Building the Momentum for Effective Investor Stewardship

Recommendations for change

Standard Life Investments
tomorrow's company

January 2014

Standard Life Investments

Standard Life Investments is a leading asset manager with an expanding global reach. With £178.8 billion* in assets under management, our range of investment solutions is backed by our Focus on Change philosophy of which our governance and stewardship activities are a critical component. Progressively strengthened, in no small part since the 2008 financial crisis, governance and stewardship are embedded at the heart of both our investment process and the investment service that we provide to our clients.

Responsibility and accountability go hand in hand. In taking responsibility for governance and stewardship, it is important that Standard Life Investments be as transparent as possible, and account, in a fair and balanced way, for how we have fulfilled our responsibilities. We believe this is particularly important at a time when it is incumbent upon the investment management industry to demonstrate that it is engaging effectively with investee companies, and that it is pulling its weight in influencing the development of law, regulation and other aspects of public policy that are so critical to ensuring that long-term capital is not only allocated efficiently but also rewarded with attractive risk-adjusted long-term returns.

standardlifeinvestments.com

Tomorrow's Company

Tomorrow's Company is a London based global think tank delivering value for business leaders and owners by addressing the systemic and behavioural questions of the business world.

It defined the inclusive duties of directors for the UK's Companies Act 2006; its work on financial markets informed the creation of the UN PRI and its thought leadership is at the heart of the UK Stewardship Code and of the integrated reporting movement.

Tomorrow's Company believes businesses can and should be a force for good and inspires generations of business leaders to shape the way they do business. Its work today will restore the licence for business to operate and for businesses to be successful tomorrow.

tomorrowscompany.com

*assets under management as at 30/06/2013

Stewardship defined

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

Why Stewardship Matters, Tomorrow's Company 2011[1]

Investor stewardship

"The rights and duties of shareholders give them a stewardship role alongside that of directors in protecting the long-term health of the company and promoting the long-term value of the investment. Directors are the effective controllers of companies. They are entrusted by shareholders with the management of the company on a day-to-day basis and are accountable to - and can be influenced by - shareholders. This idea that the core responsibility for stewardship is shared between shareholders and directors is, we believe, very important."

Tomorrow's Owners: Stewardship of Tomorrow's Company, Tomorrow's Company 2008[2]

Practical measures to make the UK Stewardship Code effective

"The shareholder spring and the Kay Report show that a consensus is starting to form about the practical measures that need to be implemented. There is still much hard work to be done to ensure that effective engagement and comply or explain, which lie at the heart of good governance, are embedded as best practice but it's as much about the how as the why."

Keith Skeoch, CEO, Standard Life Investments, 2012

Foreword

Stewardship is a term that is nowadays part of daily parlance in investment and business circles. Stewardship is recognised as important by governments and regulators. Stewardship is no longer an optional extra and has to be taken seriously.

Despite this, stewardship still struggles to secure its place at the heart of the relationships between those involved in the stewardship chain. We believe this has to change. There is a 'stewardship gap' that needs to be closed so that every player in the stewardship chain – asset owners, investment advisors and investment managers - plays their part to promote the success of companies and deliver long-term prosperity.

To stimulate change and build momentum for improvements to bridge the stewardship gap we have developed a number of practical recommendations, which build on the success of the UK Stewardship Code and seeks to raise the bar from compliance to excellence.

If implemented, these recommendations will improve transparency and lift the lid on stewardship. Savers have an implicit right to know how professional investors are fulfilling their stewardship responsibilities and need an improved basis for giving them direction and holding them to account.

Although this report and its recommendations focus on investor stewardship in the UK, we believe many of the messages are relevant around the globe where the potential for investor stewardship is undeniable.

We should like to thank all those who contributed their views and time so willingly and constructively to assist Standard Life Investments and Tomorrow's Company in developing their views and recommendations.

Tony Manwaring
Chief Executive
Tomorrow's Company

Rod Paris
Chief Investment Officer
Standard Life Investments

Summary

It has been over a year since the publication of the Kay Review and three years since the first publication of the UK Stewardship Code. So what progress has been made towards better investor stewardship? Is there a common vision of the way ahead?

