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September 2016

Responsible Capitalism Survey

Diversity – Institutional investors rising to the challenge

Responsible Capitalism:
The rising importance of diversity in corporate governance

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Significant political and economic upheaval has prompted governments to look in increasingly greater depth at corporate governance practice. Incoming UK Prime Minister Theresa May immediately took aim at non-executive board members ‘drawn from the same narrow social and professional circles as the executive team’, accusing them of providing insufficient scrutiny. Nineteen nations in the European Union now mandate that employee representatives sit on corporate boards, while US Presidential candidate Hillary Clinton has promised corporate governance reform. When diversity considerations draw the attention of policymakers, companies and investors must increasingly take note.

Hermes Investment Management provides active investment strategies and stewardship. Our goal is to help people invest better, retire better and create a better society for all.

The Responsible Capitalism Survey 2016

Hermes Investment Management’s annual Responsible Capitalism Survey[1] was launched in 2014 to gauge the perception of responsible investment among the investment community. The 2016 survey was carried out on a group of 102 institutional investors during April to May 2016. Responses were anonymous.

The survey covers a range of topics inclusive of ESG assessment in investment decision making, corporate governance and diversity. Some of these topics are updated annually to reflect the latest developments in the responsible investing debate.

Within the past three years, we have seen responsible investment considerations grow in prominence in the mainstream investment agenda. Our survey seeks to assess how far the growing recognition of the importance of these issues is reflected in investment practice.

[1] The Survey was conducted by Citigate Dewe Rogerson.

But why has this focus emerged? Policymakers recognise the link between 'group think' and poor corporate practice. This year has seen an increasing number of shareholder votes against excessive executive pay. Often, boards globally are considered out of touch with the wishes of shareholders and accusations of cronyism have become commonplace. Diversity of boards is a key way to address this accusation head-on and why the Hermes Responsible Capitalism survey questions the attitudes of institutional investors towards diversity.

For investors, the issue is both push and pull: Boards whose members think in one direction are less likely to challenge senior management and therefore less likely to identify problems. In this way, there can be significant risk management problems where boards do not show adequate diversification.

However, boards with more diverse composition also tend to be more innovative and make better decisions. Research by index provider MSCI shows companies in the MSCI World Index with strong female leadership generated a Return on Equity of 10.1% per year versus 7.4% for those without.[1]

While corporate Britain has improved its record on board diversity in recent years, it still lags behind many other developed nations. Research by the European Women on Boards network, which includes Britain's Institute of Directors, found that women now occupy 23.2% of board seats in the UK. This falls short of the European average of 25% and leaves Britain in 9th place in the network's ranking of 12 leading European economies.[2]

The picture is similarly mixed for ethnic diversity. TUC figures show that black graduates earn an average of 23.1% less than their white counterparts.[3] This echoes research by consultancy Green Park Group, which found that the number of all-white boards in the FTSE 100 increased to 62 in 2015, from 61 the previous year.[4]

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In our Responsible Capitalism survey we found that the issue for investors appears to be risk, rather than high returns. These are febrile times, and investors increasingly recognise that certain sorts of risks can fundamentally undermine the performance of their portfolios over time. Worse, they may be accused of failing in their fiduciary duty. As such, 60% of investors believe that fund managers should be rejecting otherwise attractive investments if ethical, social and governance issues are not properly addressed. While 73.1% believe that pension schemes will increasingly start to reject investments based on governance criteria.

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Within the issue of diversity there are also still significant gaps on pay; research by The Fawcett Society shows a lifetime gender pay gap of almost £300,000 and the gap is even wider at director level.[5] The Government has said that it will legislate, forcing companies with more than 250 employees to reveal their pay gap. They will need to start calculating the pay gap from April 2017 – 12 months ahead of the first tables being published.

1 https://www.msci.com/www/blog-posts/women-on-boards-global-trends/0263383649
2 https://www.theguardian.com/business/2016/apr/27/women-uk-board-positions-gender-equality-europe
3 https://www.tuc.org.uk/equality-issues/black-workers/labour-market/black-workers-degrees-earn-quarter-less-white
4 http://www.independent.co.uk/home-news/shamefulhow-the-pay-gap-hits-black-graduates-in-white-collar-jobs
5 https://www.theguardian.com/money/2016/mar/07/gender-pay-gap-uk-women-earn-300000-less-men-lifetime

Various campaigns have been launched to address the gender imbalance; the high profile 30% Club, looks to place pressure on corporate management to increase the number of women on their boards. There have also been initiatives in specific sectors: financial services has long proved one of the most recalcitrant on diversity – the gender pay gap is the widest of any sector – but the Women in Finance Charter has recently been created by HM Treasury and signatory firms as a pledge for gender balance across financial services. The charter aspires to see a gender balance at all levels across financial services firms, adding: "A balanced workforce is good for business – it is good for customers, for profitability and workplace culture, and is increasingly attractive for investors."[6]

The latest Hermes Responsible Capitalism survey confirms that board diversity is becoming an increasingly pressing consideration for institutional investors. The survey shows that 79.2% of investors believe fund managers should be pricing in corporate governance risks as a core part of their investment analysis. Only a tiny proportion of investors now consider diversity of board experience (2.1%) and true independence, including independence of the chair from the CEO (1%), to be not important at all.

