Better Stewardship

An agenda for concerted action

tomorrow's company

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Foreword

The need for investor stewardship has never been greater to deliver returns to savers, restore public trust in business, improve productivity and support companies in building a sustainable economy.

In the past, efforts to improve stewardship have focused almost exclusively on the activities of asset managers and their interactions with companies. This report instead describes a search for stewardship solutions across the *entire* investment chain that links ordinary clients and savers at one end with boards and companies at the other. We see effective stewardship as the joint fruits from multiple decisions and interactions in and between boardrooms, analysts, advisors, assert owners and asset managers.

This is a consultation document. Tomorrow's Company is ultimately responsible for the content and takes full responsibility for any errors. It draws on the work of the Stewardship Alliance, comprising colleagues from Aviva, Blackrock, Legal & General Investment Management, RPMI Railpen, USS, and more recently HSBC Global Asset Management. The aim of this group has been to improve the stewardship of listed assets by the UK investment chain. The group has been working together with Tomorrow's Company since 2012 when it produced **2020 Stewardship: improving the quality of investor stewardship**, which helped lay the foundations for the adoption by the pensions industry of a Stewardship Framework and a new guide for investor engagement published by the ICSA. This in turn followed work by Tomorrow's Company in 2008, called **Tomorrow's Owners: stewardship of tomorrow's company**, which helped lay the ground for the Stewardship Code.

On behalf of Tomorrow's Company, we would like to acknowledge the contribution of all those who over 10 years have helped make the case for better stewardship, which is fundamental to everything that Tomorrow's Company does. Our approach to achieving progress is to challenge leaders throughout the system to innovate and show the way ahead. In this document we have tried to describe what, in practice, good stewardship looks like as seen through the eyes of each participant. We acknowledge, however, that there are parts of the whole investment system that we have yet to reach. The spirit of this consultation document is therefore not to say 'you ought' to anyone but rather, 'can we together?'

Of course, one part of the progress we need to make involves improving the Stewardship Code. Yet pioneers of better stewardship have always moved beyond a regulatory minimum. We have looked to set out an aspirational agenda of actions that each individual throughout the investment chain can take to improve stewardship, and then considered how regulation can create the best conditions for that improvement.

Whatever form it takes, the next stage of this journey needs to be even more collaborative than what has come before. That collaboration will need to draw on a shared sense of the common objective, a shared commitment to the principles of good stewardship and a progressively more robust description of how to evaluate good stewardship in action.

The report is primarily focused on the UK, but, in principle, if not in detail, it has global applicability.

Working with others, we hope to contribute to the improvement of stewardship across the investment chain to the benefit of UK savers, listed companies, and the national economy. We hope this work will help strengthen the implementation of the UK Stewardship Code, as well as play a role in its future evolution.

Mark Goyder
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Executive summary

There is a troubling disconnect between our system of wealth creation, and the society which it serves. The symptoms include public anger about corporate failure and excessive executive pay; the continuing impacts on living standards from the global financial crisis; low investment; poor returns for savers, pressure on pensions, and high levels of debt, especially for graduates. Public trust in the whole system – including governments, universities and the media, not just business and investment – is low. Too often the attempt to tackle these problems deals only with individual symptoms. Effective solutions will only flow from a better diagnosis of the underlying problem, and combined actions by all involved.

The wellbeing of savers and investors can only be promoted if the underlying performance of investee companies is improved. Competition between asset managers on relative performance is ultimately a zero-sum game. This is where stewardship comes in. Stewardship means *the responsible management of inherited resources so that they are passed on in better condition*. Stewardship is the golden thread that can connect, and guide the actions of, all those who play their part in the flow of money from the savings of citizens through wealth creation and back to those citizens.

Better stewardship is about a linked set of actions and accountabilities by asset owners, asset managers, and companies, facilitated by the actions of regulators and advisors. Companies need a critical mass of shareholders to hold them to account. Citizens need stewardship by both boards and owners to deliver long-term returns and keep an eye on how companies behave. The test of its success is more effective and more responsible wealth creation in companies. A stewardship code can support and underpin this but the most effective change comes from industry and market leaders.

Overall quality of investor stewardship has improved since the introduction of the Stewardship Code in 2010 but a 'critical mass' of stewardship investors has not yet materialised. According to a 2016 survey only 68% of asset owners have a stated policy for exercising their stewardship responsibilities. However only 37% set out their stewardship expectations in all their mandates. Asset managers reported that engagement was excellent with nearly a quarter of all companies and good with 44%. They also reported that they are spending the most time on remuneration at the expense of more important issues.[1] Progress is often stalled by the complexity of the investment chain and a tendency to blame others.

A pincer movement of leadership and regulation is needed. Each participant in the system can lead by asking '*how are my actions helping improve the performance of the underlying assets over the longer term?*' Small actions can reinforce each other to form the habits, values and culture of stewardship across the investment chain. In earlier decades a focus on total quality and lean management transformed the working methods of many industries. Success for stewardship will be assured when a similar common language has been developed and adopted for describing and ranking and celebrating investment institutions, advisors and companies on the basis of their stewardship. Drawing on the pioneering work of the Stewardship Alliance of institutional investors, and the work of Tomorrow's Company on good governance, this report sets out for discussion the concrete actions for each link in the chain.

In the UK, leadership by government and regulation is also needed. Government needs to set out its overall policy for long-term wealth creation. Stewardship needs to be central to the terms of reference of the Financial Conduct Authority. The Stewardship Code should start by linking stewardship to promoting the long-term success of a company. It should apply to asset owners, asset managers, investment consultants, research analysts and all relevant service providers and advisors. It should require each investment entity to state its purpose and report against it, and report resources invested in stewardship.