The UK Stewardship Code evolved from The Institutional Shareholders' Committee's Statement of Principles.[3] Its evolution gained impetus from a recommendation by Sir David Walker, then of Morgan Stanley, and now Chairman of Barclays. In his report for the government, he asked how so many institutional investors could have failed to protect the assets of their clients in the spectacular destruction of value in the banking industry leading up to 2008.[4] This question points to the risk management argument for taking stewardship seriously. There is also growing evidence linking a focus on stewardship with enhanced portfolio performance.[5]

Standard Life Investments and Tomorrow's Company convened two dialogues with individuals who have responsibility for every part of the 'stewardship chain' – asset owners, asset managers, investment consultants, company chairmen and executives, trade associations, civil society organisations, government and regulators.

Participants identified six obstacles to progress towards empowered investor stewardship:

- a lack of understanding of stewardship and its importance
- weaknesses in the way investment performance is defined, measured and reviewed
- an inequality of knowledge and information about stewardship
- too much reliance on external experts and advisors, especially among smaller pension funds
- limitations in the view investment consultants have of their role
- the closure of defined benefit schemes (with their collective decision-making) and the consequent dispersal of decision-making to millions of individuals.

Overcoming these barriers will require joint and complementary action throughout the 'stewardship chain' to achieve the full benefits of improved investor stewardship.

Our recommendations, on pages 12 to 16 focus on achieving the following objectives:

1 Better definition of the meaning of stewardship

2 Simplifying and strengthening the criteria for assessing investor stewardship

3 Putting stewardship at the heart of the investment relationship

4 More effective evaluation, review and reporting of stewardship

5 Better engagement by asset owners and asset managers with ultimate owners and clients.

Introduction and Context

For good stewardship to be exercised by asset managers, the meaning, the significance and the benefits of stewardship need to be in the minds of asset owners when they are making their decisions. Ideally, asset owners should empower their managers to act with conviction when acting as stewards of the funds they manage. Asset owners may decide to dismiss the importance of stewardship and choose asset managers who do not give this priority, but this should be as a result of an informed choice, not inertia.

Standard Life Investments and Tomorrow's Company held two dialogues in March and May of 2013, attended by representatives of every link in the stewardship chain, from asset owners to companies. The dialogues were intended to build on the current debate stimulated by the Kay Report on Long-Term Decision making in UK Equity Markets.

Unlike many of the responses to the Kay Report, and statements on the subject of stewardship, this document is the result of an extended and practical discussion amongst all parts of the investment value chain and those who shape its rules and operations – asset owners, asset managers, investment consultants, company chairs and executives, trade associations, civil society organisations, government and regulators. Throughout the document we use the term 'institutional investors' when the discussion covers both asset owners and asset managers.

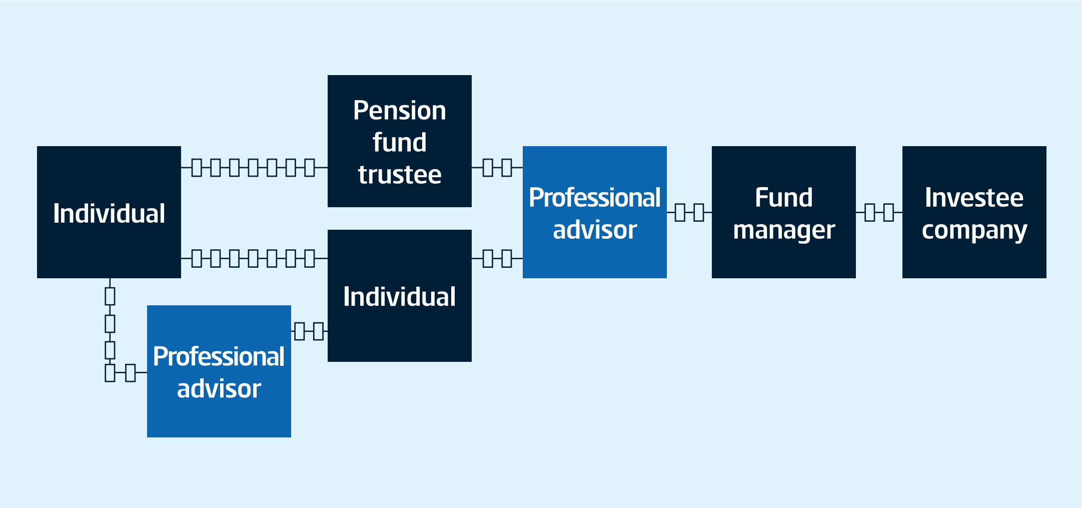
The recommendations made in this report build on the following aspects of the Kay Report's diagnosis:

- the capital markets should be judged by their ability to sustain wealth creation by companies and earn returns for savers
- stewardship is needed throughout the system - by pension trustees, investment consultants, asset managers, company directors
- the timescale on which active asset manager investment performance is judged is too short and incentivises them to focus on relative not absolute performance
- little new capital is raised by listed companies; therefore promoting good governance and stewardship is a central not incidental function of equity markets
- the UK Stewardship Code should be strengthened and broadened so that investors engage with companies on strategy not just corporate governance
- shareholding is increasingly fragmented which reduces the incentives for stewardship. Institutional investors who own less than 1% of a company do not have sufficient incentive to become good stewards: the answer to this is to get them to work together so that their combined stakes in a company make their engagement imperative.

