Responsible Ownership for the Long Term

Briefing Paper for Trustees prepared by the Marathon Club

Introduction

In their "Guidance Note for Long-Term Investing" the Marathon Club identified a number of areas in which pension schemes could exploit their position as long term investors. While this paper addresses trustees of pension schemes, its principles also apply to institutional investors such as endowments, foundations and charities.

One particular aspect of investing over long time horizons is that there is abundant opportunity for the effects of good and bad governance of investee companies and of positive and negative social and environmental impacts of corporate activities to be felt. This Briefing Paper explores this aspect of long term investment in more detail, recognising that, while general policy statements are relatively straightforward, the more detailed implementation, monitoring and measurement activities remain difficult to achieve effectively in practice.

The principal objective of pension scheme investment is to generate and secure returns which enable the scheme to fulfil its pension obligations, by making the assets outperform the liabilities over the long term. It is now widely recognised that there are aspects of corporate structures or activities that can have a marked impact on the outcomes for that company (or, perhaps, on other companies which may also be investments of the scheme) but which are not captured by 'traditional' financial analysis. In addition, many pension scheme trustees recognise that the welfare of their members extends beyond their financial circumstance and that investee companies can act in ways that affect (either positively or negatively) the welfare of members more broadly. It is for these reasons that active, responsible ownership is now an accepted and important part of a trustee's fiduciary responsibilities.

We can identify two aspects to active, responsible ownership:

- Firstly, the rights and responsibilities attached to the scheme's investments should be executed in a considered, long-term way. This means not only making use of the voting rights attached to equities, but also exploiting (and if necessary, creating) opportunities to engage with the management of the scheme's assets around such issues as, for example, long term strategy, M&A activity and board structure.

- Secondly, in the assessment of investment opportunities, pension scheme trustees (or, more typically, their agents) should try to integrate an evaluation of the widest possible range of risks and opportunities. These should include not only 'traditional' financial factors such as sales, costs, competition and so forth, but also more intangible factors such as environmental costs, social impact or shareholder rights. This is commonly known as integrated financial analysis or 'integration'.

Even from these brief descriptions it is clear that it is impossible for most pension scheme trustee groups to do justice to these two aspects of active, responsible ownership. The majority of trustees will seek to delegate the activities to their agents. Section One of this Paper describes ways in which the delegation of voting and engagement can be achieved.

Section Two expands the idea that active, responsible ownership is relevant beyond voting and engagement, and also to other asset classes outside of equities. Section Three goes on to explore in a little more detail the relevance of an integrated analysis of long term investment risk and return opportunity – which is likely to require delegation, within guidelines, to the scheme's fund managers.

Recognising that delegation is not abrogation, Section Four considers frameworks in which this delegated activity can be managed and monitored. The note closes (Section Five) with a selection of possible paragraphs for a scheme's Statement of Investment Principles, and sample wording for an Investment Manager Agreement (IMA).

Collectively, and in some cases individually, pension schemes are significant owners of economic activity. It is our aim in this guide to encourage and equip all schemes, large and small, to optimise their position as active, responsible investors, both individually and in collaboration with other investors, to the benefit of their members.

Section One: Who is responsible for voting & engagement?

The Marathon Club believes that institutional investors have a general fiduciary responsibility to ensure that investments are managed in the long term interest of their beneficiaries. One aspect of this is the appropriate use of the rights and responsibilities that arise from asset ownership. The Marathon Club asserts that shareholder value can be improved, and capital preserved, through constructive consultation and engagement with companies and wider corporate governance and environmental, social and governance (ESG) initiatives. This is an integral part of active, responsible ownership. Pension fund trustees as responsible investors have a major role to play in promoting this.

Generally speaking, Trustees have neither the time nor resource available to them to be able to discharge this responsibility directly themselves. Their role is principally in the setting of policy and the monitoring of the delegated activity. Increasingly, there are opportunities for schemes to work together to engage with investee companies either alongside other individual large investors or via independent networks such as the UN PRI, IIGCC, NAPF, ICGN, or the LAPFF[1].

