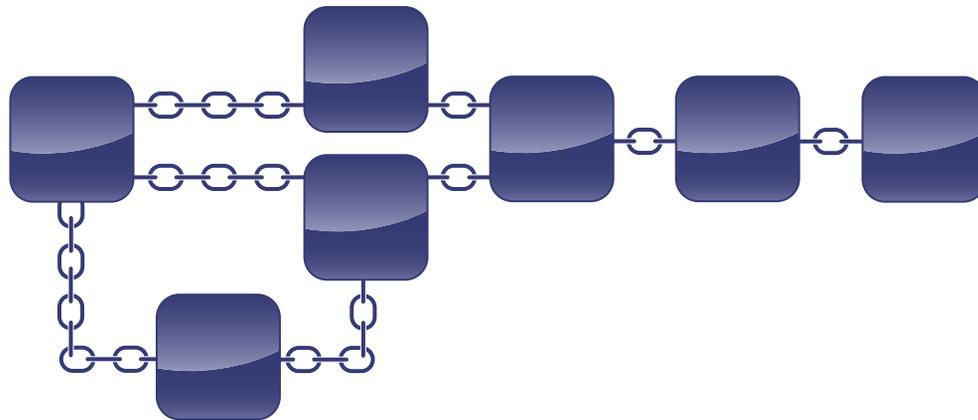


Tomorrow's Stewardship

Why stewardship matters



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Foreword

The case for stewardship is compelling – that we should all build on what others who have gone before us have achieved, and that in turn we leave to others who will follow greater value on which they will be able to build.

Good stewardship is a lot harder to achieve in practice, than it is to describe in theory. Recent events have reminded us that there can be no presumption of inexorable and incremental progress. For national economies in the UK and elsewhere, though not the emerging economies of the East, recovery is slow.

The economy had become ‘taken for granted’ – seemingly delivering growing prosperity without ordinary citizens having to pay much attention to how it works. Now we need to understand the fundamentals, recognising that we – as individuals and as nations – simply cannot afford another such meltdown, but uneasy that the fundamentals that caused the last crisis have not yet been fully tackled.

This is why stewardship matters so much. It recognises some basic truths – that it is people working in companies that create value and that the relationship between investors and others who lend to companies must be shaped by supporting companies to play this primary role: if there is an imbalance, and the financial economy serves its own interest, there can be a huge price to pay for all of us.

But it is also about acknowledging that the economy is not some ‘deus ex machina’ – cogs and wheels able to achieve perpetual motion. We are the ghost in the machine, it is our money, our wealth, and our work that fuels and finances it.

Judgement is vital. When is enough, enough? Do I understand and can I take a real responsibility for the decisions I am taking in the boardroom? Do I have the same sense of ownership that I would for my home and family? How can I ensure that I am building for the long-term, not chasing short-term but illusory gain?

We also need to change the way we think about ‘value’. It is increasingly evident that economic income is necessary but not sufficient. Rather success is about creating economic, social and environmental capital, and recognising the systemic interdependencies between these different value drivers. Governance and leadership is critical in unlocking value.

The Stewardship Code is a welcome and significant development, and we hope this next phase in our work makes a further contribution to winning support for stewardship in practice. Of course, we recognise the practical difficulties given globalisation and high frequency trading. As we work out new solutions, we are increasingly convinced that the principles of stewardship provide the surest guide to future success and prosperity.



Tony Manwaring
Chief executive, Tomorrow’s Company



Mark Goyder
Founder director, Tomorrow’s Company

Introduction

Wealth is created in companies. Companies operate within what Tomorrow's Company calls the 'triple context' – where value creation will increasingly depend on integrating social, environmental and economic value drivers. It is an environment where non-financial and intangible assets are significant drivers of corporate performance and where value is often created through collaborative global networks, reshaping traditional boundaries of power, control and influence.

This context will increasingly shape the way boards and investors pursue success. Central to achieving this success will be stewardship – being a custodian, having a duty of care and responsibility not just for the present but for future generations. In the ideal economy, stewardship is an attitude of mind which informs the behaviour of every contributor to the process of wealth creation.

We define stewardship as:

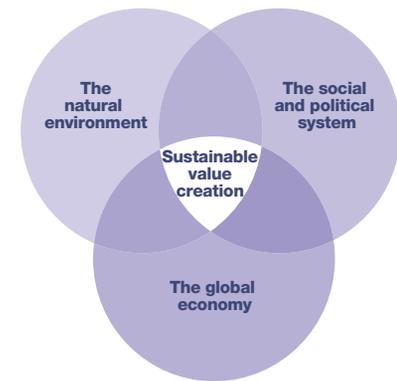
“the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition.”

It is an approach to performance and accountability which runs throughout the investment system and beyond it into the stakeholder relationships. From the simplest family business to the most complex web of investments, stewardship connects the needs, priorities and preferences of investors with the decisions of companies.

Boards and managers are there to make decisions but they need to know their boundaries. The same is true of fund managers and of every other link in the chain. They need to be given a clear mandate; but without stewardship there is no one to hold them properly to account.