While recognising Kay's point that the problem is systemic and requires multiple interventions, the dialogues focused particularly on the relationship between the asset owner and the asset manager, and on pension funds as asset owners.

Participants also acknowledged the importance of the shift from defined benefit (DB) to defined contribution (DC) schemes, and the need for particular steps to bring stewardship to life for DC beneficiaries and clients.[6]

The 'Stewardship Chain'



Stewardship is the cornerstone of the relationship between a company, its investors, its stakeholders, and the society from which it grows. [7]

The stewardship chain links together companies, investors and society. It allows savings and other forms of capital to be entrusted to others who can manage and nurture them. It also enables value to be released to the ultimate providers of capital.

Barriers to Better Investor Stewardship

The dialogues highlighted a number of barriers to better investor stewardship:

- an asymmetry of information between the different players in the 'stewardship chain' about stewardship and its importance
- weaknesses in the way investment performance is defined, measured and reviewed
- an inequality of knowledge and information about stewardship among different participants in the stewardship chain
- too much reliance on external experts and advisors, especially among smaller pension funds
- limitations in the view investment consultants have of their role
- the closure of defined benefit schemes (with their collective decision-making) and the consequent dispersal of decision-making to millions of individuals.

A lack of understanding of stewardship and its importance

As the Financial Reporting Council (FRC) says in its introduction to the UK Stewardship Code:

"Stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole. In publicly listed companies responsibility for stewardship is shared. The primary responsibility rests with the board of the company, which oversees the actions of its management. Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities." [7]

Some participants in the dialogues commented that there was currently insufficient understanding of good stewardship. Many asset managers do not describe their stewardship approach in ways that makes its benefits clear. There is room for institutional investors to improve the communication of their approach to stewardship and track record on their websites and in their statements of policy. While some of the best examples have to remain private, it is in the interests of those asset managers and asset owners who are committed to stewardship to publicise what they have achieved and how good stewardship has enhanced portfolio resilience and sustainable financial returns.

This lack of understanding is compounded by inconsistencies in the current wording of the UK Stewardship Code. In its introduction to Code, the FRC is clear about the importance and value of stewardship to "promote the long-term success of companies".[8] However, in the seven principles of the Code against which companies are expected to report, this focus is lost.

The seven principles of the Code bypass long-term wealth creation and instead, deal with public disclosure of policies, conflicts of interest, monitoring, collective action and voting. All these areas of policy are important, but at no point does the current Code hold signatories to account against the real purpose of stewardship. Institutional investors are not required to describe their role in contributing to the promotion of long-term success of companies and although some may do so, many do not. The statements of some signatories do no more than repeat corporate governance policies that were in place long before the introduction of the Code.

As a result, too many discussions of stewardship end up being about tactical and peripheral governance issues, not about the promotion of the long-term success of companies.

Stewardship does not feature in the way investment performance is defined, measured and reviewed

There is the opportunity to create a more positive relationship in which asset owners empower asset managers and give them the courage to be a good steward, secure in the knowledge that they will be rewarded for success. For asset managers to have this courage, they need to clear about the value that they are being asked to create for the ultimate clients or beneficiaries.

Asset owners need to take a more holistic and long-term view. This means moving away from defining fund manager performance exclusively in terms of how well a pension fund performs in relation to its industry's financial benchmark, and especially away from a quarterly review against that criterion. (More detailed discussion of the issues and guidance for asset owners is contained in 'Tomorrow's Value: achieving sustainable financial returns'.[10])

The contribution of good stewardship to the generation of portfolio returns is poorly understood. Current benchmarking methods are sub-optimal as they do not capture how the asset manager's or owner's approach to stewardship contributes to the long-term success of the portfolio. The challenge is to refine the current methods of evaluating asset managers and the measurements that effectively capture the contribution of good governance and stewardship on a systematic basis. This is a problem that asset owners and asset managers continue to face and it will only be overcome if there are more regular conversations about stewardship between them.