Introduction

Ten years ago, as the global financial crisis was unfolding, and on the same day that the government had to nationalise the whole of RBS and large parts of a majority stake in Lloyds Bank, Tomorrow's Company published **Tomorrow's Owners: stewardship of tomorrow's company**. This report suggested that shareholders had four main ownership-related roles – member, analyst, financier, steward. It concluded that the last, 'stewardship' was the most neglected. It went on to say:

> *"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. This idea that the core responsibility for stewardship is shared between shareholders and directors is, we believe, very significant, with many implications for the relationship between the two groups."*[2]

A year later Sir David Walker produced his findings on the failings of the banks. He suggested the introduction of a Stewardship Code in parallel with the UK Governance Code, The *UK Stewardship Code* was introduced in 2010 on a Comply or Explain basis. It was derived from an existing code developed by the Institutional Shareholders Committee. At an early stage the Financial Conduct Authority, the regulator for fund managers, gave statutory leverage to the stewardship code by insisting in its Conduct of Business Rules that all UK-authorised asset managers produce a statement of commitment to the UK Stewardship Code. This was followed by the introduction of over 20 stewardship codes around the world.

Some of those institutional shareholders who took stewardship seriously felt that it was not rigorous enough, and in collaboration with Tomorrow's Company this led to the formation of the 2020 Stewardship Group which then described in a 2011 report how the quality of stewardship might be improved. Through collaboration with the Institute of Chartered Secretaries and Administrators (ICSA) and the National Association of Pension Funds (now the Pensions and Lifetime Savings Association (PLSA), the 2020 Stewardship Group stimulated the production of a Stewardship Framework – new guidelines for pension funds in buying asset management services and a good practice guide for company engagement.

But the group did not feel satisfied with progress. Looking at the survey evidence from the ICSA and the Investment Association it concluded that the movement towards greater investor stewardship had reached a plateau. It challenged the regulator, the Financial Reporting Council, (FRC) to differentiate between those who took stewardship seriously and those who didn't. It also felt that too much of the early focus had been on asset managers. There is a stewardship value chain that links savers at one end with investee companies at the other, and the principles of good stewardship need to be applied at every link in this chain. For investor stewardship to be stimulated, asset owners need to define clear investment principles and set out clear mandates to those whom they entrust with their investments.

The group has grown in membership and evolved, in collaboration with Tomorrow's Company into the Stewardship Alliance. Its membership of asset owners and asset managers have worked to define excellence in investor stewardship. At the same time Tomorrow's Company has continued its work with listed and private companies to deepen its understanding of the stewardship role of the board. It has also pressed the case to government and political parties for policy changes that will facilitate stewardship.

This is unfinished work. We all recognise that there are key participants in the stewardship value chain whom we have yet to reach. These especially include the advisors – investment consultants, proxy advisors, and the researchers and commentators, especially the investment research community. We aim to encourage a better shared understanding right along the value chain, and among all stakeholders, about what good looks like. Without this shared understanding, the risk is that discussions of short-termism, executive remuneration, productivity, talent and climate risks all take place in separate specialist compartments rather than being part of one discussion about the journey to better stewardship in the interests of beneficiaries and society.

To its credit, the FRC has responded to some of these concerns. It has introduced different tiers of code signatory and accepted the need in due course to delist those who do not show sufficient progress. It has been receptive to the idea of extending the reach of the Stewardship Code. And, mindful of these challenges, it is now preparing to review the whole code.

This is therefore a great opportunity for all those involved to stand back and consider:

> *What do we mean by stewardship? Can we agree on its essential principles?*
>
> *Can we agree on its benefits in terms of the whole system of wealth creation to savers, to companies and their shareholders and stakeholders, and to society as a whole?*
>
> *What are the barriers to progress?*
>
> *How can we, from our position in the system, contribute to progress?*
>
> *What is the part that regulation and government policy can play?*

This report is intended to provoke just such a discussion.

In Section 1, we say why stewardship matters, define what we mean by stewardship, and set out four stewardship principles. We describe the whole stewardship value chain. We set out, for consultation, our definition of concrete actions for each link in the chain.

In Section 2 we review progress since the launching of the stewardship code; describing the context today and the barriers to further progress.

In Section 3 we offer our own ideas about what needs to happen next if we are to build the widest support for effective stewardship right across the wealth creation system on which the UK's future prosperity depends. This includes the action needed by regulators, but does not focus on this in isolation.

In Section 4 we raise key questions which we believe should be debated before the FRC decides how to revise the Stewardship Code. These include questions about the definition and principles of stewardship, the scope of stewardship, the actions that might be taken by leaders, and finally, the role of government and the regulator.

Section 1: Stewardship today

Why stewardship matters

"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, European Commission 2010[3]

"The capital markets system has reached a stage where it is primarily self-perpetuating. The quoted sector no longer looks to equity markets as the main source to raise capital. The ownership of shares must therefore evolve so that it becomes the conduit for bringing about long-term sustainable prosperity for the entire system. …However, this… implies profound changes to the way we invest. It implies that a large part of the reason for investing in quoted companies is stewardship and that in turns brings its own set of issues. …Investors collectively end up financing or owning the whole of the economy that they live and work in, so knock on effects which are not apparent when looking at single investments begin to have a profound cumulative effect on them in their totality.
Saker Nusseibeh, Hermes Investors 2017[4]

The amount of money that was lost by every citizen of the UK as a result of the global financial crisis has been estimated around £1tn, or £16,000 for every citizen. Even after the recovery of the markets, it has been calculated that an investor in bank shares would today still be 17% worse off than in 2008.[5] Against this background, there is a vital need to protect investors. While stewardship involves extra cost, it is difficult to argue against this investment in the exercise of proper stewardship by investors.[6] More positively, the University of Oxford Smith School assessed over 200 academic studies. It found that 88% of the research analysed showed solid ESG practices led to better operational performance of companies; 80% of the research found stock price performance was positively influenced by good sustainability practices and 90% of the cost of capital studies show that sound ESG standards lower the cost of capital.[7]

In an analysis of over 3,500 institutional long-only active equity funds in Mercer's global investment database, a recent report found that these fund managers replaced all of the names in their portfolio every two years, on average. While this is an improvement since the financial crisis, Mercer's review of academic literature suggests that the current average turnover is still twice as high as the hypothetical optimal from a risk return perspective.[8]

Stewardship matters for many reasons. There is corporate and investor self-interest in having a robust wealth creation system in which there is adequate investment, and in which companies are managed for the long-term benefit of shareholders and society. All organisations benefit from having a clear accountability. Boards of companies are elected by, and formally accountable to, their shareholders. It is important that those shareholders exercise stewardship. Section 172 of the UK Companies Act currently defines the duty of directors as being to *promote the success of the company for the benefit of its members as a whole and in doing so have regard (amongst other matters) to the likely consequences of any decision in the long term; the interests of the company's employees; the need to foster the company's business relationships with suppliers, customers and others; the impact of the company's operations on the community and the environment; the desirability of the company maintaining a reputation for high standards of business conduct; and the need to act fairly as between members of the company*. In the UK Corporate Governance Code, the Financial Reporting Council says that the purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company[9]. Finally, stewardship has the potential to engage citizens in the investment process and increase levels of accountability, trust and understanding.