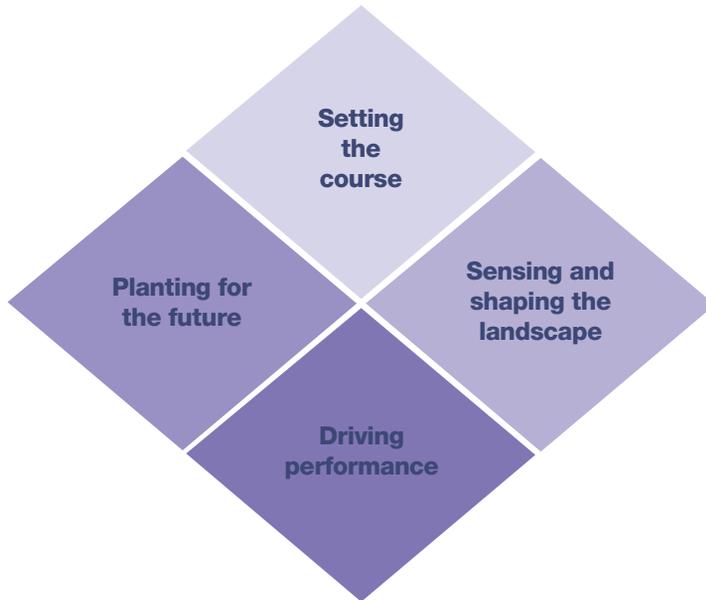
This report seeks to encourage companies, shareholders and others in the investment system to think about stewardship, what it means, why it matters and the extent to which they can act as stewards themselves or influence those who exercise stewardship on their behalf.

The triple context



In its discussions of the concept of stewardship, the World Health Organisation has described it as *“the glue that holds the system together, the oil that keeps it working smoothly, and the energy that gives it technical direction.”*¹

The essence of stewardship has been captured in the four **Tomorrow's Company Stewardship Principles** which were first published in 2009.²



Setting the course encourages clarity of purpose, roles, and relationships.

Driving performance is about continually stimulating improved performance and capability.

Sensing and shaping the landscape is about how the company anticipates and influences change in its surrounding environment.

Planting for the future reflects the need for consistency between short-term actions and long-term success.

Enclosed with this document is the **Tomorrow's Company Stewardship Manifesto**. This offers an agenda for change, and identifies the part that each participant can play in creating an effective stewardship value chain.

Part 1: What is stewardship?

The concept of stewardship has a long tradition. In medieval times the bailiff or steward was employed to look after the estates of the Lord of the Manor. He would give the Lord of the Manor an account of his stewardship before leaving the job.

In its simplest sense stewardship means looking after someone else's money or assets. Stewardship – in this sense of protecting assets – lies at the heart of many jobs. A bar steward, a security guard or a treasurer might all define their roles in terms of stewardship.

But stewardship has developed a richer meaning and it is this richer meaning on which Tomorrow's Company has been drawing over the last few years.

In its fullest meaning, stewardship goes beyond the defensive to the proactive. There is much more to stewardship than being a good security guard or making sure that no one raids the bar. There is a tradition of stewardship which is about enhancing, and not simply protecting value. The best stewards find an appropriate way to invest wealth, ensuring that more wealth is created, and that the conditions for future wealth creation are enhanced.

Under this sense of stewardship we all have a responsibility to leave the job, the company, or the world a better place as a result of our time in charge.

Stewardship in this wider sense is not the same as altruism or unselfishness. It is enlightened self-interest. It is the recognition that we all stand on the shoulders of our ancestors and provide the legacy with which our children live. Our families, our organisations, our communities and our planet will last a lot longer than we will and we serve them best when we carefully balance our narrow self-interest with a concern for their wellbeing in the future. There is interdependence between us and the wider system of which we are a part, whether it is the economy, the financial system, or the natural environment.

The best stewards find an appropriate way to invest wealth, ensuring that more wealth is created, and that the conditions for future wealth creation are enhanced.

“We need a new deal between financial regulation and society. A deal in which financial services are back at the service of the real economy. And at the service of citizens. Citizens who are also taxpayers. Those same taxpayers who are paying the bill of bailing out the banks. Citizens and taxpayers who have lost all trust in the financial system. Who don’t believe it works for them. And who won’t forgive us if we don’t learn all the lessons of the crisis. And change what needs to be changed in the financial sector.”

Michel Barnier
Member of the European
Commission
Internal Market and Services³

The golden thread of stewardship

Stewardship is the cornerstone of the relationship between a company, its investors, its stakeholders, and the society from which it grows.

Stewardship is the golden thread that links business, the economy and society into a resilient fabric. It binds together the agendas of citizens, company directors, savers, pension trustees, insurance companies, fund managers, advisors, regulators and government policy, and client choice into behaviours which work with the grain of the market to create the long-term risk-adjusted returns that investors need.

Stewardship and the stewardship value chain

Stewardship does not stop at the boundary of one company.

Companies, investors and society are all linked together in a stewardship value chain through which those who have savings or inherited assets entrust these assets to others who manage and nurture them. The chain can vary in length. In the shortest chain, the family owners of assets entrust the responsibility to some of the family to run the business, giving an account of their stewardship through regular reports and the annual meeting.⁴