Generally, governance activity (including both voting and engagement, and possibly extending as far as 'intervention') should be part of the role of the scheme's chosen investment manager(s). This approach maximises the impact of such activity by making it an extension of the investment manager's underlying investment 'thesis'. In certain cases, Trustees may feel that it is appropriate to appoint a specialist 'voting and engagement overlay manager' to provide a coherent approach across all the scheme assets. In either case, these agents have a major role to play in ensuring that companies are run in a manner consistent with clients' best interests.

The Marathon Club supports the following five principles in the revised guidelines issued by the Institutional Shareholders' Committee in September 2005 and updated in June 2007 on "The Responsibilities of Institutional Shareholders and Agents - Statement of Principles":

- Maintain and publish statements of their policies on active engagement with investee companies
- Monitor performance of companies and maintain an appropriate dialogue with them
- Intervene where necessary
- Evaluate the impact of their policies
- Report back to clients/beneficial owners

Investment managers should comply with these requirements as a matter of course and as standard good practice – indeed the majority of investment managers now recognise their governance role as delegated 'owners' of the assets that they manage. However, there are a multitude of different approaches to this activity ranging from voting, through engagement, to intervention, or combinations of those approaches. Furthermore, as with any aspect of active management, investment managers have different views on which issues are important, and why. It is therefore vital that trustees make their objectives and intentions in this area clear to their delegated agents. This is true whether those delegated agents are internal or external investment managers.

1 UNPRI – United Nations Principles of Responsible Investment; IIGCC – Institutional Investors Group on Climate Change; NAPF – National Association of Pension Funds (UK); ICGN – International Corporate Governance Network; LAPFF – Local Authority Pension Fund Forum

Items that trustees might want to set out in their policies include:

- Geographical regions to be included (e.g. UK only? developed markets only?)

Guidelines or standards that should be used for reference (e.g. Combined Code, voting recommendations from Research, Recommendations and Electronic Voting (RREV), International Labour Organisation (ILO) Standards, Global Compact, etc.)

- Voting only? Or engagement / intervention?
- Investment principles in line with the UN PRI.

In addition, trustees can expect their investment consultants to evaluate and monitor fund managers in this area. The ISC Statement of Principles outlined above has been complemented by a supporting statement from investment consultants in October 2005 endorsing the principles and outlining the practical support to be provided by investment consultants to their clients. In particular, investment consultants have a role in encouraging trustees whether or not to include an evaluation of engagement ability in manager selection. This implies that investment consultants should have a demonstrable knowledge of how fund managers discharge these activities and whether they too delegate some of the consequential actions.

Delegation of these actions still requires responsible stewardship on the part of pension fund trustees in reviewing their intermediaries' delegated activities. Even if they are not directly involved in the day to day voting process and engagement, pension fund trustees should still regularly review their intermediaries' activities and performance against the policies and objectives they have established. In order to achieve this efficiently and effectively, trustees should establish monitoring systems that allow them to quickly identify important areas and readily compare activity across multiple agents.

Later sections of this guide set out ways of holding fund managers and other intermediaries to account and other organisations have published best practice guidance[2] which may also provide helpful detailed advice.

2 "Delegating Shareholder Engagement: Holding Fund Managers to Account" Local Authorities Pension Fund Forum Trustee Guide October 2006

Section Two: Active ownership – beyond equity governance?

Traditionally the concept of active, responsible ownership has focussed on equity ownership since this is where the rights and responsibilities associated with ownership are most clearly defined and most easily executed. Furthermore, equities still generally form the lion's share of pension assets with, as a recent study[3] shows, the UK and Ireland having significantly more exposure to equities than continental Europe.

However, there are a number of forces at work that lead pension scheme trustees to consider a wider range of asset classes than the traditional equities and bonds:

- 'Mark to market' accounting standards encourage diversification of assets to reduce volatility of returns.
- Increasing maturity of closed schemes suggests a gradual risk reduction; however
- Poor funding positions require additional returns above those offered by bonds; and
- A greater strain on sponsor covenants; therefore
- Alternative assets offer risk (volatility of returns) lower than equity, but returns higher than bonds.

