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Is the Stewardship Code fit for purpose?

A field study of engagement by asset management firms

Key conclusions

- Engagement by asset management firms (AMs) is characterised by constructive challenge rather than by the 'purposeful dialogue' anticipated by the Financial Reporting Council (FRC)
- The desire of asset management employees to maintain their privileged access leads them to behave with caution towards their investee companies
- 'Stewardship', as promulgated by the FRC, is perceived as inappropriate, costly, and risky
- Companies exploit AM firms' concerns about collaborating with their competitors by playing AM firms off against each other
- In the absence of evidence for the benefits of engagement, attempts to introduce measures or targets are likely to lead to additional cost and 'gaming' behaviours

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Abstract

The Stewardship Code was established by the Financial Reporting Council (FRC) in 2010 following concerns that asset management firms behaved like 'absentee landlords'. Its stated aim is to enhance engagement by asset management firms (AMs) with their investee companies.

We conducted in-depth interviews with 29 participants and observers of the asset management industry to understand the nature of engagement and stewardship as practised in major UK-based AMs with long-term shareholdings.

Our findings reveal that AMs have two main approaches in engaging with their investee companies. In line with prior research, we find that fund managers use engagement activities to ask questions to obtain private information that might improve the performance of their funds.

In contrast, governance managers within AMs engage with non-executive directors in order to understand environmental, social and governance issues that might affect on the performance of any relevant fund within the AM's total portfolio.

Engagement is not therefore characterised by the 'purposeful dialogue' that underpins the Code's intended aims. Our participants' concerns about the risky and costly nature of engagement reduces the likelihood that they will undertake the 'ownership' behaviours intended by the Code.

Consequently, divestment of a shareholding, rather than engagement, is the preferred action when faced with concerns about a company. Collective engagement is both rare and limited in scope because AMs lack incentives to share information with competitors.

In the absence of any evidence for the benefits of engagement, attempts to introduce measures or targets are likely to lead to additional cost and 'gaming' behaviours.

Introduction

The introduction of the Stewardship Code followed the financial crisis of 2010 amid concerns that AMs behaved like 'absentee landlords' (Myners, 2009). Prior to the crisis, overall voting levels in the banking sector were around two thirds and votes against resolutions at less than ten per cent (Walker, 2009).

> The Code is voluntary but has enforcement through the Financial Conduct Authority's Code of Conduct Sourcebook so that all asset owners and asset managers are required to sign.

The aim of the Code is to reduce the risk of financial failure by encouraging greater governance by AMs through enhanced engagement, consisting of 'purposeful dialogue' between investors and publicly limited companies (PLCs). Notably, the Code does not contain a clear definition of stewardship nor of the behaviours that indicate its existence.

> **What is meant by stewardship and engagement?**
>
> 'Stewardship activities may include monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration. Engagement is purposeful dialogue with companies on these matters as well as on issues that are the immediate subject of votes at general meetings.' (The UK Stewardship Code 2012, FRC)

Occasional reports by the FRC and other agencies provide a high-level view of stewardship compliance, reporting, and practices in the UK. These reports are based on self-reported surveys of firm-level activity completed by one unidentified individual. While these reports claim that overall commitment to stewardship by asset owners and managers has increased, there is notably little evidence of systematic stewardship behaviours or outcomes. Critics of the Code point to the Code's inevitable limitations in the face of fragmented and international share ownership, legal practicalities, and asset management incentives for short- to medium-term fund performance.

Our report, based on in-depth interviews with a range of individuals involved in the investment management industry, aims to enhance understanding of how stewardship plays out in practice. Our findings have implications for continued attempts to inculcate stewardship behaviours in the absence of more fundamental structural changes to the sector.

Objectives

The objectives of the study were to:

- Enhance understanding of engagement and stewardship as practised by AM employees.
- Explore perceptions of the Code and its effectiveness.
- Investigate whether behaviours have changed since the introduction of the Code.

Research methodology

We conducted in-depth semi-structured interviews with 29 participants in, and close observers of the asset management industry. Our sample includes 21 fund managers, analysts and environmental, social, and governance (ESG) managers from 13 of the UK's major asset management firms. The fund managers and analysts in our sample are responsible for long-term funds in UK equities. We also interviewed representatives from the FRC, the Pensions & Lifetime Savings Association (PLSA) and the Investment Association (IA), a Head of Investor Relations from a FTSE-100 company, and two corporate governance experts from professional bodies. All interviews were conducted face-to-face at the offices of the interviewee.