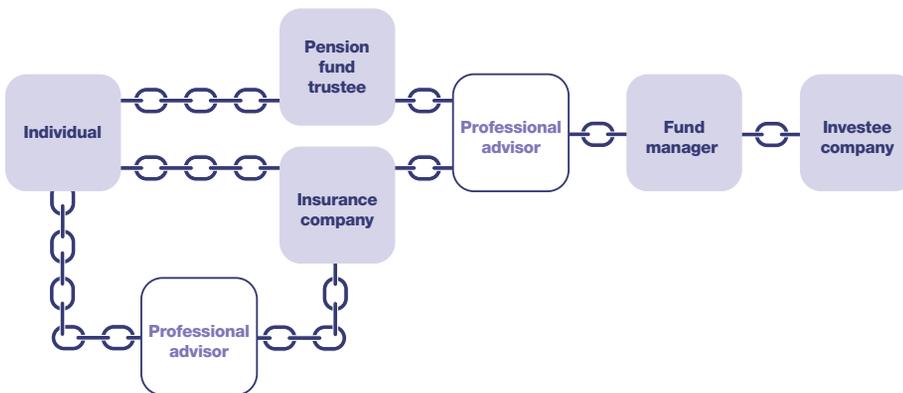
At the other extreme, there is a much longer chain from an employee to a defined benefit scheme. Regular payments are deducted from salary by the employer. These are passed on to the trustees of the pension scheme, who in turn pass the payments to the managers of the scheme. The scheme managers are employed to invest the money in line with the trustees’ requirements so that the pension promise can be met. The time horizon for these trustees has to be long. A thirty-year-old working for a company today may expect to work until around 70 and live until around 90, so the job of those handling their savings ranges over several decades. The trustees of a pension scheme, working with the guidance of investment consultants, have the responsibility to define an investment policy and decide on the appropriate asset allocation. Fund managers are selected to look after the investments and therefore be stewards of those investments, accountable to the trustees.

For retail investors and members of defined contribution pension schemes, the chain may be shorter but the accountability of those in the chain is just as important. For the clients of life insurance companies the chain is less clearly visible, but somewhere in the insurance company is a committee or body with responsibility for deciding how clients' assets should be invested, and what degree of stewardship should be exercised.

Stewardship is needed in all forms of business, but it faces its toughest test in the increasingly lengthy and disjointed chain that links ordinary savers at one end to investment in companies at the other.

Stewardship is needed in all forms of business, but faces its toughest test in the lengthy chain that links savers at one end to investment in companies at the other.

The stewardship value chain



Part 2: The benefits of stewardship

At its best stewardship can operate all the way along the value chain, protecting and enhancing value for individual companies and their investors. Through this activity, the clients of the system and the fund managers whom they employ challenge the boards of companies, protecting and enhancing the return for investors generally, and bringing wealth and wellbeing to the communities and wider society in which they operate.

Benefits to an individual company

Stewardship is central to the task of a company's board of directors and the board is the focal point for company stewardship. Directors are put in place by their shareholders to exercise this stewardship. Their first task is to set a course so that all those involved with the company know its purpose and their part in achieving this end.

Business is not a laboratory that lends itself to controlled experiments. But there is a large body of historical research and of anecdotal examples which link strong purpose and values with long-term survival. The most famous example is 'Built to Last', a Stanford study looking at a portfolio of listed companies which had outperformed the stock market by 15 times over fifty years. The authors, James Collins and Jerry Porras, found common characteristics in these companies which included what they called a "core ideology" – a set of long-term beliefs about what defined the company and what it stood for. The study showed that the most successful enduring companies combined stock market ownership with a purpose beyond profit. But as businesses become larger and more complicated, the pressure to sacrifice a company's unique purpose can become stronger.⁶

The same study also showed how the most enduring companies succeeded in renewing themselves and adapting to the changing world around them. In its work on effective stewardship Tomorrow's Company has concluded that good stewards never lose sight of current results, but they also scan the wider world, encourage innovation, and keep a balance between immediate performance and investment for the future. Good stewardship helps ensure companies do not become too lazy and slow to change, or lose trust and destroy their licence to operate through management greed or ruthlessness in pursuit of immediate shareholder return.

Stewardship is central to the task of a company's board of directors and the board is the focal point for company stewardship.

Good businesses "keep a clear vision of who their customers are, and are run by people who don't think they should simply maximise profits next week."

Mervyn King
Governor of the Bank of England⁵

Stewardship by institutional investors underpins good stewardship by boards

In following stewardship principles, the major owners of a business not only elect a board but take part in its decision-making. Their influence extends beyond monitoring financial performance. They help to shape what the company stands for and how it behaves. This form of stewardship is often seen in family or employee-owned businesses, but is rarely feasible in listed companies.⁷ Here the exercise of stewardship is less direct but no less important.

Properly applied the discipline of institutional investor stewardship operates through dialogue, challenge, reporting and accountability. This reminds boards that they are not in their jobs to serve themselves but to create value for shareholders – not just today's but also tomorrow's. This discipline is a vital protection against executive greed and short-termism.

After the financial crisis in the UK Sir David Walker, an experienced banker and former company chairman, was asked by the UK Government to examine what went wrong. He was shocked at the failure of the fund managers to become involved in challenging the banks on their strategy, their risk management, and their business model.⁹

But as explained earlier on page 4, stewardship means enhancing as well as protecting value. Fund managers who claim to be effective stewards will be working to promote the quality of stewardship across the listed market as a whole. Since it is not possible for a single institutional investor to become deeply involved in the decision-making of hundreds of companies, investors who want to be really vigilant stewards have two choices – they either narrow down their holdings so that they can get to know the companies in which they have a stake, or they collaborate with each other to share out the burdens of engagement.

Shareholder return can in the end only be enhanced by healthy companies, engaging and inspiring talented people to create excellent goods and services that somebody wants. If fund managers are acting in the best interests of their clients, they will want to ensure that through their stewardship they create the right climate for this.

“...it is clear in retrospect that some major corporate actions, in particular the RBS bid for ABN AMRO, were risky mistakes, and while several institutional shareholders expressed significant concerns at the time, they were not able or willing to force a change of strategy.”

Lord Turner
Chairman of the Financial
Services Authority⁸

Fund managers who claim to be effective stewards will be working to promote the quality of stewardship across the listed market as a whole.

