

Responsible Capitalism and Stewardship





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Stewardship, or being a more responsible and active owner of the companies that you invest in, is vitally important to responsible capitalism. While the entire investment chain needs to encourage more sustainable behaviour by companies, ultimately it is asset owners who have the responsibility of ensuring that investment works in the interests of pension fund beneficiaries.

There are many parts of the investment chain including asset managers, companies, accountants, investment banks and investment consultants, whose incentives do not always align with the aim of maximising benefits for pensioners.

Investment banks, for example, have a vested interest in driving transactions such as encouraging as much trading of stocks and as many deals as possible, neither of which necessarily add value. Effective stewardship and responsible ownership focuses on the creation of sustainable wealth and is good for the entire investment process.

So, what does responsible ownership mean? It is about ensuring that the interests of everyone in the investment chain are aligned, that capital is allocated appropriately and that all material risks including those of an environmental and social nature are being addressed in the interests of and within the risk appetite of the beneficiaries. The key to ensuring alignment is having the right governance in place. The board needs to have the right skills in place, there must be effective remuneration policies which pay for performance, executives should have "skin in the game" and the interests of minority shareholders should be looked after fairly.





Responsible ownership also means engaging – not just with company managements but also with public policy makers. If policies at a national or sector level can be positively influenced it can improve the standards in the whole economy, reducing risks and the cost of capital. If we can achieve a change at a public policy level, it has a ripple effect on the whole industry. Pension funds are universal investors invested in thousands of companies across all sectors of the economy, so they are less interested in how, say, AstraZeneca is doing compared with GlaxoSmithKline, and more concerned with the health of the entire pharmaceutical sector.

In addition to the division at public policy and company level, engagement takes places on multiple levels in another sense as well. Strategic, environmental and social issues are very specific to companies in a particular sector while governance is often driven by regulatory standards in specific countries. Then there are certain public policy themes engaged that have a global dimension, such as climate change, access to water and bribery and corruption.



Currently, the engagement process is not as effective as it could be because asset ownership is fragmented and there is a layer of asset managers and investment consultants between institutions and the companies that they own. In our survey of 109 institutional investors, 61% said that fund managers should be more transparent and share their ESG (environment, social, governance) analysis of companies at least quarterly. In future, we expect a growing number of asset owners will demand greater transparency from their fund managers.

There is momentum for investors worldwide to take their responsibilities as owners more seriously. For example, Japan and Malaysia have followed the UK, South Africa, Switzerland and others in adopting a stewardship code, while Singapore and Hong Kong are among other markets that are consulting on introducing their own codes. In the US, shareholder resolutions relating to ESG issues are often employed by investors as a way of encouraging change and board level access. Many countries have also adopted corporate governance codes. As an example, the Spanish regulator in February 2015 made a material update to its corporate governance code to bring it up to date with global best practice. These are complementary initiatives, with corporate governance codes dealing with the responsibilities of companies while stewardship codes address the responsibilities of asset owners and asset managers.

The financial crisis revealed that investors had plenty of room to improve in terms of understanding the risks that the companies they invested in were taking or were exposed to and whether the risks and returns of company managements were aligned with the risks and returns shareholders were exposed to. In many cases, they were not. Investors did not really understand when they invested in banks that were producing stellar returns, the extent to which this was based on high levels of leverage or the risks that this presented.

It is no surprise, then, that there is increasing evidence that good stewardship adds value to companies. Hermes Global Equities released research in 2014¹ showing that corporate governance standards have a meaningful impact on shareholder returns, proving that companies with poor or worsening standards of corporate governance have tended to under perform. In addition, Hoepner et al, based on Hermes EOS company engagements, show that "some groups of ESG engagement target firms experience a significant reduction in their downside risk during the engagement process and, on average, considerably higher annual returns than their peers after the engagement has been successfully completed".