The Code operates on a 'comply or explain' basis. It reminds AMs that they have a responsibility to "protect and enhance the value that accrues to the ultimate beneficiary", and sets out seven principles that they should follow in relation to their stewardship role:

1. Publicly disclose their policy on how they will discharge their stewardship responsibilities.
2. Have a robust and publicly disclosed policy on managing conflicts of interest in relation to stewardship.
3. Monitor their investee companies.
4. Establish clear guidelines on when and how they will escalate their stewardship activities.
5. Be willing to act collectively with other investors where appropriate.
6. Have a clear policy on voting and disclosure of voting activity.
7. Report periodically on their stewardship and voting activities.

Main findings and their implications for practice

1. Engagement is driven by investment, rather than ownership, concerns

The majority of the fund managers and analysts in our study engage extensively with PLCs, meeting with senior management in order to understand issues related to strategy, performance, capital structure, and risk. However, all expressed very little interest in the Code. In contrast, ESG managers are knowledgeable about the Code, meeting with non-executive directors to understand corporate governance issues. In line with prior academic research, we find that the purpose of engagement is to obtain private information that supports investment decisions and can provide a competitive advantage. Consequently, our findings indicate that normal engagement activities involves little 'dialogue'. Our AM interviewees estimate that they spend 70-95% of their time in private meetings listening and the remainder asking questions and challenging decisions: ***'getting them to justify actions they've either taken or are thinking of doing'*** (Fund Manager). In contrast, our FRC interviewees assumed that private meetings were characterised by equal speaking time in the form of a dialogue.

AM employees conceal their opinions because they wish to avoid alerting the companies and fund management competitors to their ideas. Engagement is equated, not with stewardship, but with 'active investment': ***'I listen to what they say and then see how that measures up to what they do'*** (Analyst). The purpose is to support investment decisions: '***If they go in a different direction than we think they should, we divest in the shares'*** (Fund Manager). More active behaviours are commonly eschewed: ***'It's arrogant to say one should influence a company'*** (Fund Manager).

2. Long-term investors are frustrated by the PLCs' attitudes

AM participants are generally pessimistic about their capacity to engage with PLCs, challenging a ***'naïve belief that if you say something to a company they'll listen to you'*** (Fund Manager) and expressing frustration about companies' responses to their questions: ***'it's flattery … window dressing ... a cosmetic exercise'*** (Analyst). One recurrent theme was that companies play investors off against each other: ***'They are very good at turning engagement into a process to pound people into submission'*** (Head of ESG). Engagement is viewed as a means for PLCs to pursue their own interests: ***'The PLC still feels run by [management] for themselves rather than for their investment community and long-term shareholders'*** (Head of ESG). This perceived power imbalance, combined with a desire to obtain private information, leads to appeasement behaviours by the AMs: ***'We've got to be really careful about not dominating a company or pushing our weight around'*** (Fund Manager). Inevitably this restricts engagement activities to private meetings rather than the public arena: ***'We are very careful about how we talk to the press or use the market'*** (Fund Manager).

Attempts to express concerns about a company's actions can lead to subtle forms of pressure: ***'It gets tired, you know, 'can our chairman come and speak to your chief executive?' ... I think the old boys' network stops a lot of things happening'*** (Fund Manager). Concerns about antagonising PLCs also feed into conversations about executive remuneration because ***'it is inevitably difficult to object to someone's pay if you're paid more and they are doing a harder job'*** (Analyst). However, public outrage notwithstanding, absolute levels of executive remuneration are largely regarded by those close to the industry as an irrelevancy, as noted by the PLSA interviewee: ***'It's not central to the company's strategy, in terms of generating value, and it's certainly not going to be the issue that will enhance or destroy value for the investor'***.

The effects of this perceived power imbalance are more apparent for the smaller investment houses and PLCs. Both the Head of Investor Relations and the PLSA interviewee noted that PLCs tend to privilege only their top twenty investors with one-to-one meetings while ***'an investor will want to engage with [their top twenty investments], and clearly they're not going to be the same list'*** (PLSA interviewee).

