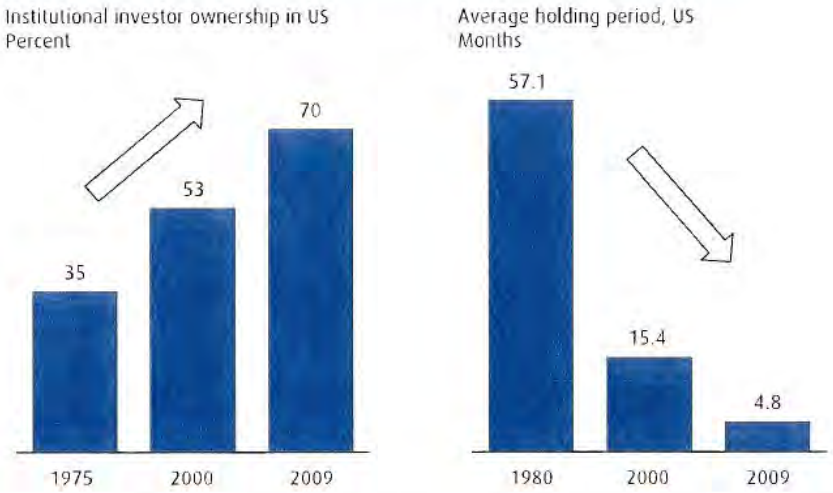
Eliminate unnecessary intermediation and strengthen internal capabilities

First, asset owners should strive to eliminate unnecessary links in the ownership chain and boost in-house expertise. Yale endowment investment head David Swenson, for instance, avoids investment consultants and funds of funds. He is most critical of the latter, arguing that 'no one should invest with a fund of funds. If you're a fiduciary, you should know where the money is going. If you can't do it yourself, you shouldn't do it.'

Empirically, investors who invest in hedge funds through a fund of hedge funds have fared worse than those who invest directly. According to Hedge Fund Research, since 1990 funds of hedge funds have generated average annual returns of 8.17 per cent while individual hedge funds have gained 12.15 per cent per annum. Part of the differential is attributed to management and performance fees extracted by funds of hedge funds, which are additional to the fees paid to the underlying hedge funds.

Where possible, pension funds and other long-term asset owners should also strengthen internal capabilities. According to the Marathon Club, 'Those funds or

Figure 4: Increasing institutionalisation of ownership and declining holding period



Source: John Bogle, Restoring Faith in Finanical Markets, *Wall Street Journal*, 19 January 2010

sponsors who can sustain and manage an in-house team may find it easier to obtain alignment between the fund's objectives and the manager's investment strategy'. In some markets, larger pension funds – such as the California Public Employees' Retirement System, Canadian Pension Plan Investment Board ('CPPIB'), and Universities Superannuation Scheme (UK) – have built substantial in-house investment management expertise.

A recent study of Canadian pension funds found that greater reliance on in-house investment management has brought about stronger performance. In the past decade, the largest nine Canadian public sector pension funds returned an average 5.5 per cent per annum while their eight largest US counterparts – which employ outside managers more extensively – gained 3.2 per cent annually. A Canadian pensions expert noted that 'research shows internal teams not only save money by cutting high external money management fees, but also perform better as investors because they are more closely aligned to the mission of the pension fund'.

Strong in-house capability, however, does not preclude using outside managers. CPPIB, with assets of C$125bn, employs external managers in niche areas where it is unable to develop the required expertise.

Where asset owners strive to be active owners, many will need to upgrade their monitoring and engagement capabilities, as the requisite skills for engagement and investment success are substantially different. In a recent survey, 61 per cent of UK pension funds conceded that they lacked the necessary skills to engage effectively with investee companies. Correspondingly, asset owners that delegate engagement activities to fund managers should ensure that the latter possess sufficient competencies in this area.

In countries with many small pension schemes, such as the UK, policymakers should consider facilitating consolidation to build scale and thereby strengthen the ability of pension funds to recruit investment and other talent. In Scotland, a project intended originally to explore the potential for greater resource sharing among 11 small local government pension schemes ultimately concluded that consolidation of schemes was the best way forward. The consulting firm that conducted the analysis noted that 'it is increasingly difficult for [smaller] funds to recruit staff with expertise in the ever more complex investment instruments in which their funds invest'. If consummated, this merger will create a sizeable fund with assets of £20bn. In Wales, some local authorities are similarly exploring a merger among themselves.

> "To measure performance quantitatively, it may be sensible to supplement market index comparisons with other metrics."

Revamp performance metrics and other arrangements

Second, where outside fund managers are retained, asset owners should put in place arrangements – pertaining to such matters as performance evaluation, fee structure, and portfolio turnover – to encourage long-term thinking and active ownership by investment managers.

The starting point is to lengthen the performance review time period and reduce emphasis on relative returns. According to a US value asset manager, 'Until managers are evaluated on a longer-term basis, the market will remain short-term focused. Managers should be evaluated on a five- to ten-year basis, since a market cycle is at least that long'.

The Marathon Club recommends that asset managers be evaluated using a five to seven-year time horizon and that annual reviews focus on a fund manager's investment process and whether the portfolio assets – in terms of number of holdings, degree of concentration, types of assets, turnover level, valuation ratios, and so forth – match the stated philosophy.