Even when such conversations do happen, participants in the dialogue felt that there are shortcomings in:

- the definition of the stewardship objective
- the current measurement criteria that would be logical in the light of the objective, and
- the frequency and the focus of the reviews which asset owners use in relation to asset managers.

A vacuum is created in the absence of such definition, measurement and review, and the gap tends to be filled by short-term behaviour by asset managers and their clients which lead to results addressing the only dimension for which objectives, measures and benchmarks are clearly defined.

As in any other market activity, there is more than one dimension to performance. Benchmarking needs to be used with care. It needs to be seen as part of a wider judgement of overall investment performance, otherwise, there is a risk that it has a distorting effect on behaviours and performance. Achieving this wider judgement represents a particular challenge because of the timeframes over which asset manager performance is measured, which can be aggravated by the frequency of review. An asset management firm which knows that its investment performance is going to be judged over shorter periods will inevitably be tempted to adopt strategies that move away from the longer term protection and nurturing of assets towards opportunistic behaviour. While this may achieve some short-term improvement in the value of the portfolio, this may not be sustainable.

A fundamental objective of the role of investment consultants and actuaries is to help asset owners protect and nurture assets. Ensuring that this is front of mind is critical.

An asymmetry of knowledge and information about stewardship amongst different participants in the stewardship chain

Trustees are not experts, their advisors are. Trustee choices tend to be shaped by the way investment consultants frame the options. As the pension trustees have to decide on their 'Statement of Investment Principles' (SIP), trustees should start thinking about the importance of stewardship as part of securing their investment objectives well before any 'beauty parade' of possible asset managers. It can then be reflected in the wording of their 'request for a proposal' (RFP) from an asset manager.

At present, many trustees are not presented with the stewardship options, and without prompting and briefing they cannot be expected to know what they are looking for. A representative of the consulting industry explained during the dialogues that while some in his profession saw the discussion of stewardship as an inescapable part of the process, others would only go into the stewardship options if the asset owners had requested this or even made a separate budget available for this work.

Stewardship also needs to feature clearly and strongly in the communications that asset managers are asked to make in bidding for business. This includes presentations to the trustees, written documents, and also the general information that appears on the asset manager's website showing the importance given to stewardship, and the extent to which stewardship concerns have been integrated into overall investment policies and practices. The same applies to the reports given by asset managers to their clients.

Too much reliance on external experts and advisors

Investment services are often complex and this makes understanding and determining what 'good' value is much harder. But this should not allow the responsibility for decisions to be shifted away from pension trustees and towards experts.

Some participants in the dialogues felt that there is a 'cult of external experts' in the investment chain. This can have a disproportionate influence on small pension funds and lay trustees who are not large enough to employ in-house experts. As a result, they depend too much on accountants, actuaries, IFAs, lawyers and pension consultants providing pension-related tasks. The result is that trustees lean too heavily on their advisors to navigate through different choices and issues to act in the best interests of their beneficiaries. There is a responsibility on such advisors to provide better information about the stewardship aspects of their work, without allowing themselves to move from a position where they are supplying information and advising on options to a position where they are pre-empting or heavily influencing the decision. This is especially true for smaller pension funds which do not have in-house expertise.

Participants acknowledged that there are difficulties in achieving economies of scale through an aggregation of assets. Equally, they felt that there are opportunities, short of full merger, to build more collaborative activity to achieve shared stewardship objectives. These changes would give a voice to members of smaller pension funds and help with the governance challenge of these funds.

Limitations in the view investment consultants have of their role

The current business model and working practices of the investment consulting industry compound many of these difficulties and changes are needed so that investment consulting becomes part of the solution rather than part of the problem.

Although demand is growing among asset owners for stewardship, this demand is yet to reach a tipping point where consultants see it as a value-added product to offer. In the meantime stewardship risks are being treated by the investment consulting firm and the buyer of their services as an unaffordable luxury rather than an essential underpinning of effective asset management.

Habits are hard to break and what gets measured gets managed. As such, change cannot come from advisors themselves – attitudes need to change on all sides. But these expert advisors are in a unique position to take a lead. There may also need to be a change of incentives to break the habit.

The closure of defined benefit schemes (with their collective decision-making) and the consequent dispersal of decision-making to millions of individuals

The move from DB to DC has arguably weakened the chain by which beneficiaries can hold their agents to account. As a result, the incentives for good stewardship have been diminished.