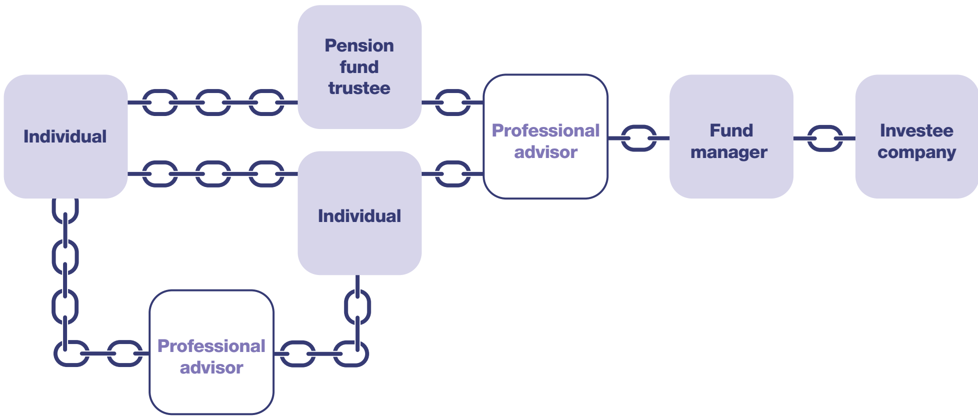
Stewardship and long-term wealth creation

Core to this view of stewardship is the focus on delivering investment returns through improving the long-term performance of the underlying assets, rather than through trading. As Professor John Kay pointed out in his 2012 report, the investment industry overall cannot improve returns for the average saver simply by trading assets between itself – because *"competition between asset managers on the basis of relative performance is inherently a zero-sum game…The asset management industry can benefit its customers – savers – taken as a whole, only to the extent that its activities improve the performance of investee companies"*. In other words, the asset management industry can only deliver value to savers in aggregate by increasing the size of the cake, rather than competing over the size of each slice.[10]

The definition and principles of stewardship

Tomorrow's Company defines 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."* In this definition stewardship applies to every link in the investment chain from the ultimate beneficial owners, through to the issuing company and its relationships. Through stewardship the various players at each point in the investment chain can better serve their ultimate beneficiaries – individuals saving for the future and companies seeking funds. As the FRC puts it, in its initial consultation on the future direction of 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, thereby benefiting companies, investors and the economy as a whole.*

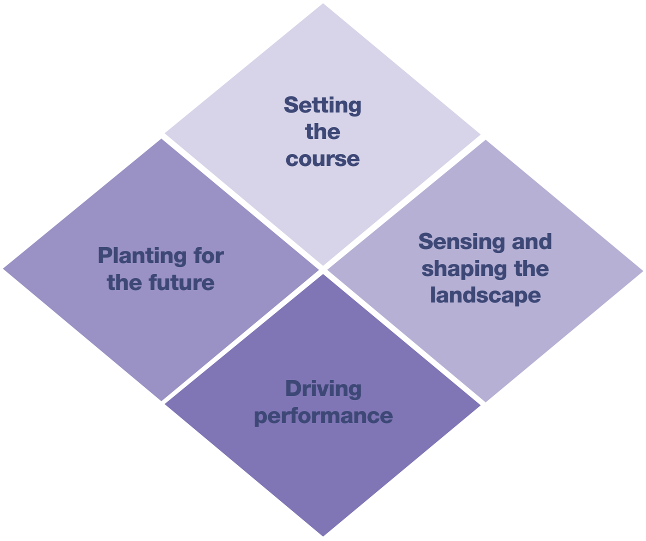
It follows from this definition that, important though engagement between asset managers and companies is, stewardship is about much more than engagement. Better stewardship is about a linked set of actions and accountabilities by asset owners, asset managers, and companies, facilitated by the actions of regulators and advisors. The test of its success is more effective and more responsible wealth creation in companies with the generation of more value for savers and investors, and more value created by employees and shared between customers, employees and shareholders and society. The market participants involved in delivering this success include all those involved in the stewardship value chain, which at its most simplified, looks like this:



A stewardship code can support and underpin effective stewardship but the most creative and effective change will come from leaders in business and investment – referred to in this report as industry leaders. If the code operates at the level of principles, and requires signatories to state objectives and then be accountable through reporting for living up to them, that is better than specifying actions or processes and requiring compliance (box ticking). This is where the principles of stewardship come in. Entrepreneurial freedom is at the heart of effective wealth creation. Just as a prescriptive and compliance-minded approach to corporate governance risks killing innovation and diversity, so too with stewardship. The best stewards are those who follow the spirit, not the letter, of stewardship. Ideally all market participants, and those who advise them, will be working to shared principles so that, although they occupy different places in the value chain, their actions are more aligned to the intended outcome.

The principles of stewardship

The essence of stewardship has been captured in the four **Tomorrow's Company Stewardship Principles** which were first published in 2009.[11] These are described in detail in the Appendix, together with the questions that they imply for a company's board.



In line with these principles to support the long-term success of companies, the stewardship of a company by its investors will ideally cover, amongst other things:

- the purpose, values and culture of the company
- the nomination and election of directors and their mandate from shareholders
- its business model, strategy, time horizon and risk appetite
- its objectives and results both short-term and long-term
- its time horizon and risk appetite
- opportunities and threats in its external environment
- the health of its key relationships – employee engagement, supply chain, customer loyalty and shareholder relationships
- capital allocation
- the balance between dividends, buybacks and investment, alongside capital structure
- impact on the environment and climate change
- human capital management, talent and diversity issues.