“One critical factor holding companies back from defining success in a broader way is the pressure – sometimes real and sometimes perceived – to deliver short-term results to please impatient investors. However, we believe that the market will reward those who set and explain long-term goals in building sustainable businesses of lasting benefit to society.”

Tomorrow’s Global Company¹⁰

Benefits to companies and investors as a whole

Adopting a stewardship approach does not just benefit the direction and performance of an individual business but can influence the performance of all companies and therefore the performance of a whole portfolio of shares. For example, challenging one company on an issue such as, say, poor water management, unsatisfactory director performance, or new risks associated with its supply chain can bring such emerging issues to the attention of others and can help to set standards that have a wider application.

It is sometimes suggested that **all** investors have a short-term focus. This is an unhelpful generalisation. Fund managers are not all the same and the market needs to be better at distinguishing those fund managers who are serious about stewardship.

Fund managers want their investments to perform, but their methods and time horizons differ. There is evidence that the short-term behaviours and expectations of some fund managers can affect the wider climate of expectations and the behaviour of the investment community, which can in turn encourage a company to place an undue emphasis on short-term performance and the immediate share price at the expense of longer-term investment.

A 2005 survey by the US National Bureau of Economic Research showed that over half of 400 executives questioned would avoid initiating a project that would be very positive in terms of net present value if it meant falling short of the current quarter’s consensus earnings.¹¹

Such pressures will only change when clients make their stewardship preferences known. A 2011 report by FairPensions has demonstrated how a narrow interpretation of fiduciary duty has emerged which gets in the way of stewardship.¹²

A vibrant, healthy and sustainable ecology of investors serves everyone well. We need to develop a diverse market place in which different styles of investment compete for business. It is the pension trustees and other buyers of fund management services who have the power to send these signals up the stewardship value chain by the mandates that they issue. It is fund managers who can now choose to make stewardship a clear characteristic in some of their funds so that investors can opt for this approach.

Stewardship of wider impacts by both boards and investors

In exercising stewardship, boards and investors can have positive impacts that reach further than the performance of individual firms, creating ripples across whole sectors of industry and contributing to the future sustainability of the world around them. This includes their impact upon:

- climate in the literal sense
- biodiversity
- talent and education
- clean air, water, sanitation and infrastructure
- a strong civic society which promotes ethical behaviour and upholds the law.

“Stewardship should be in the DNA of pension fund trustees. Being concerned about the long-term effects, both positive and negative, of environmental, social and governance factors that can impair a company’s performance is not about altruism but enlightened self-interest. It is a question of materiality, not morality.”

Donald MacDonald
BT Pension Fund trustee and former
chairman of UNPRI¹³

The Carbon Disclosure Project (CDP) is an excellent example of a collaborative investor-led stewardship initiative. It operates the only global climate change reporting system against which 300 organisations in 60 countries disclose their greenhouse gas emissions, water use and climate change strategies. The not-for-profit organisation currently boasts over 550 institutional investors, holding US\$71 trillion in assets under management and has collected the largest database of primary corporate climate change information in the world.

The aim is to *“harness the collective power of corporations, investors and political leaders to accelerate unified action on climate change.”*¹⁴

Stewardship of the whole not of the part – seeing the wood for the trees

Mark Goyder, founder director, Tomorrow's Company

The way we manage our woodland is a perfect metaphor for the way we manage our companies.

We can chop down the trees, and harvest the wood for an immediate cash benefit – but if we do that we would be left with barren land.

We could insist on a rigid view of what the trees ought to be like, and have a mono-culture of trees planted in rows. But that would ignore the wider value of the wood, and the plants and wildlife that thrive in it.

The full importance of the forest to us depends on its diversity, its webs of interdependence, and the wider social value it has to those who use it. True stewards are the ones who take responsibility for the condition of the whole wood. They plant for the future, but they also intervene to take out dead wood.

So when fund managers talk about shareholder value, if they include in their definition of shareholder value the promotion of long-term wealth creation in these healthy conditions, then there is no conflict between their definition of success and the needs of their clients. But many of them don't. They cannot, or will not, see the wood for the trees.

Shareholder return can in the end only be created by healthy companies, engaging and inspiring talented people to create excellent goods and services that somebody wants. So if fund managers are acting in the best interests of their clients, they will want to ensure by their stewardship that they create the right climate for this.

Part 3: Stewardship in practice

From its foundation the company is a living being, with its own reputation, relationships and ambitions. It soon grows beyond the stage where its direction is determined by a single owner or manager. This is where stewardship starts. Shareholders elect a board of directors which takes on the stewardship of the company with responsibility not only to promote the economic health of the business but also to identify the role the company is to play in the economy and society and uphold its values. Examples of excellent stewardship can be found in all forms of business, from the decisions made by pension funds, by employee-owned, family or private business through to some of the great global listed companies.

TTP Group

Planting for the future

TTP is a private technology development company owned by its employees and ex-employees. The company was started in 1987 by a group of 28 technologists. Its current turnover is £45m and it employs 330 people in the UK, continental Europe, the USA and China.

The core of TTP's business is the long-term development under contract of new processes and technologies. The company has completed a number of major technology developments, some of which have taken over a decade to bring to fruition. In 2000 it floated TTP Communications. This enterprise was formed in 1993 to take advantage of the new GSM mobile telephone standard. A current major project is Tonejet, a digital colour printing technology, which can be used to print directly on to metal cans, plastics or glass. The TTP development team has been working on this technology for 17 years.