Under the new pension arrangements, which followed the recommendations of the Turner Report, an estimated 15 million people are eligible for auto-enrolment.[10] It is harder for fund managers to engage individual clients in their millions, as opposed to engaging pension fund trustees in their hundreds.

The financial risk is now increasingly with the individual. Currently, most pension schemes lack the governance and feedback mechanisms to make it possible to engage the individual in making stewardship choices.

Furthermore, with more personal pensions being organised on a contract basis, rather than managed by trustees, the individual saver is now far less supported when it comes to making decisions about stewardship. The inequality of knowledge and information about stewardship is thereby further increased. Contract-based pension funds are under pressure from regulators and politicians to keep investment costs low.

The recent OFT study to investigate the defined contribution workplace pension market concluded that there was a “stewardship” gap between individual savers and those who invest on their behalves. Specifically, it identified a lack of independent scrutiny of contract based schemes. As the number of savers who are eligible for these schemes increases, it is important that they are given information that allows them to judge if their expectations about the stewardship of their funds are being met. There is therefore a need for bulk providers of contract-based pensions to bridge this gap. One method is the formation of an independent committee to provide scrutiny of the scheme offered by a provider.

Recommendations

The emphasis of the dialogues was on the relationship between the asset owner and the asset manager. But it is of course acknowledged that joint and complementary action is needed throughout the chain to achieve the full benefits of improved investor stewardship.

There are several elements involved:

- that the asset owner embeds its approach to stewardship in its SIP and selects asset managers accordingly. Also, the asset owner specifies in its SIP what it sees as its role in promoting the long-term success of companies[11]
- there is built into the annual cycle of asset owner meetings and decision-making a review by the asset owner against those principles. This covers the way they intend to evaluate their success and that of their asset managers as part of their review of investment performance
- each signatory to the UK Stewardship Code, whether asset manager or asset owner, sets out in an 'annual stewardship report' the progress it has made in the year in promoting the long-term success of companies
- in order to help asset owners in this process, investment consultants should highlight to clients those investment strategies and processes of which good stewardship forms a core
- with the assistance of investment consultants and other advisors, the asset owners SIP needs to set out:
  - a coherent view on what good stewardship looks like
  - how, in its evaluation of investment performance, it strikes the appropriate balance between tangible and immediate financial returns and the exercise of stewardship in the interests of protecting and promoting the long-term success of companies.

These then need to be reflected in the RFPs and investment mandates that the asset owner issues.

To assist the above, there are a number of key objectives which need to be met:

1 Better definition of the meaning of stewardship

2 Simplifying and strengthening the criteria for assessing investor stewardship

3 Putting stewardship at the heart of the investment relationship

4 More effective evaluation, review and reporting of stewardship

5 Better engagement by asset owners and asset managers with ultimate owners and clients.

Recommendation 1: better defining stewardship

The UK Stewardship Code is the most important means by which the key objectives identified through the dialogues could be achieved as all signatories would embrace the application of them in applying the principles of the Code.

To achieve this and to further emphasise and strengthen the importance of stewardship, we therefore encourage the FRC to amend the preamble to the principles of the Code to focus on the long-term success of companies as follows:

In order to promote the long-term success of companies and thereby protect and enhance the value that accrues to the ultimate beneficiary institutional investors should:

- publicly disclose their policy on how they will discharge their stewardship responsibilities
- have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed
- monitor their investee companies
- establish clear guidelines on when and how they will escalate their stewardship activities
- be willing to act collectively with other investors where appropriate
- have a clear policy on voting and disclosure of voting activity
- report periodically on their stewardship and voting activities.[12]

It is envisaged that this change could be made by the FRC when it undertakes the next formal review of the Code in 2014. By that time, the Law Commission's on-going review of fiduciary duties should have been completed, and its conclusions may reinforce the FRC's views on the aims of stewardship and the important role of investors in this regard.

Once this change has been made, the seven principles and their accompanying guidance will automatically steer signatories to the Code towards accounting for their actions in promoting the long-term success of companies. For example, the signatory's policy disclosure would logically be expected to begin with a description of how the signatory intends to promote the long-term success of companies.

Recommendation 2: industry leadership in moving beyond the minimum set out in the UK Stewardship Code

Raising the bar - from compliance to excellence

The Code follows the UK tradition of 'comply or explain' where the high level objective is set out in a code and is then reflected in a series of principles which signatories are expected but not compelled to follow. Good practice is not prescribed initially. It evolves over time through the diverse efforts of different signatories to find the best way of complying with the spirit and not simply the letter of the code. In time, as this good practice crystallises, there may be aspects of it that are included in the guidance or even the code itself. Communication by the signatories about their approach is essential, including explaining any instances where they have chosen not to comply with the code.