Therefore, whilst this note focuses on responsible / active equity ownership, it is important to recognise that responsible ownership also applies to other assets classes. For example:

- Corporate Bonds: the need to monitor the use of additional capital raised, whether it is being used effectively to grow the company or whether it is being used as leverage
- Property: building regulations with respect to energy usage; issues around the quality of the working, or living environment; access to transport; provision of facilities; etc
- Private Equity: need for transparency between General Partner and Limited Partners; sustainability of business model of investee firms; governance structures in advance of public listing; etc.
- Infrastructure: shares many of the issues of both Property and Private Equity
- Hedge Funds: concern over possible market abuse (e.g. fraudulent rumours) and transparency

Furthermore, by having long term time liability and investment horizons, and by taking such a wide stake in the investment markets across a broad range of countries, continents and asset classes, pension funds (particularly the larger ones) can be argued to be “universal investors” who have a long term interest in the overall health of the world’s economy and wellbeing. Funds in such positions are therefore increasingly conscious of the need of seeking to mitigate ESG risks by exercising their influence as enlightened owners.

This aspect of responsible ownership can be expressed through engagement with investee companies, but can also be exploited in the actual selection of investments, whether by choosing to target 'responsible' firms (such as those developing low-carbon technology) or by integrating an evaluation of long-term ESG factors into the investment decision-making process. Again, this is applicable in other asset classes beyond equities.

In summary, there are two aspects to responsible active ownership of assets and they both apply beyond the traditional sphere of equity ownership. Firstly, owners can, and increasingly do, take an active role in exercising influence on investee companies or assets - as experience has grown, so also has confidence and awareness that the conduct of companies is material to investment returns. Secondly, investors have noted a correlation between well run companies, good ESG risk management, and good performance – this is now being used to inform and influence investment decision-making. While more research may be required to prove causality, “the argument that integrating ESG factors into investment analysis and decision making will only lead to underperformance simply cannot be sustained”[4]

3 http://www.mercer.com/assetallocation

4 Demystifying Responsible investment Performance, UNEP FI/Mercer

Section Three: Where in the investment process can long-term views make a difference?

To understand the current approach to voting, engagement and ESG risks it is necessary to understand the development history of these two areas.

Voting and engagement were long seen as 'peripheral' to the real business of buying and selling investments and typically these activities were handled by administrative staff. For a long time many investors either did not vote or voted with management, and engagement was seen simply as a way for the investor to gain a better understanding of the company rather than a chance for dialogue. Gradually however the importance and value of the rights of ownership has been recognised. The more enlightened long-term shareholders now use their votes thoughtfully and engage in a real dialogue with their portfolio companies – particularly on issues where the value of their investment is under threat, or value-enhancing opportunities are being missed. Examples might include voting against the issuance of preference shares, or discussing company strategy with board members.

Similarly, ESG risks and opportunities have only recently been recognised as valid concerns for 'mainstream' investors. For example, the introduction of carbon credits in Europe has forced investors to take account of the 'Cost of Carbon' in their evaluation of European and even global companies, and it is widely acknowledged that other factors too can have an important impact on the future long-term profitability of a company. Further, examples include the potential litigation exposure facing US tobacco firms, or reputation risk arising from the use of child labour in manufacturing in developing countries.

The Marathon Club believes that the most effective approach is for a proper consideration of the widest possible range of ESG issues to be integrated into the investment decision, and additionally for these issues to inform any engagement that the fund managers undertake with their portfolio holdings. It is also important for trustees to raise these issues with their investment consultant and advisers, and to engage with other investors through collaborative initiatives (e.g. UN PRI).

As indicated in the previous section, this approach should also apply to investment decisions on other asset classes, e.g. real estate, private equity, infrastructure, hedge funds.

Section Four: How can Trustees evaluate their agents' activity?