To measure performance quantitatively, it may be sensible to supplement market index comparisons with other metrics, such as internal rates of return for exited investments. Relative comparisons should not be abandoned entirely because active managers should strive to outperform their respective market indices over the long run.

Some asset owners have embraced this approach. Having committed to a three-year investment, a US public pension fund refused to meet the asset manager during the first year to discuss results, believing that a full review of performance should occur only after the second year.

In terms of fee arrangements, asset owners should consider introducing performance fees and spreading fee payments over multiple years. Investment consultant Towers Watson recommends calculating performance fees based on a rolling period of three years or longer.

Additionally, it may be worthwhile to consider tying a meaningful portion of an investment manager's fees to the quality of its stewardship activities. To accommodate different investment styles, the proportion of fees 'at risk' could vary. A higher proportion could apply to corporate governance-oriented activist as well as passively managed funds. For index funds, the reasoning is that 'if you can't sell, you must care'. By contrast, a lower percentage could apply to quantitatively driven and other short-term oriented asset managers. Asset owners with long-term obligations, however, must decide whether it is consistent with their long-term investment objectives to invest in funds that do not espouse stewardship.

Equally important, fee arrangements that will harm stewardship should be avoided – for example, zero management fee structures where the asset manager earns income exclusively from securities lending.

Moreover, asset owners should consider

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capping portfolio turnover. Increasing capital market liquidity has lowered transaction costs but also reduced the consequences of imprudent investment decisions and commitment of fund managers to investee companies. As the chief investment officer at a UK investment house remarked, 'If investors believe they are always able to enter and exit freely, what is the incentive to engage?' Limiting portfolio churn may prompt asset managers to think longer-term and engage actively with investee companies.

To maintain symmetry, asset owners should be willing to agree to restrictions on withdrawing their funds. Long-term oriented focus funds, for instance, usually impose lock-ups of two to three years on investors.

Rationalise portfolio holdings

Third, to improve monitoring capabilities and alleviate free-rider issues, asset owners and asset managers should consider reducing the number of portfolio holdings. Concentration of holdings increases the incentive to monitor investee companies because a greater proportion of gains would accrue to the instigating investor. With fewer holdings in their portfolios, fund managers would be more able to undertake intensive engagements with investee companies, critical in such areas as evaluating board effectiveness where meaningful insights are gleaned through face-to-face meetings rather than scanning annual reports.

To strengthen their capacity to act as active owners, two large Dutch pension funds are contemplating shrinking their equity portfolios from 4,000-5,000 to 300-400 holdings, a potential reduction of more than 90 per cent. In the UK, a large investment house abandoned the practice of replicating, or 'hugging', market indices several years ago and today takes sizeable positions in a small group of core holdings.

A further benefit of fewer portfolio holdings is that it will likely instil a stronger investment discipline. Legendary investor Warren Buffet has noted that 'a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying into it'.

Firms that construct market indices can help investors to realise this objective by shrinking the number of companies in the largest indices or developing substitute benchmarks that provide broadly equivalent exposure to each market segment but contain fewer companies.

Re-orient the passive investing model

Fourth, asset owners and asset managers should work together to change the business model and governance approach of passive funds so that stewardship is featured more prominently. How passive funds approach stewardship is highly significant given their present size and expected growth. Towers Watson predicts that, over the next ten years, the proportion of institutional investor assets allocated to passive investing will increase from 25-33 per cent to 50 per cent.

While it may not be reasonable to expect passive funds to adopt the same resource-intensive intervention approach as focus funds with respect to individual holdings, it would seem sensible for them – at a minimum – to focus on ensuring a sound regulatory framework and undertaking regular, low-intensity engagements with portfolio companies.

To encourage passive investment managers, asset owners may wish to provide explicit incentives – such as fees for good stewardship as suggested above – and revise the metrics used to evaluate their performance. For example, tracking error performance could be supplemented by metrics that capture changes in 'beta' over time, such as a multi-year rolling price-earnings ratio or return on equity of the stock market or a market segment.

As investment houses expand their passive product offerings, they should supplement the traditional marketing focus on low cost and tracking error performance with an emphasis on good stewardship.

If passive managers are unable or unwilling to discharge their stewardship responsibilities competently, asset owners should consider undertaking these activities themselves or outsourcing them to specialist providers or industry associations.

Clarify fiduciary duties

Lastly, policymakers should clarify to asset owners and asset managers that discharging fiduciary obligations requires thorough examination of both short- and long-term considerations. It is also important to stress that – when making investment and other important decisions – qualitative assessments could be as vital as quantitative data, especially when precise calculations cannot be made easily, such as regarding the value of a vote.

> "Discharging fiduciary obligations requires thorough examination of both short- and long-term considerations."

Furthermore, some commentators have suggested reforming fiduciary standards so that pension fund trustees feel less compelled to conform to mainstream practices regarding their investment and stewardship approaches.

CONCLUSION

While not all investors need to be stewards and stewardship obligations should be allowed to be discharged in different ways, tackling the underlying structural impediments will make it easier – and more natural – for asset owners and asset managers to adopt an active, long-term oriented mindset. ■