3. Engagement with investee companies is seen as costly and risky, and is rarely driven by asset owners

Engagement is regarded as a necessity for shareholdings that represent a large proportion of share capital, but otherwise a costly and risky alternative to divestment. Participants are reticent to influence the PLCs rather than questioning and challenging their behaviours because: ***'[It] is quite dangerous because fundamentally we are fund managers, not CEOs'***. This is clearly at odds with the intentions of the Code. One fund manager explained how two major attempts at engagement had failed, with detrimental consequences for his fund: ***'Both times it would have been better for us to sell our shares'***. Liquid shareholdings reduce the need for lengthy engagements, summed up by one fund manager's comment: ***'It's much easier to sell your shares than to change the business ...The value creation we can make from getting heavily engaged in a company is generally not worth the time'***. Several participants noted the cost of engagement; costs that are passed onto clients: ***'The bloke in Manchester, it's costing him money for me to waste my time being talked to by someone who's not listening'*** (Analyst).

Several ESG managers noted that engagement activities require social skills that may not coincide with investment management ability, and, where absent, can put relationships at risk: ***'We have some [fund managers] who you'd rather weren't in the room when you're doing engagement, hopeless. Their expertise is on making investment decisions … it doesn't follow that they're good with an aggressive chief executive'*** (Head of ESG). Our PLSA interviewee expressed a similar concern about asset owners' ability to challenge asset managers on their engagement and stewardship activities: ***'We help them get beneath the skin of the marketing material, that's quite difficult ... [the AMs] are very well resourced and they're very clever people. The majority of funds are always going to be too small to individually hold to account fund managers.'***

Our non-AM participants do not observe a 'cosy' relationship between fund managers and their investee companies, but one acknowledged the inherent dangers of 'inbuilt bias' arising from 'a relatively small pool of individuals that operate in similar circles, from similar backgrounds'.

4. Collaboration between AMs is rare, reactive, restricted to ESG issues, and unlikely to increase given current incentives

Collective engagement might offer a solution to the relative power wielded by the largest PLCs, but it tends to be reactive and requires that AM's interests are perfectly aligned: ***'I have no choice but to engage with them and talk to the [company], and then you have other investors, saying, I'm going to sell my shares'*** (Head of ESG). It is largely restricted to ESG issues because of concerns about competitive advantage and legality: ***'It's always a bit dangerous when you're talking to competitors, you're not keen to share the information. There's also the issue about concert parties as well.'*** (Fund Manager). All the AMs in our study belong to the PRI Clearing House, regarded by ESG managers as helpful for both sharing high-level information and for limiting the ability of the PLCs to play off investors on ESG issues.

Following the collapse of Carillion, a letter sent jointly by the Work and Pensions Committee and the Business, Energy and Industrial Strategy Committee to several key investors asked, 'What steps did you take to influence the financial decisions of the board, what response did you receive, and what lay behind your decision to sell shares in the company when you did?' (Daily Business Group, 2018).

5. The Stewardship Code has changed firm-level activity but has not altered individual behaviours

The Code has reinforced and expanded the ESG role. However, ESG teams are small – no more than four or five people in the AMs in our sample (excluding admin). Their compliance or oversight role means they are viewed by fund managers as protectors rather than creators of value for AM funds. The ESG managers believe that the Code has increased the reporting and transparency of firm-level engagement 'in a more structured way'.

However, we find little evidence that the Code has changed the behaviours of individuals. Our participants view lack of engagement not as a dereliction of duty but as a considered choice within the incentive structure of fund-based P&Ls. Consequently, the introduction of the Code has had no discernible impact on the behaviours of individuals. Even the ESG managers, who are the most supportive of the Code, believe its major impact has been to formalise and publicise existing behaviours: ***'We're doing what we did before ... maybe the word stewardship is more bandied about and maybe it's raising consciousness in some people's minds, but it hasn't made a massive difference'***.

Our PLSA interviewee noted that economic changes may be a major driver behind genuine stewardship: ***'In a defined contributions world, where the [individual investor] is the one bearing the investment risk, they [will] have a much greater interest in that money is generating good returns in a way that's responsible and that the [fund] managers are engaged with companies, regulators, and policymakers'***. However, this will depend on changes to fund managers' incentives and market changes that might increase complexity and hence reduce accountability even further.