There are a wide number of tools available for trustees to evaluate investment activity, including independent performance and attribution analysis and risk analysis tools. However, the assessment of responsible ownership or ESG risk is much less well developed, making it hard for trustees to track what they or their agents (the investment managers) are doing in these areas, still less determine whether they are adding value.

The first essential component of any monitoring framework is that data from various managers is presented in a clearly understandable and easily comparable way. This may require trustees to agree with their equity managers a bespoke reporting format for voting and engagement activity. The framework should allow the trustees to identify key elements of the activity, and track development through time, either directly or through their investment consultant and/or advisers.

ESG risks are more difficult to assess and may require the use of specialist monitoring providers. Importantly, the function of such monitoring is to facilitate discussion of portfolio holdings and risk exposure between the trustees and their agents, and thereby allow the trustees a greater depth of understanding of their investments. For example, if analysis reveals a higher than average (index) exposure to 'high carbon' companies, the trustees could explore with their fund managers their view on this risk, and the opportunities that they have identified in the companies they have chosen to invest in.

Clearly there may be some overlap between governance risk and the voting and engagement activity: if ESG analysis reveals a particularly high exposure to poorly governed companies this could indicate that the manager is seeking opportunities to engage with their portfolio holdings in order to tackle those governance issues and thereby unlock value in the investments.

Section Five: How can Trustees reflect their views in Scheme documentation?

In this section, we set out a number of examples of the wording that might be used. These examples are neither exhaustive nor prescriptive, but suggestions that may be considered in the context of each case.

Policy on responsible ownership

A. Possible wording for the Statement of Investment Principles

- As long-term investors, the Trustees encourage [and require] their investment managers to consider a broad range of factors that might affect the value of their investments, including (where appropriate) environmental, social and governance (ESG) factors.

- The Trustees recognise that these factors are not equally relevant to all asset classes or investment approaches. However, where they believe such factors may have an impact on investment returns, the Trustees will undertake to evaluate the portfolio's exposure and discuss these factors with the investment manager.

- The Trustees support the principles in the guidelines issued by the Institutional Shareholders' Committee in September 2005 on "The Responsibilities of Institutional Shareholders and Agents - Statement of Principles", and expect their investment managers to comply with these principles, and to report back accordingly. The Trustees also expect their investment consultants to adopt the ISC's Statement of Practice relating to consultants which broadly reflect the updated Myners Principles

- The Trustees will make proper use of any rights that arise from asset ownership, and to meet any associated responsibilities to the full, often through their investment managers. The activities arising from such 'responsible ownership' take different forms for different assets, but include, for example, voting and engagement in the case of equity assets. The Trustees will regularly report their ownership activity in an agreed format.

- Recognising the importance of ESG and responsible ownership for the success (or otherwise) of long-term investment, the Trustees will include an assessment of their investment managers in these areas in their regular qualitative monitoring, and they will be amongst the factors considered in any future manager selections.

Alternative wording

Policy on ESG factors

1. The Trustees expect its fund managers to take into account environmental, social and governance (ESG) considerations in selecting retaining and realising investments, where these factors are likely, in the fund manager's view, to have a material impact on the performance of the portfolio.

Policy on Corporate Governance and Voting

2. The Trustees attach great importance to the maintenance of good standards of corporate governance by companies in which it invests. Accordingly, the Trustees have corporate governance policies for various markets (including the UK) with which its fund managers are expected to comply. A copy of these policies is attached as an Appendix, and available to members upon request.

3. The Trustees believe that institutional investors have a general fiduciary responsibility to ensure that investments are managed in the long term interest of their beneficiaries and asserts that shareholder value can be improved through constructive consultation and engagement with companies and wider corporate governance initiatives.