TTP's application of stewardship principles means that the rewards for the successful developments are not treated on an 'eat what you kill' bonus basis. They are equitably shared among the TTP workforce. Employees are encouraged and assisted to become shareholders. When TTP Communications was separated from TTP group, all employees had a share of the benefits from the flotation.

“When we embark on a development we can take a long view and be ambitious. At any time there will be some people in the company earning money and others who are spending it. Our people work long and hard both on such wealth creating projects and on earning the money to finance them. They do this not because they want it to make them rich, although our aim is to make them rich enough to significantly enhance their lives. They do it because they love the work, they enjoy a challenge, they get satisfaction from being members of a team that is creating something new, and they feel that the rewards are fair.”

Gerald Avison
Chairman of TTP Group

Wates Group

Engaged and governing owners

Wates was founded in 1897 and is a substantial construction services and development group. The company is committed to building close relationships with customers, suppliers, regulators and the communities it works in. It employs over 2500 people across the UK. The Wates family owners define their role in terms of stewardship and describe themselves as “*engaged owners*”.

The family has recently reviewed the governance of the business and decided that it wants the main five family members, who between them own a significant majority of the business, to be directly represented on a single board, merging the previously separate Family Holdings board and the Wates Group main commercial board.

Explains Tim Wates: “*We want the stewardship to be in one place. We see ourselves as stewards and that other [non-family] directors are stewards alongside us.*”

Family members also undertake roles that transcend the conventional separation between managers and owners. Inside the business, each family member is a “champion” of a specific business stream. Such involvement is designed as a support mechanism and Wates is careful to ensure that these “champions” don’t diminish the authority of line managers reporting through to the externally appointed chairman and CEO. Tim Wates notes: “*As a family, we really do know our business and our people.*”

In their work outside the business each family member builds connections and networks. James Wates, for example, is a prominent leader in construction associations nationally, and Jonny Wates is engaged extensively in the wider green agenda.

Wates places great trust in the abilities of its own people. In the words of Tim Wates: “*Stewardship is intrinsic in people, we only bring it out of them. It’s a natural human emotion. People want to do good, make a positive contribution and leave a legacy behind them. They are proud of what they do. It happens that as a family business we can bring that stewardship mentality into the company*”. He also comments that “*the world of business can be hard driven. We have a responsibility to make sure that our managers respect people’s overall health, safety and well-being. People may have a very difficult day but cannot have a horrible place to work*”. This concern extends beyond providing a good working environment and is evident from the company’s investment in external help lines for issues such as bullying, mental health and stress, as well as a support line for employees facing any kind of domestic problem.

Timberland

Pushing profit through Path of Service

Jeff Swartz became CEO of Timberland in 1998. The company currently has around \$1.4 billion in revenue and its products can be found throughout the world. Timberland undertook an ambitious international expansion throughout the 80s and early 90s. This led to rising production costs with the company entering the red for the first time in 1995, posting a net loss of \$11.6 million.

Timberland reduced its product range and after an aggressive marketing campaign, its performance recovered. Returns on investment grew from 3% in 1996 to 8.2% by 1999. Despite poor performance after the dotcom crash in 2001 and the credit crisis the firm bounced back quickly in each case. For example in 2007 the share price halved. Revenues, dipped down to \$1.29bn in 2009, approximately 13% off their peak in 2006. By 2010 revenues had improved – increasing to \$1.43bn, an 11% rise from the previous year. Jeff Swartz attributes the resilience of the business in large part to the unique ‘Path of Service’ programme that he instigated after an encounter with the City Year volunteer programme in Boston.¹⁵

“Every Timberland employee is entitled to, and accountable for, 40 hours of paid time doing citizen service... Path of Service is our way of making manifest our values... When we get together for our international sales conferences, we have 70 or so countries represented and we do citizen service. We serve in Brazil, we serve in China, we serve in Egypt, we serve with Jews and Muslims and Christians and agnostics and atheists, we serve with men and women. We find the ability to be purposeful, we find the way to be able to take this notion of profit and push it to a place that is deeply rewarding.”

“Business has a power and a responsibility that’s broader than just earning the maximum profits it can for its shareholders every quarter. As CEOs, we must deploy our creative and productive power to strengthen both our balance sheet and civic society at the very same time.”¹⁶

As a listed company Timberland has to give a full account of its stewardship to outside investors and bankers, as well as to the family. When challenged by bankers at a time of crisis in 1995 to “*cut the country club crap*” Jeff Swartz demonstrated clarity on his values and purpose. He reiterated what he saw as a stewardship obligation, doubling the number of community service hours employees were paid to undertake. This move reinforced his leadership authority and made clear to both investors and consumers that Timberland’s aim to be a responsible citizen remained coherent and consistent even during times of financial difficulties.

Shaftesbury

Stewardship as long-term relationships

Shaftesbury invests only in London's West End, where it owns approximately fourteen acres of property. The chief executive, Jonathan Lane, describes the company's business as "*urban farming*" – reflecting the company's values as well as its long-term relationship with its investors, stakeholders and the local community. The company has out-performed its market for over twenty years.

Shaftesbury has a deep understanding of its 'patch'. As Jonathan Lane says, "*we walk our fields every day*". Just as a farmer knows which crops to sow in a field, Shaftesbury knows which location is best for a particular use or tenant, placing its restaurants close to the West End's 38 theatres and its premier cinemas.