Define actions across the chain that support stewardship

Current initiatives to improve the stewardship of companies by their investors have focused on improving disclosure of stewardship across the chain. While this is helpful, more focus needs to fall on defining the actions that each actor in the investment chain can carry out to support stewardship. By defining clear actions for each part of the UK investment chain, we can deliver better stewardship to benefit all – savers, the companies they own, and the wider economy. What follows is an outline of the actions across the investment chain that would support stewardship and hence improve returns for savers and society. This is the fruit of detailed discussions with members of the Stewardship Alliance. We offer it to all those involved in the stewardship chain. We recognise that, at this stage, it remains incomplete, particularly in regard to the stewardship contribution of investment consultants, proxy advisors, and service providers and would particularly welcome suggestions that would help to rectify this. The extension of stewardship to retail is an issue for the future that is not covered here.

Stewardship in practice

Actions for asset owners and investment consultants

Pension trustees owe a fiduciary responsibility to their beneficiaries to secure the 'best realistic returns over the long term'.[12] The role of the trustee is to set the direction and to ask the right questions of in-house professionals and consultants.

Asset owners can play a crucial role in encouraging stewardship, both in how they invest directly, and in their allocations and mandates to external managers. Over time the exposure to equities is gradually declining as a proportion of total assets. Asset owners have increasing exposure to alternative assets from private equity, to property and, and through their mandates in these areas they have the opportunity to influence the stewardship of many unlisted businesses and other assets. In spite of these changes they invest a significant proportion of their assets directly and indirectly in the UK's listed equities.

Decisions are taken by a mix of trustees, in-house investment professionals, in-house stewardship professionals and external investment consultants. The balance between these groups depends on the fund, from in-house to fiduciary management. All those involved are conducting two processes through which they can give direction and set priorities about stewardship with appropriate engagement according to their structure and level of resource. These are **the structure and award of mandates** and **the monitoring and assessment of mandates** once awarded. Whoever is involved, the same overall principles of stewardship apply:

- In the structure and award of mandates to external asset managers, place an emphasis on stewardship in order to enable and encourage asset managers to enhance the sustainable value of listed companies. This could be helped by a new guide from the PRI on how asset owners incorporate responsible investment into mandates.[13]
- Commit to monitor managers over longer time periods. This is in contrast to monitoring quarterly performance which can create short-term incentives which reduce the ability for stewardship and can damage long-term returns.
- To reinforce the focus on the longer term when considering the capital allocation of the fund, set expectations to asset managers about their role in influencing the capital allocation decisions within investee companies and other assets. While this is normally in the remit of the asset manager, it can be appropriate for the asset owner to take a view. For example, it may not make sense to encourage asset managers to pressure companies for higher dividends, if the dividends received can only be invested at a lower return than could have been achieved by the company. This would imply a lower use of income mandates.

Below are example actions for how these aims can be put into practice:

Structure and award of mandates and setting of investment principles

- Trustees can ask investment consultants to explain how proposed investment selections or mandates can help limit the risks identified by the Law Commission's interpretation of their fiduciary duty: *'Trustees should consider, in discussion with their advisers and investment managers, how to assess risks. This includes risks to a company's long-term sustainability. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees'*.[14]
- Make it clear in the Statement of Investment Principles (SIP) how it is hoped the chosen allocation of assets and mandates have enabled investment managers to positively affect the performance of investee companies owned on members' behalves.
- Place the issue of stewardship into the heart of investment allocation and mandates; for example, by allocating scores to stewardship in requests for proposals (RFPs) including it as a regular agenda item for manager meetings; and monitoring exactly how managers are progressing.
- Most surveys find that savers do care about ESG and other stewardship factors in their investments. Defined Contribution (DC) schemes should consider incorporating basic stewardship principles as the default position, rather than just an optional extra.
- The International Corporate Governance Network (ICGN) model mandate can be a useful starting point for constructing a mandate.[15]
- Balance the need to keep fees low with the necessity of providing the scope and resources for asset managers to dedicate resources to stewardship.
- When selecting managers, it can be useful to reference an asset manager's performance under the FRC, PLSA or PRI frameworks.

Assessment of mandates

- Constantly assess how one's selected managers are influencing companies through their activities, either by direct engagement, AGM voting or the effect of their trading on the stock price. This might involve analysis of their portfolios through time – perhaps study its concentration, stated investment time horizon, number of engagements with the company, or portfolio churn – or by engaging directly with investee companies for feedback on the quality of the investor's engagements.
- Consider risk not only from the possibility of short-term losses, but also from being unable to meet long-term obligations with insufficient investment returns.
- Collaborate with peers and organisations, such as the PLSA and PRI, to constantly improve the assessment and measurement of stewardship by asset managers.
- Good disclosure does not always mean good stewardship, therefore ask for concrete examples of stewardship. Furthermore, short holding periods, limited investment horizons or heavy portfolio diversification may all hinder the ability to be a good steward.
- Make the case and evidence how good stewardship is improving companies' performance through time. Question how different asset allocations, or how resources dedicated to stewardship can be better deployed, to deliver sustainable enhancement in their value.

Investment consultants
All asset owners to some degree rely on the advice of investment consultants. For small asset owners, this can be extensive and can include fiduciary management. For large asset owners this can complement a large in-house team of investment professionals. Where fiduciary management is involved, it is particularly important to ensure that there is no conflict of interest such as may occur where an investment consultant recommends an in-house fiduciary management service without going to the market.

The selection and monitoring of asset managers based on stewardship requires considerably more resources than ranking investment funds on short-term fund performance. The large investment consultancies have the scale to carry out this analysis, when many in-house asset owner teams do not. Therefore, they are well placed to help asset owners meet stewardship obligations. The organisation Focusing Capital on the Long-Term (FCLT Global) has also created a **useful resource to guide pension trustees** and other decisionmakers. Among other points it suggests asking:

> **Do the incentives built into the mandate support a long-term relationship?** *For example, fees that decline with the longevity of the partnership rather than with the assets under management may provide owners incentives to be more patient through periods of underperformance.*
>
> **Do the mandate terms reward long-term investing and mitigate the common "buy-high, sell-low" pattern of chasing performance?** *It is tempting to invest in managers after strong performance and terminate them after poor performance, leading owners to chase rather than capture strong returns. Contracts that renew on a long-term calendar basis and place explicit caps on manager asset capacity can support a process driven by long-term factors instead of short-term performance.*[16]