In line with this approach, the Principles and Guidance of the Code should be seen as the 'floor' of acceptable practice, and accompanied by efforts within the industry to achieve higher standards of excellence.

It is in the spirit of a voluntary code that different signatories will approach their stewardship activities in different ways. But, while approaches to investor stewardship may vary, there does need to be a common framework by which those different approaches can be evaluated. Developing a common framework of evaluation, which includes reporting, enables comparison and differentiation and so make stewardship a real differentiator in the market for retail investment.

In developing the framework, the following questions are a relevant starting point:

For asset owners and asset managers:

- Do you report periodically on your progress in contributing to the long-term success of companies through your stewardship and voting activities?
- Do you regularly account to your clients or beneficiaries as to how you have discharged your responsibilities in reports which comprise qualitative as well as quantitative information which are designed to provide

a clear basis of comparison with other asset managers? (see page 15)

- Do you publish an annual stewardship report to those to whom you are accountable on your stewardship policy and its execution?
- Have you developed a client engagement programme for stewardship?
- Does this programme start with an explanation of the stewardship policy saying how you promote the long-term success of companies, how you assess the effectiveness of boards, and hold them to account, and how you act when boards fail to operate in the best interests of all shareholders?
- Are you communicating in accessible ways to clients the key contents of the annual stewardship report, and providing methods by which clients and beneficiaries can contact them and contact each other to express their concerns on particular companies or issues?

For asset owners:

- Do you report at least annually to those to whom you are accountable on your stewardship policy and its execution? And do you build into your annual cycle of meetings and decision-making a process whereby you review progress in implementing your stewardship policy?

These questions can be used in different ways to help everyone who is faced with deciding which asset manager to select. In practice we can expect this to happen in two stages beginning with the wholesale market.

For the wholesale market – better information for pension funds, charities and other collective investment vehicles

Some asset managers and asset owners have already made a start in suggesting a framework for evaluation and comparison between the stewardship offerings of different asset managers. Standard Life Investments and Tomorrow's Company supports the 'Stewardship Framework' developed by the 2020 Stewardship Group.[13] We also welcome the positive action by the National Association of Pension Funds (NAPF) in building on this initiative and publishing its 'Stewardship Disclosure Framework' against which all asset manager signatories to the Stewardship Code have been invited to report.

It would therefore be helpful for the FRC to say how it intends to build on this voluntary development and what changes it envisages making in the Code's principles and guidance with the aim of enabling a better-informed evaluation which inherently addresses issues of comparison easier.

Some participants in the dialogues went as far to say that they felt that it should be a policy objective of the FRC to encourage this voluntary development and to set a date for it to become mandatory.

For the retail market – better information for individual savers

The work in the wholesale market would then lay the foundations for retail investors to be offered choice in the marketplace based on the accreditation of those companies which are excelling in stewardship.

As the onus and risk shifts to the individual, it is important to develop a simplified 'retail-friendly' label of excellence. There are examples from outside financial services. There is the experience of food labelling, and the evolution of a trusted Fair Trade label for coffee, tea and other commodities.

Such a development needs to be a joint exercise by all involved – the investment consulting industry, the asset management industry, and asset owners.

We therefore recommend that:

- **all signatories to the UK Stewardship Code are encouraged to move towards using an agreed and easily understood set of criteria to enable an informed evaluation of their stewardship activities**
- **all the representative organisations which make up the Institutional Investors Council (IIC), and the investment consulting industry, build on work already done by the Financial Reporting Council, the NAPF and the 2020 Stewardship Working Party to simplify comparison and incentivise stewardship through real differentiation in the market**
- **the IIC bring together relevant interested parties, including consumer groups, with the aim of developing an agreed approach to stewardship accreditation for retail funds to create not only incentives to excel in stewardship but also a basis to inform savers.**

Recommendation 3: a stewardship agenda for the investment consulting industry

The issues raised by these dialogues pose a critical question for professional investment consultants: What is the best contribution the industry can make towards the promotion of long-term success by the companies in which its clients are invested?