Shaftesbury knows that by improving the environment for its tenants and their customers, its shops and restaurants remain fully let and in demand. Then its revenue increases for the ultimate benefit of its predominantly institutional shareholders to whom it distributes over 90% of its net income. Shaftesbury works closely with Westminster City Council and its tenants on initiatives such as reducing waste and noise and increasing re-cycling and personal safety. A recent initiative is its work with the newly formed Sustainable Restaurant Association (SRA), which helps restaurateurs to achieve sustainability in food and other areas of their business. Shaftesbury is encouraging its tenants – particularly independents – to join SRA by offering to pay their first year's subscription. It sees this as an effective risk management tool, conscious of the increasing customer awareness of the source and quality of the food eaten in restaurants.

With the average project taking them at least ten years to come to fruition, shareholders tend also to take the long view. Shaftesbury seeks investors who are comfortable with its approach of creating long-term value, which is then reflected in steady shareholder returns and increasing dividends.

With Jonathan Lane's tenure as chief executive coming to an end, Shaftesbury gave its shareholders six months' notice of its plans for recruitment of a successor. It also explained that Jonathan Lane would be staying on as deputy chairman for continuity. Its first action was to meet each of its major shareholders – described as "*shareowners*" by Jonathan Lane to ask for their views and advice. The company said that it learnt a great deal from their combined experience of succession challenges in other companies. On their advice, Shaftesbury employed a professional recruitment consultant to consider external as well as internal candidates.

Hermes Equity Ownership Services and Infineon AG

Driving performance through Investor Stewardship

Hermes Equity Ownership Services (Hermes EOS) helps institutional investors around the world meet their fiduciary responsibilities and become active owners of public companies. Its clients hold equity in Infineon AG, a German DAX 30 company.

Hermes sought to understand why so much shareholder value had been lost since Infineon's listing in 2000. After carrying out a proprietary screening process Hermes EOS concluded that delays in Infineon's strategic decision-making and implementation, as well as apparent mistakes with regard to management board appointments, contributed significantly to its poor performance and inability to recover share price losses.

In discussions with Infineon, Hermes EOS found little willingness or sense of urgency to make the necessary changes. So it proposed a resolution at the 2009 AGM to allow shareholders to express a view on the individual performance of each member of the supervisory board. Though the resolution was not successful, it was obvious from the very significant votes against certain individuals that many investors believed that change was necessary.

At the 2010 AGM Hermes EOS formally proposed an alternative shareholder candidate for election to the supervisory board. This individual was not elected but won strong support from international and German investors. As a result, several weeks before the AGM, the company's candidate for the supervisory board offered to step down after only one year if elected, and promised to identify a suitable independent successor during that period in consultation with major shareholders. A new and high-quality chair was appointed at the 2011 AGM.

In its own words, Hermes EOS seeks by their engagements to *"fill the gap left by the investment industry's tendency to focus on the short-term"*.¹⁷

This stewardship initiative has been described by some commentators as *"a sea change"* in German corporate governance, encouraging further debate about German supervisory board nomination practices.

John Lewis Partnership

Pension Fund Stewardship

John Lewis Partnership (JLP) has a defined benefit scheme with over seventy thousand partners. Until 2006 a John Lewis employee could join the scheme after having worked in the firm for five years. However, this generous scheme was becoming steadily more expensive. There was also a concern that given around 50% of their staff stayed for less than five years, an overwhelming proportion were not benefitting from the scheme.

After much discussion at the elected Partnership Council and within the pension scheme and the company, a solution was devised that was felt to be fair to all parties. Partners agreed to reduce their annual pension in line with any extension of longevity beyond that which had been assumed, allowing the risk of the pension scheme to be shared. The five year qualifying period was reduced to three years and new recruits were given the option of having a defined contribution scheme for the first 3 years.

These proposals were then communicated through a carefully planned series of discussions with the Partnership Council and through the pension scheme. There were many discussions about the implications and how to deal with them fairly but ultimately the Partnership Council supported the change. JLP is now rare among major UK retailers in retaining a defined benefit scheme for their employees. It took a difficult decision, balancing conflicting interests and overcoming resistance from employees losing out from the proposed changes.

The fourth principle of stewardship, 'planting for the future', is all about achieving the best balance between the short-term and the long-term. It involves engaging owners and other stakeholders in dialogue on the trade-offs involved and the approach adopted here exemplifies the principle in action. JLP were able to make necessary changes and ensure the sustainability of their pension scheme through effectively asking their partners, who are also their owners, to take a long-term view whilst putting aside narrower short-term interests and incentives.

Stewardship in listed companies – the challenges

There is a ‘dialogue of the deaf’ between many boards and investors.

Some listed company non-executive directors have told us that they find it impossible to imagine fund managers of listed companies adding any value to the stewardship of ‘their’ business. Here is one reaction from a company chairman:

“I want to keep fund managers as far away from my business as possible. They don’t understand the first thing about how to make the business more successful. It’s a waste of time trying to involve them. I was involved in a two-hour meeting with one respected fund manager recently whom we asked to comment on our business and he didn’t tell me anything I didn’t already know. It was so superficial.”

This reaction towards the very people responsible for electing them may be an extreme example but it is symptomatic of the gulf that has developed between some companies and their investors.

On the other hand many fund managers are equally dismissive of stewardship. As one remarked to Tomorrow’s Company:

“My job is to be an owner of shares, not an owner of companies. I am judged on the share price performance of my portfolio. If I don’t like the company I sell the shares. My clients don’t pay me to get involved with companies. And if I told them I could get involved but it would cost them more, they would not be interested. Of course fund managers will feel they have to make noises about stewardship but they don’t really mean it.”