A positive example of leadership has come in 2017 from twelve leading investment consultants which have agreed to ensure clients are made aware of The Pensions Regulator's (TPR) guidance that pension schemes take into account environmental, social and governance (ESG) factors where they are financially material.[17] This was the result of an initiative by the Association of Member Nominated Trustees (AMNT) and the UK Sustainable Investment and Finance Association (UKSIF).[18]

Actions for asset managers

UK asset managers have significant influence both in the UK and globally through their direct stakes in companies. The UK asset management industry manages £6.9tn of assets. Over £1tn is from UK retail investors, £3tn from UK asset owners and £2.7tn from overseas. Within this, £2.2tn are equity holdings by members of the Investment Association, and the portion of this invested in the UK accounts for 31% of UK domestic market capitalisation.[19]

There is a wide variation in approaches between investment funds, from index funds to smart beta, active long-only, hedge funds and activist investors. Irrespective of the style of fund, all actions taken by an asset manager influence the companies they invest in. This ranges from the decision to buy and sell, to the questions asked in meetings, voting at AGMs and involvement in collaborative initiatives.

The key difference between active and passive funds lies in the ability by active managers to sell the stock if all engagement fails. Active managers who want to focus their limited stewardship resources will face the challenge of reconciling this with the need for adequate portfolio diversification (in the interests of lower volatility). Otherwise, however, the principles of good stewardship apply equally to both.

For stewardship teams, similarly, the task is broadly the same. The obvious difference is that in active management stewardship teams help portfolio managers to incorporate stewardship into their approach to investment as well as to engagement. There is also the option of trading shares and changing the portfolio where engagement has not produced the desired result. On the other hand, where stewardship teams are dealing with significant index holdings, there is the potential to take a particularly long-term view. In this case there may be more benefit in considering the improvement that can be made across entire industries, or even the economy as a whole, thereby increasing beta for their clients. In order for the aggregate of these activities to improve the long-term performance of companies, all those involved in asset management companies can consider the following aims.

Aims for asset management

- Identify and consider where relevant all the long-term drivers of value in investment analysis and decision making. This includes incorporating material ESG matters as appropriate.
- Encourage companies, in line with mandates, to focus on delivering long-term value, rather than meet short-term profit expectations.
- As far as possible have an integrated approach between stewardship and investment teams, and in addition between multiple funds within one asset manager.
- Where possible look to engage with company management where there is a difference of opinion, before exercising the option to sell.
- Engage more systemically on public policy issues, collaborating with other investors where justified to achieve more impact on issues that affect beneficiaries.

Example actions – investment managers and analysts

- When interacting with individual companies, always promote a focus on long-term performance.
- Discourage the delivery of short-term earnings performance when it is achieved at the expense of the long-term.
- Include an analysis of long-term factors and the wider impact on stakeholders in your investment analysis where relevant.
- When engaging with company executives be open about your investment position in their company, whether you are a significant holder, looking to buy or have an underweight or short position.
- In pitching for mandates, or in marketing materials, be able to state clearly how one's investment activities are expected to positively enhance the underlying performance of companies or other assets over the long-term.

Example actions – stewardship team

- Make the case for integrating ESG issues directly into investment decisions because issues such as employee conditions and environmental or social safeguards can profoundly affect a company's long-term performance.[20]
- Promote more joined-up internal conversations. Encourage joint input from portfolio managers and stewardship teams when considering specific stocks. (One conversation between fund managers with executives may be sending a different message to a conversation between an ESG specialist and the company's board.)
- Encourage executive pay schemes that align incentives with the long-term success of the company.

Actions for sell-side analysts

While sell-side research is fraught with conflicts of interest, it performs a vital role in the investment chain and influences many buy/hold/sell decisions. Sell-side analysts create a public debate around companies, asking the questions on results calls and producing consensus forecasts. This improves transparency and hence accountability. Sell-side analysts often have the capacity to carry out more in-depth primary analysis than is possible on the buy-side.

Potential actions

- Perform the deep-dive independent primary analysis that is not always possible by those with less resource. By drawing attention to factors that deliver long-term value the market can value them at a premium or discount, which creates a more efficient capital market. Without this long-term information, vital considerations are not being taken into account when investment decisions are made.
- Challenge consensus thinking and achieve success through writing good research rather than marketing.
- Every research note should have a section covering the long term and wider aspects of companies' future sustainability risks and opportunities.
- Consider 3-5-year views.
- Factor in ESG analysis given evidence of benefits.[21]

Actions for companies

Too often there is a perception that companies have little power over the shareholders they attract. In contrast, the reality is that every action a company takes has an impact on the shareholders on their register and on the ability of their current shareholders to be effective stewards. Companies can proactively attract shareholders that engage and support them in pursuing their purpose and strategy.

If stewardship is working effectively then the board and executives will find interactions with shareholders a positive and useful experience. There may also be times when companies should have caution when listening to shareholders. The board and executive have a duty to promote the success of the company over the long-term. This will not always exactly coincide with the wishes of current shareholders, or those who make the most noise. It may be helpful for companies to consider the priorities of the ultimate owners or beneficiaries, who will often be individuals saving for their pensions.

Companies also have a role to promote stewardship as the sources of capital through their own pension funds. Companies can invest according to the actions outlined above for asset owners. This can help create the focus on stewardship that they would wish to see from their own shareholders.

Companies can attract and support stewardship investors through some of the following aims. These can be supported by different actions for the key individuals in a company.

- Articulate a long-term vision for the company that will attract stewardship shareholders.
- Underpin this with a clear board mandate that can be used as a basis of all communications with shareholders. The mandate defines the purpose, values, strategy, risk appetite, and time horizon of the company.
- Use reporting of the wider drivers of long-term value, such as integrated reporting.
- Avoid commenting on or adding to the short-term noise of financial markets.
- Develop strong relationships with investors, rather than with 'the market'.
- Explore ways of incentivising long-term shareholders or rewarding them for the resource invested in stewardship – for example issuing additional shares for those who have been shareholders for 2 years or more.
- Provide greater access to long-term stewardship shareholders applying the concept of the 'Stewardship AGM' championed by the Investor Forum.
- Create joined up communication between the executives, investor relations officer (IRO), company secretary and chairman.
- Create joined up communication that integrates the feedback received from the workforce and other stakeholders with that received from investors.