Investment consultants are responsible for explaining to pension trustees and others how they can achieve their investment objectives. If important dimensions of asset manager performance, such as stewardship, are not part of the standard range of indicators by which investment consultants help clients assess asset managers or their own investment performance, then the industry, helped by the profession, has a responsibility to rectify this omission. The importance and value of stewardship is inadequately explained at present. There is now an important opportunity for the industry to recast the way in which it communicates the importance of stewardship as an essential element in underpinning long-term investment performance. It also needs to move from a position where stewardship is regarded as an optional extra or a luxury, to one where it is seen as an essential cornerstone of successful long-term investment.

Some questions to be explored are:

- What are the implications of recent developments in investor stewardship for the investment consulting industry?
- How does the investment consulting industry shape its work so that in the longer term stewardship is designed into the standard offer of the investment consultant?
- Does the industry go far enough to meet the needs of clients in the light of the growing importance of stewardship considerations in assessing investment performance?
- Does the industry need to revisit its methods of defining and evaluating investment success?
- Is the current method of benchmarking promoted by the industry optimal in view of the intentions of the UK Stewardship Code?
- What will be the future role and responsibility of investment consultants in educating clients about stewardship?
- How can the industry work closely with asset managers, asset owners and other groups to support the effective working of the UK Stewardship Code in terms of long-term wealth creation by companies?

We therefore recommend that the investment consulting industry set up a review into its own contribution to the advancement of stewardship.

Recommendation 4: an agenda for government in continuing to oversee the effectiveness of the current regulatory framework and address any current regulatory obstacles to better stewardship

The role of government is crucial to the future impact of investor stewardship.

The Law Commission has undertaken a review of fiduciary duty but there are a number of other issues that have implications for the role of government.

The dialogues identified the need for government to investigate the regulatory barriers to stewardship. For example, how can government and relevant regulators make it easier for smaller pension funds to merge, or act in concert, thus reducing the overall cost inhibitions experienced by a smaller pension fund wishing to exercise good stewardship?

It is also critical that the government steps back and looks at the implications of the shift towards DC and contract-based schemes. A growing number of savers and investors do not rely on trustees but on insurance companies, mutual funds and savings organisations to exercise stewardship on their behalf. There is a case in the future for encouraging the development of a 'trustee-style' independent 'Stewardship Oversight Body' which oversees the exercise of stewardship in the interests of clients.

There is, however, a much deeper issue which needs to be addressed by government. Through regulation, and the array of incentives and penalties for which Government is cumulatively responsible, the climate has been made much more hostile to investor stewardship. In particular, there have been changes in the regulations and accounting standards covering pension accounting which have contributed to the de-risking of client portfolios away from equities and into bonds, leading to reductions in the proportion of pension beneficiaries' funds that are held in equities.

Pension funds may well ask whether it is reasonable that they show a greater interest in the stewardship of companies through one arm of government policy while through the other arm, it is being made so much more difficult for them to hold shares in companies at all. Several dialogue participants pointed out the effect of mark-to-market accounting regulation in tipping the balance of investment away from equities and towards bonds.

In the same way, it seems illogical to have done so much to shore up the balance sheets of banks in other ways, while making it harder for UK institutions to hold shares in those banks.

We therefore recommend that, building on the Kay Report the government establishes a cross-departmental review of the regulatory obstacles to investor stewardship. As this review would be designed to enhance the investor contribution to the long-term success of companies, we believe the review should be convened by the Department for Business Innovation and Skills, who would work closely with HM Treasury (which is responsible for the financial services industry), and the Department for Work and Pensions (which is responsible for pension funds).

The spirit of such a review should be consistent with the argument developed in the Kay Report that government should move away from the 'micro-management' of market participants and leave market participants more freedom to make their own decisions. In this spirit, the review should work closely with the IIC in their efforts to promote investor stewardship accreditation (described in Recommendation 2). Also it should have regard for the Law Commission's review of fiduciary duties.

Conclusion

The recommendations in this report are by no means exhaustive. However, taken together, they represent an agenda through which the high-level intentions of the UK Stewardship Code can be advanced to strengthen relationships in the stewardship chain.

Progress depends crucially upon a collaborative approach between different participants in the stewardship chain.

Clarity was a key theme of the dialogues. Asset owners need to be clear about the benefits of stewardship in terms of long-term investment performance. They need to be clear that ultimately the wealth that is created through their investments can only flow from the performance of companies and other wealth creating entities. They need to support the development and use of a framework which facilitates comparison between the stewardship of different asset managers, so that they end up giving business to asset managers who perform well on this important dimension.