4. The Trustees consider that its fund managers and other agents have a major role to play in ensuring that companies are run in a manner consistent with clients' best interests. The Trustees support the following five principles in the guidelines issued by the Institutional Shareholders' Committee (ISC) in September 2005 on "The Responsibilities of Institutional Shareholders and Agents - Statement of Principles":

   - Maintain and publish statements of their policies on active engagement with investee companies
   - Monitor performance of companies and maintain an appropriate dialogue with them
   - Intervene where necessary
   - Evaluate the impact of their policies
   - Report back to clients/beneficial owners

5. The Trustees ask that their fund managers comply with these principles where relevant and require managers to report regularly on their compliance with them and to provide post-hoc quarterly reports on voting and other significant matters where appropriate. This also extends to environmental, social and governance (ESG) matters that the fund managers consider to be material.

6. The Trustees also expect their investment consultants to adopt the ISC's Statement of Practice relating to consultants which broadly reflect the updated Myners Principles.

7. In addition to the monitoring performed by fund managers and other agents, the Trustees will take further action in relation to individual companies, whether independently or with other parties, where it considers it in the best interests of beneficiaries to do so. Voting is one part of the engagement process and the Trustees vote on all resolutions at all Annual and Extraordinary General Meetings of UK companies in which it has holdings. It has also extended voting selectively to overseas markets. It will continue to maintain its own corporate governance policy and to refresh it at regular intervals.

Alternative wording

Responsible Investment

i. As an institutional investor that takes it fiduciary obligations to its members seriously, the Trustees aim to be an active and responsible long term investors in the assets and markets in which they invest. By encouraging responsible corporate behaviour, the Trustees expect to protect and enhance the value of the fund's investment in the long term.

ii. The Trustees therefore require their fund managers to pay appropriate regard to relevant extra-financial factors including environmental, social and governance (ESG) considerations in the selection, retention and realisation of all fund investments. The Trustees expect this to be done in a manner which is consistent with the Trustee's investment objectives and legal duties.

iii. Specifically, the Trustees have called upon its investment managers to use their influence as major institutional investors to promote best practice by investee companies and by markets to which the fund is particularly exposed.

iv. The Trustees also expect the schemes investment managers to undertake appropriate monitoring of the policies and practices on material ESG issues of current and potential investee companies so that these extra-financial factors can, where material, be taken into account when making investment decisions.

v. The aim of such monitoring should be to identify problems at an early stage, and enable engagement with management to see appropriate resolution of such problems. The Trustees use voting rights as part of their engagement work to ensure that voting is undertaken in a prioritised, value-adding and informed manner. Where collaboration is likely to be the most effective mechanism for encouraging company management to address these issues appropriately, the Trustees expect fund managers to participate in joint action with other institutional investors.

vi. The investment committee monitors this engagement on an on-going basis with the aim of maximising its impact and effectiveness. The Trustees governance, social and environmental policies are also reviewed regularly by the board and updated as appropriate to ensure that they are in line with good practice.

B. Investment Manager Agreement

The exact wording of segregated mandates should be reviewed and agreed by lawyers and therefore the following is only an initial suggestion for paragraphs that could be inserted into a 'standard' IMA as a starting point for discussion.

In the case of pooled mandates, it may be possible to establish a side letter to the formal pooled fund documentation which, whilst it may not carry the same legal weight as the documentation itself, at least ensures that both sides are clear about how the Trustees would like to address these issues.

- The Trustees recognise that they are long-term investors. Furthermore, because the Scheme invests in a range of asset classes and countries, they consider that they are 'universal investors' with a stake in the long-term health and stability of the global economy.
- Bearing this in mind, the Trustees require their fund managers to take account of the widest possible range of factors in their investment decisions. In particular, the Trustees wish to see evidence that the extent to which environmental, social and governance (ESG) issues may have an impact on the future profitability of the Scheme's investments has been taken into account in investment decisions.
- The Trustees also take seriously their role as asset owners. The manager is required to vote on all resolutions at Annual General Meetings and Extraordinary General Meetings for those UK companies in which it invests. It is further required to vote where possible in overseas markets; particularly where the resolution under consideration could have a meaningful impact on the future profitability of the company.
- In addition, the investment manager is required to engage with the management of the companies and assets in which it invests to raise and discuss issues that the investment manager believes could be material for the company or asset, including ESG issues.