Chairman: The chairman has a pivotal role in forming the board, providing stability and insulating the executives from the short-term pressure of financial markets. Chairmen are also now spending more time meeting investors.

Potential actions

- Tell the long-term story so it can be captured in investment decisions.
- Create a clear board mandate, initially as a private process and document to clarify minds within the board and exco, but ultimately as robust basis for engaging with shareholders. This will help protect the executives from the occasional short-term pressures of financial markets.
- Ensure that all communications with shareholder and all stakeholders are consistent with the board mandate and linked to the company's purpose and values.
- Hold a Stewardship AGM or equivalent conversation that prioritises long-term investors and embeds a habit of dialogue around the long-term strategy and business model.
- Develop appropriate ways to ensure that stewardship shareholders are consulted and involved in the nomination of directors.
- Ensure NEDs have some time meeting shareholders and there is sufficient feedback from financial markets to the board.
- When meeting investors, where possible, request that the meeting includes the governance and/or ESG analyst as well as the investment manager.
- Executives should be rewarded for long-term performance that takes into account 'how' performance is achieved as well as 'what' has been achieved.
- Create the structures so that the board hears the views of key stakeholder groups.
- To maximise the effectiveness of discussions with ESG or stewardship specialists, ensure there is a clear mechanism by which messages filter back into executive decision-making.

Board NEDs: NEDs currently have relatively little contact with shareholders, and primarily learn about shareholder views from updates given to the board. The danger with this lack of contact is that a disconnect emerges. NEDs may misinterpret what is being asked by long-term shareholders.

Potential actions

- Initiating a discussion about the company's approach to seeking out the right shareholders.
- While the time of a NED is scarce, spend some time engaging and listening to the key stewardship shareholders. This could involve an NED meeting open to all shareholders, a yearly meeting between the board and largest shareholders, or selected meetings, or joining one day of a management roadshow.
- Challenge the executives to articulate a clear long-term vision for the company, and for this vision to permeate through all communication to financial markets.
- Challenge the executives to act in the interests of long-term shareholders, which may not be the same as the short-term pressure from financial markets.
- Ensure the board is meeting its obligations under Section 172 of the Companies Act.

CEO and CFO: Executives often complain about the short-term pressure from shareholders, when instead they could take a more proactive approach to attract and support the shareholders they want. Part of this is articulating a clear long-term vision, and part is how to interact with financial markets. Anecdotal evidence suggests that the CEO and CFO may spend 20% of their time meeting investors. The question is how to use this time to promote the long-term health of their business rather than short-term share price movements.

Potential actions

- Set out a clear vision for the company's purpose and strategy. Communicate to financial markets that pursuit of this goal will involve some short-term volatility.
- Make the case to invest long-term, even when this implies lower short-term profit.
- Develop a clear framework of indicators for the health of customer, employee, and other key relationships whether using integrated reporting or other approaches. Make this a central part of the narrative about the company's progress, thereby stimulating stewardship investors to focus more on the underlying drivers of success. Engage investors in understanding the culture of the business, encouraging investor meetings on site or in contexts where they meet managers and other staff and feel the pulse of the organisation.
- Use investor interactions as a useful means to constantly question the strategy, while recognising that the market may not always be right, including on areas such as investment allocation or what constitutes an efficient balance sheet.
- Recognise that standards of environmental and social responsibility are constantly advancing and therefore it is important to try to remain ahead of the curve.

Investor Relations Officer (IRO): The IRO has a crucial role in coordinating how a company interacts with financial markets. The IRO coordinates management roadshows, advises on messaging to investors, communicates daily with analysts and helps decide what information to disclose in reports. They also provide important feedback from financial markets back to executives and the board.

Potential actions

- When allocating management meetings, prioritise investors with a focus on stewardship and the long term. Ideally this should involve allocating company executives' time to those investors who provide the best quality conversations about long-term strategy. These should include both those who support the company's strategy but also those who do not.
- Improve disclosure of the longer-term and broader drives of value. For example, by incorporating ESG factors or adopting integrated reporting.
- When meeting investors, request they disclose their ownership position, including relative over-weight or underweight exposure, and why they have taken such a position.
- Refrain from providing too much guidance to sell-side analysts on quarterly results as this can create a false sense of short-term stability making it harder to adjust expectations when necessary.
- Only comment on news flow when necessary. Avoid adding to the short-term noise in financial markets.

Section 2: Better stewardship

Introduction

In this section we describe the context today, review progress since the launching of the Stewardship Code; and describe barriers to further progress.

The context today

- The decline of defined benefit pension (DB) schemes continues. This usually means that the investment risk is transferred from the pension fund to the individual.
- The growth of fiduciary management – outsourcing investment decision-making to a third party.
- The creation of master funds such as the *Pension Mastertrust*, created by Legal & General Investment Management (LGIM), designed to take away some of the technical burdens of pension administration for employers while allowing employees to make their own choices of funds.
- The creation of the Investor Forum to facilitate combined stewardship intervention.
- The Investment Association (IA) focus on how the investment industry can help improve UK productivity suggesting how asset managers should engage with investee companies through:
  - clearer articulation and measurement of long-term drivers of productivity
  - encouraging companies to stop quarterly reporting
  - improving reporting on capital management strategy and outcomes
  - improving reporting on culture, human capital and accounting for intangibles.
- The International Corporate Governance Network (ICGN) has developed a Global Stewardship Code, and is working to obtain an international transferability or passport so that following the code in one jurisdiction is recognised in another.
- Proxy and voting research agencies have consulted on their Best Practice Principles.
- The updated Markets in Financial Instrument Directive (MiFID II) and accompanying regulations came into force splitting payments for analyst research and trading commission.
- The EU approved the Shareholder Rights Directive, effective 2019, imposing a number of stewardship-related obligations.
- The FRC has divided signatories of the Stewardship Code into two tiers.
- The FCA's Asset Management Market Study in 2017 found that:
  - price competition is weak in a number of areas, with evidence of sustained, high profits over a number of years
  - investors are not always clear what the objectives of funds are
  - fund performance is not always reported against an appropriate benchmark
  - it had concerns about the way the investment consultant market operates.
- The Competition Commission has launched an investigation into the investment consulting market which will conclude by March 2019.
- Competition continues to place downwards pressure on fees with the shift to index funds and asset owners taking management in-house.
- New technologies increasing the risk of disruption and disintermediation across the investment chain.
- The challenge of delivering returns in a low-yield environment, after a few decades benefiting from the tailwind of declining interest rates.
- Public dissatisfaction over executive pay leading to government proposals on pay ratios.
- The collapse of Carillion and fresh questions about whose interests are served by the current system.
- Brexit and its implications for businesses and investment institutions.