Investment consultants have a vital part to play in enhancing this clarity. They frame the stewardship choices that asset owners make. Investment consultants need to be clear in their minds about the importance of stewardship to the long-term success of companies, and therefore to the long-term success of investment portfolios and the long-term returns to clients. They can help clients insist on high standards of stewardship and ask the right questions about stewardship in 'beauty parades'.

Asset managers too can enhance clarity throughout the stewardship chain. They can better communicate their own stewardship intentions and achievements, and in doing so move the market as a whole in the direction of improved investor stewardship.

The investment industry as a whole, represented by the Institutional Investors Council, can take a lead in making stewardship a much clearer part of its common language, and accrediting those fund managers which are excellent in stewardship with trusted labels which ordinary consumers understand.

The government can play its part, especially by supporting the recommendation to strengthen the preamble to the UK Stewardship Code, to reinforce the focus on the long-term success of companies and removing all the regulatory obstacles to better stewardship, having regard for the current Law Commission Review of Fiduciary Duties of Investment Intermediaries. This would leave all market participants clearer on their own obligations and rights.

This will then create the conditions where it is both natural and possible for the FRC's review of the UK Stewardship Code in 2014 to result in an evolutionary change in the quality of investor stewardship, building on progress that has already been achieved and contributing to the success of companies.

On their own, clarity and transparency will not deliver effective investor stewardship. They can encourage stewardship behaviours by all institutional investors. They can help to spread the adoption of rigorous stewardship processes. Through this they can help to ensure that all those involved in the stewardship chain focus on the creation of value by companies. This in turn will help to enhance portfolio returns and deliver value to the ultimate clients and beneficiaries. This is the purpose of effective investor stewardship towards which our collective efforts should be directed.

Sources and Notes

1 Tomorrow's Company. Why Stewardship Matters (2011) http://www.tomorrowscompany.com/why-stewardship-matters-pdf

2 Tomorrow's Company. Tomorrow's Owners: Stewardship of Tomorrow's Company (2008) http://www.tomorrowscompany.com/tomorrows-owners-pdf

3 'The Institutional Shareholders' Committee published its Statement of Principles on the Responsibilities of Institutional Shareholders and Agents in October 2002, and reviewed it in September 2005.

4 Walker, David. "A review of corporate governance in UK banks and other financial industry entities" 2009 p.97 http://webarchive.nationalarchives.gov.uk/+/http:/www.hm-treasury.gov.uk/d/walker_review_261109.pdf, accessed 17 October 2013.

5 One example is the study by Jeremy Grant and others of 1800 activist interventions from 2000 to 2010.Becht, Marco, Julian Franks, and Jeremy Grant. "The Returns to Hedge Fund Activism: An International Study."(2013) http://www.bc.edu/content/dam/ files/schools/csom_sites/finance/Franks-031313b.pdf accessed 17 October 2013

6 Standard Life Investments has separately published a positioning paper concerning the shift to DC schemes entitled 'Activating DC' (http://uk.standardlifeinvestments.com/UK_INST_Activating_DC_Brochure/getLatest.pdf). Tomorrow's Company has also set out its vision of the steps needed at different points in the chain in its Stewardship Manifesto published in Tomorrow's Stewardship: why stewardship matters (2011).

7 Tomorrow's Company. Why Stewardship Matters (2011) http://www.tomorrowscompany.com/why-stewardship-matters-pdf

8 ibid

9 Tomorrow's Company. "Tomorrow's Value: achieving sustainable financial returns". Available on request from Tomorrow's Company.

10 Financial Services Authority, The Turner Review – A regulatory response to the global banking crisis. (2009) http://www.fsa.gov.uk/pubs/other/turner_review.pdf accessed 17 October 2013

11 Analysis of 1800 activist interventions from 2000 to 2010 in North America, Europe and Asia. See http://www.thepensionsregulator.gov.uk/guidance/guidance-for-trustees.aspx#Drawing) on drawing up SIPs.

12 FRC. "The UK Stewardship Code."(2012) http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Stewardship-Code-September-2012.aspx accessed 17 October 2013

13 2020 Stewardship: Improving the quality of investor stewardship, a report of the Investor Stewardship Working Party, Tomorrow's Company, 2012, http://tomorrowscompany.com/2020 stewardship-improving-the-quality-of-investor-stewardship- the-report-3, accessed 30 October 2013.

Tomorrow's Company
Centre for Tomorrow's Company
Charity registration number 1055908.
Registered office: Samuel House
6 St Alban's Street, London SW1Y 4SQ.

INVBGEN_13_1035_UKI_Governance_White_Paper _TCM 0114