Governance

The survey shows that:

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of investors believe fund managers should be pricing in corporate governance risks as a core part of their investment analysis.

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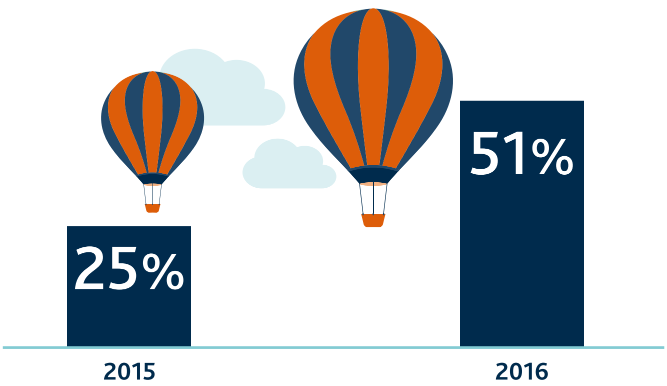
of investors now consider diversity of board experience to be not important at all.

1%

of investors now consider true independence, including independence of the chair from the CEO, to be not important at all.

Percentage of investors we surveyed who see gender diversity of senior management as important or vitally important.



This suggests the extent to which these issues are becoming front of mind for investors. In this context, gender diversity still lags somewhat, with 51% of investors we surveyed seeing gender diversity of senior management as important or vitally important. However, this represents a significant leap from last year's result of 25%. Also, gender still tops the list when set against other board diversity characteristics such as race (30%), socio-economic (19%) or educational background (30%).

Gender still tops the list when set against other board diversity characteristics followed by:

30% Race

30% Educational background

19% Socio-economic background

Nevertheless, laggard companies should take note: The issue is becoming more important. Over the next three years, 50% of investors believe that diversity of gender at board level will be highly or vitally important when assessing the investment potential of a company.

For the time being, workplace and board diversity is more of an issue for longer term investors. Those more opportunistic investors whose time horizon may be three years or less may be able to overlook a business's corporate governance short-comings, but this is not an option for those who are looking to invest for a longer period. With this in mind, pension funds have been among the first to prioritise diversity considerations.

[6] HM Treasury, Women in Finance Charter: a pledge for gender balance across financial services

Geographically, Europe has led transformation in corporate governance, but there is more engagement across the globe. Asian companies are increasingly signing up to the Principles of Responsible Investment[7] and, here too, regulators are driving change: From 2017, listed companies in Hong Kong will be forced to make public disclosures on corporate governance policies.[8] Singapore's largest sovereign wealth fund has a project to look at corporate governance investing, while Japanese and Chinese companies are also improving their disclosure and practice.

US companies have proved slower to act. However, there are signs of progress within the market; a coalition of chief executives and large asset managers, including Warren Buffet and General Electric CEO Jeffrey Immelt, have recently endorsed the 'Commonsense Principles of Corporate Governance' which seek to improve corporate behaviour in the US. On the subject of board diversity, it states that, "Directors should have complementary and diverse skill sets, backgrounds and experiences. Diversity along multiple dimensions is critical to a high-functioning board. Director candidates should be drawn from a rigorously diverse pool."[9]

Disclosure is now seen as a vital stepping stone to better practice: It seems that companies will have fewer and fewer places to hide as investors and policymakers demand greater transparency. Indeed, in the Hermes Responsible Capitalism survey, 61.8% of investors said that they want fund managers to be more transparent and share their ESG analysis of companies with clients on at least a quarterly basis.

There is increasing momentum behind corporate governance improvements, as policymakers, investors and companies increasingly recognise the value in diversity, both for risk management and for innovation. It seems likely that this will create a virtuous circle. Corporate diversity will no longer be considered a 'nice to have', but a necessary part of responsible governance.

[7] https://www.unpri.org/about
[8] http://www.scmp.com/business/companies/article/1971837/esg-new-buzzword-listed-fims-investors-hk-asia-regulations
[9] Commonsense Principles of Corporate Governance, http://www.governanceprinciples.org/wp-content/uploads/2016/07/GovernancePrinciples_Principles.pdf

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