Assessment of progress

A critical mass of investors?

The UK Stewardship Code was first published in 2010, and revised in 2012. It is due for review in late 2018. In its latest consultation the FRC says: *The UK Stewardship Code (the Stewardship Code) seeks to secure long-term value by enhancing the quality of engagement between investors and companies to improve long-term risk-adjusted returns to shareholders. It was developed to help build a critical mass of investors willing and able to engage with the companies in which they invest, to increase the quantity and quality of engagement, and to increase accountability down the investment chain to clients and beneficiaries.*[22]

Has the Stewardship Code succeeded against these criteria? Has it created a critical mass of investors? The FRC does not say. It does say that: *'evidence from surveys, our discussions with market participants, and assessment of signatory statements shows there has been an improvement in the quantity and quality of stewardship since the Stewardship Code's introduction.'*

Together with the Stewardship Alliance, and others, Tomorrow's Company has been involved in several exercises to assess progress and these are described below. Our overall view is that there has been progress but the FRC aspiration of a critical mass of investors has not been achieved.

A failure to link stewardship explicitly to the long-term success of companies
In 2013 Tomorrow's Company and Standard Life Investments held a series of dinner dialogues with company chairmen, institutional investors and advisors. The conclusions were published in 2014.[23] The dialogues 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
- 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
- closure of defined benefit pension schemes and consequent dispersal of decision-making to millions of individuals.

The report highlighted a shortcoming in the Stewardship Code in that, unlike the UK Governance Code, it did not explicitly link stewardship with the long-term success of companies. It therefore recommended that the preamble to the principles in the Stewardship Code be amended so that it started with the words:

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…

The need to create an evaluation framework for comparing stewardship
The report also said:

> *"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 for evaluation, hitch includes reporting, enables comparison and so makes stewardship a real differentiator in the market for retail investment."*

A 2015 joint review

In 2013-15 as part of its work with the 2020 Stewardship Group, Tomorrow's Company invited interested parties to review progress. They included corporate representatives such as the Institute of Chartered Secretaries and Administrators (ICSA), and the Investor Relations Society, and investor representatives including the Investment Association (IA) and the Pensions and Lifetime Savings Association (PLSA). The FRC was also there. At the time separate surveys on stewardship were being conducted from the investment perspective by the IA, the PLSA (then the National Association of Pension Funds) and for the company side, by the ICSA. For the first time these disparate groups reflected together on their experiences. The unpublished Tomorrow's Company summary of the issues raised was as follows:

Investors – especially asset managers – have been drawn into areas of stewardship that should be the responsibility of boards

> *'It is not the responsibility of investors to determine the details of a company's pay structure. Yet this is what has happened. This has left both companies and investors confused about their role. Institutional investors will inevitably seek to curb the amount of time spent on remuneration by referring companies to their generic policies as stated on their website – something that has annoyed companies.'*

Investors have been judged more on quantity than quality, activity rather than impacts

> *'One organisation produced a 'league table' in which stewardship is equated with voting against the company. Yet the benefit of good stewardship is often achieved behind closed doors, for example when a company is prompted by a meeting with investors to review its approach, or tackle a neglected risk.'*

The UK's Stewardship Code focuses on process rather than substance

> *'Nearly 300 organisations have signed up but it has been estimated by one practitioner that only about 30 institutions are doing the stewardship job seriously.'*

The UK's Stewardship Code is addressed to asset managers and would need to be amended in order to achieve the intended result with asset owners.

> *'Asset managers have a distinctive perspective from asset owners. Asset owners need to consider the balance of their entire portfolio, and match liabilities to assets against a longer time horizon. The larger they are, the stronger their ability to decide the terms on which asset managers act. For them stewardship is about much more than engagement with companies: it may be that, acting together, they can influence the entire business model of an industry to the advantage of their beneficiaries.'*

The nature of institutions holding shares on the London market is changing.

> *'While the largest pension funds can be extremely influential in the market, defined benefit pension funds hold a decreasing proportion of shares in London, down to just 3% on the latest figures. Their place has been taken by mutual funds, sovereign wealth funds and other international investment institutions.'*

There is need for a clearer understanding of fiduciary duty.

> *'Pension trustees and other decision makers have for a long time believed that they are prevented from factoring in a wider number of initiatives are being undertaken to clarify these obligations.'*

There is a need for asset owners to communicate clearly their demand for stewardship

> *'Once the understanding of fiduciary duty has been clarified, it is important that asset owners and other clients (both wholesale and ultimately retail) are encouraged and helped to communicate their expectations to asset managers. This will require innovation in the way mandates are set and investor performance assessed, and in the options of which they are made aware by investment consultants.'*

Conflicts of interest and alignment of the capital markets to human needs

During the same period Tomorrow's Company worked with a wide group drawn from across the capital markets. The 2015 report *Tomorrow's Capital Markets* reviewed the stewardship and the Stewardship Code in the context of its vision for a capital markets system in which financial value is understood as meeting human needs on an intergenerational basis, taking account of account of economic, social and environmental factors, and is measured using a broad range of indicators.

The report described conflicts of interest in the system and made the case for aligning skills and linking targets and incentives to the needs of clients and beneficiaries. It suggested the development of a stewardship ranking mechanism for asset owners and managers which might lead in time to stewardship accreditation in the wholesale market, and ultimately form the basis for a stewardship 'kitemark' in the retail market either for particular retail products or investment houses.[24]

A 2016 combined survey of asset owners, asset managers and service providers

In 2017, for the first time, the IA and the PLSA published a joint report, building on the separate ones that they had previously produced, in which they looked at how asset owners, asset managers and services providers discharged their obligations. The report is valuable because it goes beyond statistics to give detailed examples of the interventions that have been made. In this report on 2016 activity, 'engagement' is taken to mean the monitoring of and interaction with investee companies, 'voting' the exercising of voting rights attached to shares, and 'stewardship' as encompassing both engagement and voting.[25]

Asset owners
68% of asset owner respondents have a stated policy on exercising their stewardship responsibilities. However, 12% do not have a stated policy and 16% did not respond.