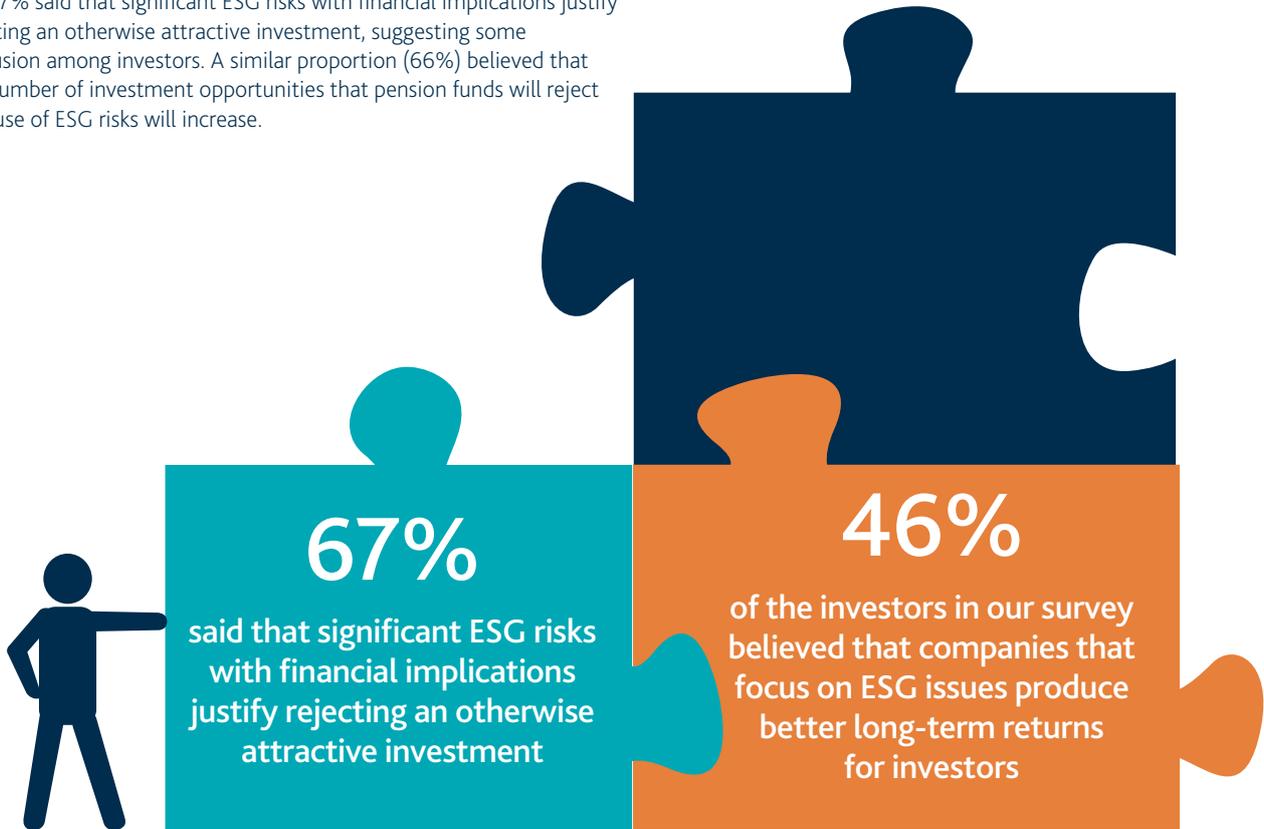
Meanwhile, a study by the Smith School of Enterprise and the Environment at Oxford University and Arabesque Partners³ shows that there is "a remarkable correlation between diligent sustainability business practices and economic performance". Despite this, less than half (46%) of the investors in our survey believed that companies that focus on ESG issues produce better long-term returns for investors, suggesting that even more research is needed to strengthen the case for a focus on ESG.

Yet 67% said that significant ESG risks with financial implications justify rejecting an otherwise attractive investment, suggesting some confusion among investors. A similar proportion (66%) believed that the number of investment opportunities that pension funds will reject because of ESG risks will increase.

Obviously, engagement has to be pertinent to the sector and company involved. In the banking sector, for example, we are concerned that there is little alignment of risk and rewards between the bank's executives and investors: investors in recent times have achieved meagre returns whilst shouldering a significant proportion of the capital at risk. Executive remuneration and the bonus culture is a strong focus of our engagement. It would seem unlike other industries bonuses are not paid for out-performance but as a kind of deferred salary. They need to be linked to performance over the right time frame and have the appropriate claw-back mechanisms.

Conduct is also a huge issue for banks at the moment, which is having a material impact in terms of the cost of litigation. Alongside the financial cost, getting the conduct right in banks is key to give banks a licence to operate in society and ensure that the banks' activities are working to support the generation of sustainable wealth and not the proliferation of non-value creating transactions.

In the oil and gas sector, on the other hand, there are real issues for long-term shareholders in terms of how much of the company's reserves need to stay in the ground to prevent runaway climate change. That is a very difficult area to engage with them about in the absence of a global carbon price. We are encouraging companies to consider the risk of a material cost of emitting carbon and to encourage governments to take a definitive stance on internalising the cost.



¹ ESG Investing: Does it make you feel good, or is it actually good for your portfolio?

² ESG Engagement, Risk & Return: An interim research progress report, Hoepner et al.

³ From the Stockholder to the Stakeholder: How Sustainability can drive financial outperformance, Viehs et al.

It is also important for investors to engage with policy makers and we are involved in various investor initiatives including the International Investors Group on Climate Change (IIGCC) and the United Nations Environment Programme Finance Initiative (UNEP-FI). Collaboration is really important at this level.