If we accept both arguments, we would in effect be saying that most fund managers are looking at the wrong things and do not have the skills to oversee the companies in which they are investing. These comments would also suggest that fund managers do not feel any pressure from their clients to look at a company as a whole, to understand what creates value and what are the risks and opportunities the company faces. Ultimately, this would add up to an admission that those beneficiaries who are concerned about how the economic performance of companies is achieved cannot expect their interests and preferences to be taken into account.

There is a ‘dialogue of the deaf’ between many boards and investors.

We would also be in effect saying that boards work better when they are unchallenged and unaccountable self-perpetuating oligarchies, free from the chore of serious dialogue with investors.

In reality most directors and most institutional investors do not take such an extreme position. They accept that stewardship is desirable and they would like it to work. But they find it difficult to make it work across the long and increasingly dislocated chain of accountability that connects investors with companies.

What is needed is each other's intelligent co-operation to make it work.

Part 4: Creating stewardship momentum

We have a choice. Through our investment decisions we can all decide if we want a system of listed companies in which ownership has become so remote and impersonal that companies are judged by their shareholders exclusively on their share price and their short to medium-term earnings potential.

Our future pensions and investments depend on there being a wealth creating environment in which companies can flourish, tomorrow as well as today. Company stewardship in turn depends on the health of the whole companies sector. In order to survive and thrive companies need natural and social as well as economic capital. Better stewardship of a company's key relationships and of the society and the environment upon which it depends is therefore a matter of enlightened self-interest.

An efficient investment system is one where pension fund trustees and other clients of fund managers start to exercise choice about stewardship, and where fund managers who show that they are serious about stewardship gain more business as a result. Institutional investors acting as stewards on our behalf play their part in two ways. First they ensure that individual companies which happen to be in their portfolio at a particular point in time are well stewarded. They become more involved in the appointment of the right directors to act as stewards on their behalf and they make sure that their own people have the skills to challenge the strategy and intervene where necessary.¹⁸ Secondly they influence investment performance more generally by the actions that they take across the system to promote the better stewardship of companies.

Better stewardship of a company's key relationships and of the society and the environment upon which it depends is a matter of enlightened self-interest.

To create a momentum for stewardship across the stewardship value chain changes are needed to ensure that:

- ordinary consumers are able to opt for stewardship when buying financial products
- insurance companies and other financial services organisations are required to put in place clear and distinct arrangements for reporting on the stewardship of the funds entrusted to them
- every organisation that collects and invests money on behalf of others has a properly constituted and accountable body which is there to ensure effective stewardship of the assets under investment
- trustees of pension funds and other fiduciary bodies receive advice from investment consultants which includes information about the quality of stewardship demonstrated by competing fund managers
- investment consultants help pension fund trustees to select the fund managers who are best equipped to fulfil their stewardship requirements
- investment consultants, in turn, stimulate fund managers to come up with a clear policy on stewardship so that they are able to provide the right advice on fund manager selection to pension fund trustees
- trustees and other fiduciaries start to instruct their investment consultants that they want to move towards issuing longer-term mandates to fund managers
- a growing quantity of fund managers receiving such mandates gradually rely less on short-term share price performance and more on achieving a rise in the share value through improving the performance of the company. They recruit more people with the experience to do this
- companies begin to see a change in the nature of dialogue that they have with their fund managers and more actively seek out investors who have a stewardship focus.

In achieving change in the investment chain, we anticipate that there will be objections and concerns raised and some of these are addressed in the Q&A on pages 24 and 25.

An agenda for tomorrow's stewardship

	Current perspectives	The stewardship vision	Policy framework
Client/ Beneficiary	Lack of voice and trust Horizon 2 - 40 years	Expresses preference for stewardship funds. Has a voice in holding companies to account	Reporting against stewardship criteria
Pension fund trustee/ fiduciary	Focus on deficits & liabilities – Stewardship is a luxury Horizon quarterly to 40 years	Understands importance of stewardship as part of fiduciary duty and issues stewardship mandates	Clarify law on fiduciary duty to include stewardship
Fund manager	Minimise own risk; beat the benchmark; increase assets under management Horizon 0 - 3 years	Competes for stewardship mandates; collaborates with others to engage strategically with companies; declares degree of stewardship in products	Make collaboration easier; strengthen Stewardship Code to differentiate degrees of stewardship
The company and its board	Meeting market expectations Horizon 0 - 5 years	Defines board mandate; builds relationships with stewardship investors; publicly ranks shareholders on quality of stewardship	Create a reporting framework which encourages better dialogue about the board's stewardship

To help make this stewardship vision a reality, enclosed with this document is the Tomorrow's Company Stewardship Manifesto which summarises the steps that need to be taken by people operating at each stage of the value chain.

A more detailed version of this manifesto is being developed along with a series of other resources designed to help the various participants in the value chain put stewardship into practice.

These can be found at:

www.tomorrowsstewardship.com

hosted on

www.forceforgood.com

Q&A

Possible concerns:	Response:
What is the point of asking fund managers to be more engaged with companies when they seem so little interested in how companies are run or how to help them be successful in the long-term?	Fund managers are not all the same. Some have a deep understanding of the companies in their portfolio and companies will listen carefully to their concerns. The aim is not to influence all fund managers. The aim is to ensure there is a critical mass of fund managers who want to exercise their stewardship role through dialogue with the company. This will ensure boards of companies are properly challenged and do not become complacent. And that there is a diversity of investor approaches which is important to the health of the whole system.
Surely the job of a fund manager is to buy and sell shares. If they don't like what a company is doing they should sell the shares, not waste their time getting involved?	Getting closer to companies makes a more efficient market for everyone. Even those funds which trade shares frequently need the best information about the companies involved on which to base 'buy' or 'sell' judgements. It is the clients who, through the mandates they set, decide the job of a fund manager. If more pension funds and insurance companies insist on stewardship, the fund managers will do as they ask.
How can a fund manager that owns less than 1% of a company's shares possibly have an influence over the company?	The dispersed nature of shareholding in the UK does make investor stewardship more difficult. Collaboration between different fund managers is important, and an increasing amount of collaboration does indeed happen. It is important that pension funds and other clients explain to their fund managers that they expect them to collaborate as part of holding companies properly to account. Such collaboration is encouraged by the UK Stewardship Code, although investors do have to be careful not to infringe the law covering 'concert parties' and other forms of shareholder manipulation.
All these arguments for stewardship might have worked years ago when UK institutional investors owned over half the shares in the FTSE 100. But now the figure is much less?	The ownership of shares is becoming more international. But whether a shareholder is based in the UK or overseas they will be at risk if they do not get involved in stewardship (some of them lost a lot of money by investing heavily in the banks just before the last crisis). In any case UK institutions effectively control around 40% of the assets of UK listed companies, so UK investors still hold enough of the market in aggregate to have a decisive influence.

Possible concerns:	Response:
<p>There used to be a lot of talk about shareholder democracy in the 1980s when Mrs Thatcher privatised nationalised industries. It didn't seem to have had much impact?</p>	<p>Individual shareholders do have some impact if they are determined and organised but it is difficult. On the other hand if retail savers put their money into mutual funds which intend to take stewardship seriously, then together they could have much greater influence without getting involved on a day to day basis. It is rather like the difference that the Fair Trade label made to ethical consumers: it enables people simply to identify and pick off the shelf products that address their concerns.</p>
<p>Is stewardship any different to socially responsible investment?</p>	<p>Yes. Stewardship is much broader. The two overlap but stewardship means a general commitment to nurture companies which are well led and think more broadly, whereas many socially responsible investment (SRI) offerings are about segregating investment according to particular ethical concerns and away from or towards particular product groups.</p>
<p>I thought that final salary/defined benefit schemes were on the decline. Does this mean that stewardship is a lost cause?</p>	<p>Defined benefit schemes have and will continue to have large amounts of money to invest and the trustees of these schemes are among the most important stewards. But the growing importance of defined contribution means a move into a less paternalist age, in which the risk of bad investment performance is borne by the individual saver, and not the employer. It is even more important that funds with whom that saver chooses to invest are vigilant and manage the risk of investing in badly managed companies here and around the world.</p>
<p>Isn't regulation and accounting and solvency policy driving pension funds and others away from investing in listed companies and towards bonds?</p>	<p>That's true. Governments and regulators need to look at the total impact of all these rules and policies. But in the end we need to inject more stewardship into the management of all our investments including bonds, private equity, and property, not just listed companies.</p>

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Publications

Tomorrow's Company has published numerous influential reports that have informed and continue to help shape the actions of companies and governments in the UK and beyond. Below is a selection of our publications.

Tomorrow's Corporate Reporting: A critical system at risk (2011)

Tomorrow's Corporate Governance: The case for the 'Board Mandate' (2011)

Tomorrow's Corporate Governance: Corporate Governance and Stewardship. A Tomorrow's Good Governance Forum lecture by Sir David Walker (2010)

Tomorrow's Corporate Governance: Bridging the UK engagement gap through Swedish-style nomination committees (2010)

Tomorrow's Global Talent: A new talent agenda for the UK (2010)

Tomorrow's Owners: Defining, differentiating and rewarding stewardship (2009)

Tomorrow's Innovation, Risk and Governance (2009)

Tomorrow's Global Talent: How will leading global companies create value through people? (2009)

Tomorrow's Owners: Stewardship of tomorrow's company (2008)

Tomorrow's Global Company: Challenges and choices (2007)

Restoring Trust: Investment in the twenty-first century (2004)

Redefining CSR (2003)

Lessons from Enron (2002)

Employee Ownership on Tomorrow's Company (2001)

Leadership in Tomorrow's Company (1999)

Sooner, Sharper, Simpler: a guide to the inclusive annual report (1998, reprinted 2006)

RSA Inquiry Tomorrow's Company: the role of business in a changing world (1995)

Family Business Stewardship (2011), in conjunction with the Institute for Family Business Research Foundation

Acknowledgements

We opened up the stewardship debate with our first ‘Tomorrow’s Owners’ report in October 2008. As we chose the day that our government was nationalising two major banks our call for action on stewardship was soon reverberating through the system. We followed up by developing principles of good stewardship. Meanwhile Paul Myners and Sir David Walker, whose constant encouragement I would like to acknowledge, were both hammering home the stewardship message in their own way. Soon there was a formal Stewardship Code – and people everywhere looking to follow suit.

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Mark Goyder

Founder director, Tomorrow’s Company

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John Lewis Partnership



About Tomorrow's Company

Tomorrow's Company is the agenda setting 'think and do' tank which looks at the role of business and how to achieve enduring business success. We focus on strong relationships, clear purpose and values as the foundation of effective leadership and governance.

In our programmes we challenge business leaders around the world to work in dialogue with others to tackle the toughest issues. We promote systemic solutions, working across boundaries between business, investors, government and society.

We believe that business can and must be a 'force for good'. This in turn requires a strengthening of stewardship by shareholders in partnership with boards of companies.

We argue that the Age of Sustainability has begun, and that in the future success and value creation will come from recognising the 'triple context' – the links between the economic, social and environmental sub-systems on which we all depend, and the opportunities this brings.

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