6. The benefits of engagement are unproven at best, and performance measures could have unintended consequences

Some participants claimed they have been successful in achieving change in their investee companies, but such examples were largely limited to specific governance issues such as the removal and appointment of particular executives. Changes related to environmental and social issues have a much more complex and lengthy causal chain. Notably, successful interventions by AMs aren't always in the public domain in the event that this might antagonise PLCs. One ESG manager suggested that ***'the law of averages says some of the companies will do what you say because they probably would have done it anyway'***. With regard to other types of change, one fund manager claimed that PLCs can be dismissive of their concerns: ***'They say "thank you very much, we've taken [that] on board and we've decided you're wrong … In terms of ever getting any change, [it's] completely ineffective … and if you ask [ESG managers] for examples of their success, they'd really struggle to come up with anything concrete.'*** Our ESG participants were largely in agreement, with the exponential increases in executive pay providing a notable example. ***'How much benefit our conversations with companies on remuneration issues has, I have no idea'*** (ESG Manager).

Our participants dismissed any notion that voting actions are a useful proxy for engagement or stewardship. Votes against a company's resolutions are viewed as a last resort because they could signal that engagement has failed and might also antagonise a company. Furthermore, different funds within the same AM may vote in different ways. Our interviewees believe that attempts to introduce other 'hard' measures for engagement would lead to additional cost and no obvious benefit to the end investor. None of the ESG managers in our sample were measured internally against specific outcomes for engagement, on the grounds that **'the law of averages says some of the companies will do what you say because they probably would have done it anyway**', and because targets would be counter-productive: ***'If I had to have ten 'successful' engagements, I could game it. That's not helpful because you'd set your aspirations quite low.'*** Several participants noted the increase in the quantity of meetings but with limited evidence of quality. The PLSA interviewee was wary of the likely effectiveness of further changes to the Code.

Conclusions

The FRC reported in 2016 that 'public trust in business remains low as we continue to see examples of poor corporate conduct'. Eight years after the introduction of the Stewardship Code our study seeks to understand how stewardship plays out in practice. While past surveys report an increase in engagement activities by AMs, we find little evidence for the type of engagement that promotes the 'ownership' behaviours intended by the Code. Incentives within the AM industry lead to a limited form of engagement that benefits short- to medium-term investment performance, preventing 'purposeful dialogue' or collective actions except under very specific circumstances. The AMs in our study exhibit the behaviours of long-term investors with short-term performance horizons, rather than long-term owners.

Our findings highlight several concerns about AMs' engagement with the major PLCs. Despite the size of the AMs represented in our study, our AM interviewees are inhibited by their belief, valid or not, that they are the less powerful partner in the relationship. Furthermore, engagement is costly, and measures of success are not evident. Their focus on investment returns and competitive advantage, rather than on stewardship, appears to drive their behaviours. Left unchallenged, the implicit assumption in the Code that engagement is beneficial and should be increased could result in negative consequences. Some AMs may resort to box-ticking, thus reducing the credibility of self-reported submissions, while others may continue to develop engagement activities without evaluating the cost-benefit trade-off for their clients.

It does not follow from our findings that stewardship is entirely absent from the AM-PLC relationship. Prior academic research has found that PLCs internalise the requirements of their investors, and this may also be true of stewardship concerns. However, it is not immediately evident how, under current incentives and market structures, a stewardship role can be explicitly discharged through the engagement activities of AMs as indicated in the Code. It is worth asking whether the Stewardship Code was intended to prevent the types of failure and scandals seen at Tesco, Sports Direct, and Carillion. It remains to be seen whether various voluntary initiatives promoted by other agencies, such as the Investment Association and the Investor Forum, will have any discernible effect in preventing the types of corporate failures seen in recent years. The greatest impetus for stewardship is likely to come from a combination of economic and wider regulatory changes (such the Financial Conduct Authority's plans to reform the investment market) — at which point the Code will likely become redundant.

The FRC issued a revised draft Stewardship Code in January 2019 for consultation. This proposes a revised definition for stewardship as well as a proposed Principle on constructive engagement. In addition, the FCA and FRC have jointly issued a discussion paper, 'Building a regulatory framework for effective stewardship'; this considers the relationship between the Code and regulation in raising the standard of stewardship in the UK and calls for input on how to encourage the institutional investment community to engage more actively in stewardship.

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