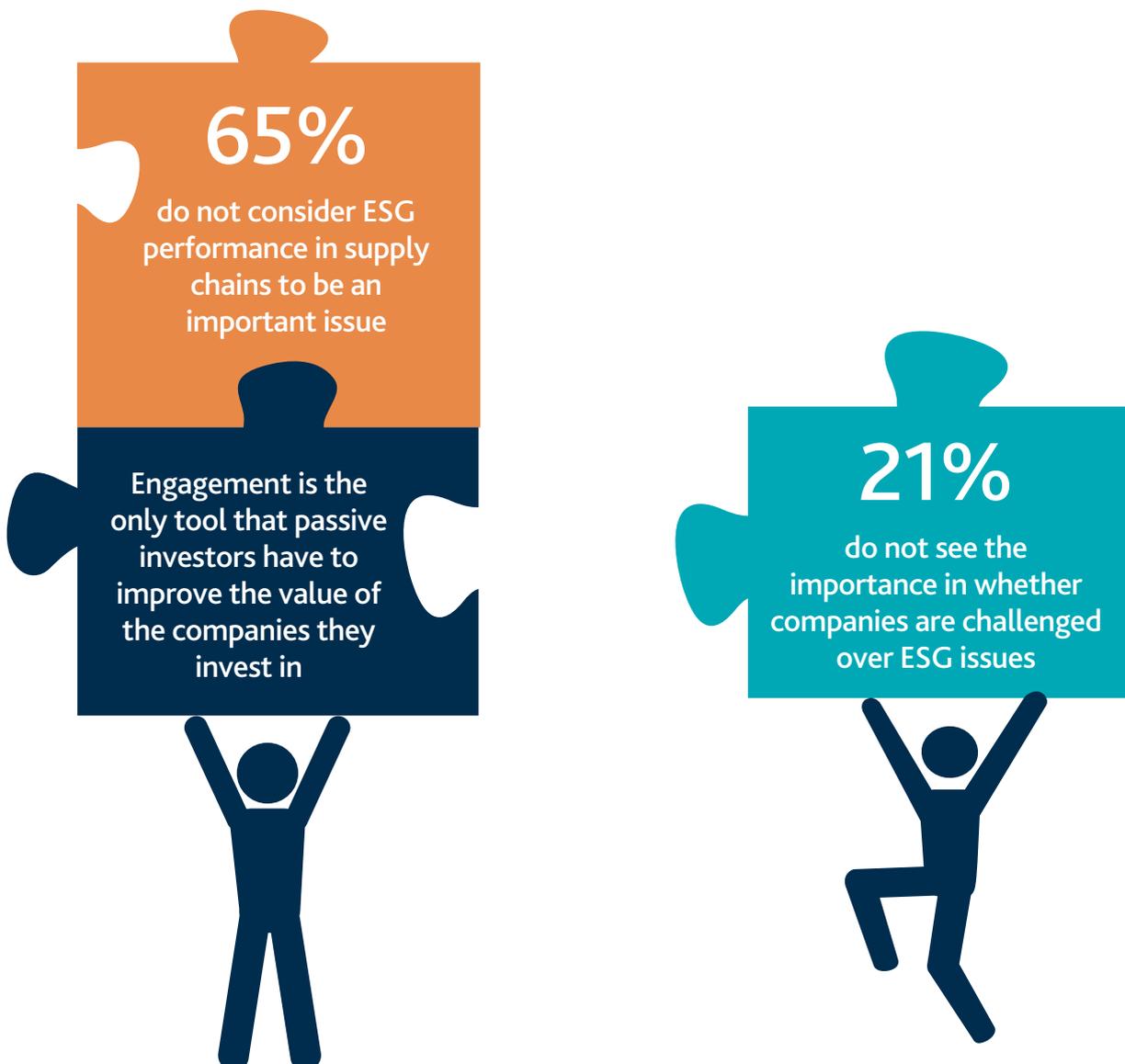
60% of the investors we questioned believed that the growth of low-cost passive management will cause large shareholders to become distanced from many of the companies they invest in, forgo voting rights and stewardship opportunities, and thereby lose the ability to influence companies for long-term gain. However, if anything, we believe passive investors should engage more, not less. Engagement is the only tool that passive investors have to improve the value and manage the risk of the companies they invest in.

Engagement and stewardship are global issues now. We live in a global economy and beneficiaries, via their pension funds, are increasingly invested all over the world, not just in the one country which a company or pension fund happens to be domiciled.

We are seeing significant momentum towards increased stewardship. However, there is still some way to go. For example, companies have suppliers all over the world and we believe it is important that they encourage responsible behaviour in these suppliers. Yet 65% of survey respondents did not consider ESG performance in supply chains to be an important issue.

It is also worrying to see that, although 71% of respondents believe that institutional shareholders have an ethical/fiduciary responsibility to challenge companies in relation to poor ESG practices, more than a fifth (21%) still do not see it as an issue. Whenever there are poor ESG practices that lead to the destruction of value, investors have a fiduciary duty to speak up.

Resources dedicated by investors to engagement and stewardship remain very limited. Hermes' stewardship resource (Hermes EOS) is one of the largest of its kind in the world and is only 26 strong. There is therefore a significant opportunity for asset owners to effectively collaborate and increase their investment in responsible ownership thereby contributing to ensuring the alignment of companies and public policy makers to the generation of long-term wealth for beneficiaries to enjoy in a sustainable economy.



Hermes Investment Management

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Our investment solutions include:

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