Only 10% of asset owner respondents did not consider engagement a factor in manager selection. Only 37% of asset owners set out their expectations with respect to stewardship in all mandates and a further 16% in at least half. This leaves 31% that do not address stewardship in mandates, albeit 23% said that they intended to include it soon or will consider doing so. All asset owner respondents consider they have some stewardship responsibilities with 68% including it in their Statement of Investment Principles.

Asset managers
Over 60% of asset manager respondents have institutional clients that in their majority expect them to exercise stewardship, i.e. both engagement and voting.

The survey did point to a sense of progress over previous years. Respondents considered that their engagement with nearly a quarter of companies was excellent, and good for 44%. UK companies' responsiveness was cited as the key reason for this. In terms of how this compares with the previous year: 57% of respondents indicated that there had been no change; 27% noted an improvement; and only 1% saw a deterioration. Overall, respondents reported that engagement leads to better investment decisions and thus improved long term returns for clients/beneficiaries.

Engagement was considered to enhance value. One asset manager observed that *"the quality of discussion with companies has improved over the last few years, with a broader list of issues being observed by companies and raised by shareholders. Also, the link between particular ESG issues and strategy is becoming clearer in such discussion. However, there are still too many companies only wanting to get shareholder views and approval on executive pay, which is concerning"*.

Respondents continued to report a mismatch between the issues they regarded most important, (strategy) and those on which they spent most time (remuneration). The top four issues respondents consider to be the most important are company strategy, financial performance, leadership and capital allocation.

Productivity
Over half of asset manager respondents had engaged on at least three of the issues raised in the IA's productivity report, particularly on the long-term drivers of productivity. About two thirds plan to engage on these issues in the future. 20% had engaged on discontinuing quarterly reporting and 25% intend to do so in the future.

Regulatory reticence on stewardship

Given public concern, it is disappointing that wider government policy and regulation, outside of the Stewardship Code itself, has not been more positive in signalling the importance of stewardship, let alone providing incentives for those who exercise it. This is partly due to the siloes in government and the compartmentalisation of government regulation. Take as an example the **FCA's Asset Management Market Study**. The FCA said about its terms of reference that *'the focus of this market study will be understanding whether competition is working effectively to allow both institutional and retail investors to get value for money when purchasing asset management services'*.[26] Stewardship is not mentioned in these terms of reference. And value for money was defined in the following terms which could only very indirectly be interpreted as having anything to do with the encouragement of investor stewardship.

> *'Value for money in this sector will reflect the expected rate of return, net of any costs and charges, for a given risk tolerance, taking into account the nature of service provided by the investor'.*[27]

In 2017 the FCA published its conclusions.

> *'The market study found that it is difficult for investors to know what to expect from their fund and it is difficult for investors to assess whether or not their fund is performing against relevant objectives, including those set by the fund manager. We believe that investors could benefit from greater clarity as well as being better able to compare objectives between similar funds.'*

If this regulator considered stewardship to be an important component of value for money for investors, one would expect it to make stewardship a key criterion for its assessment of value for money. The word 'stewardship' does not appear. The same applies to the FCA study of the role of investment consultants, and the referral to the Competition Commission which launched an investigation which will conclude by March 2019. Again, the context for this investigation appears to be a one-dimensional view of the market. The terms of reference do not mention stewardship, and nor, so far, have any of the hearings or submissions from the major players in investment and investment consulting industry.

Action by government and regulators will never be the primary driver of progress. Yet if some of the key market regulators of the investment industry seem to pay so little attention to stewardship, that is bound to inhibit progress.

Barriers to stewardship across the investment chain:

Asset Owners

- Limited understanding of stewardship, and difficulty in communicating expectations to asset managers.
- Despite efforts by the Law Commission, pension trustees often misunderstand their fiduciary duty, even fearing litigation if they depart from a focus on short-term profit maximisation.
- Good stewardship is hard to measure, assess or disclose. As such it remains easier to base investment decisions on short-term performance.
- Fragmented pools of capital, especially in UK pension funds, create a lack of resources for stewardship.
- The combination of regulation and sponsor pressure can drive some pension funds to compromise longer term value creation in order to avoid short-term volatility.

Investment Consultants

- Not promoting stewardship to their clients.

Asset Managers

- Pressure for quarterly reporting.
- Stewardship too often remains a siloed activity that is seen as an extension of ESG (environmental, social and governance) rather than integrating stewardship into investment decision making.
- Asset managers are often incentivised to achieve short term performance.
- The amount of time devoted to remuneration has driven out other issues.
- Stewardship involves cost to the steward but the benefits are enjoyed by other shareholders.
- The best stewardship engagement may take place in private and go unrewarded

Sell-side Analysts

- Not producing research that is long term.
- Not producing research that captures broader issues such as the risks and opportunities of environmental, social and governance factors.

Clients and Savers

- Investment and pensions remain a ‘black box’.
- Individual savers are not aware of or interested in the choices they have. (Most savers in master trusts use the default option).

Companies

- Short-term CEO tenure and remuneration.
- Companies are too rarely proactive in creating a board mandate and attracting investors who will support it, and discouraging investors who have different priorities.
- Boards can become distracted by the obligations of quarterly reporting and the short-term noise.
- Boards and executives on the one hand, and institutional investors on the other, can slip into a ‘dialogue of the deaf’ where each assumes that the other is not interested in stewardship.
- The risk of an opportunistic take-over can make it hard for a company to focus on the long term.
- Smaller quoted companies complain that it is hard to engage investors because they are low priority.

Government and Regulators

- No coherent commitment to stewardship across departments.
- Stewardship as a policy objective not reflected in the work of FCA, Competition Commission.
- FCA approach to asset management focuses on narrow model involving price competition.
- FRC in early years pre-occupied with:
  - quantity of signatories, not quality of stewardship
  - reporting of process, not substance.

Section 3: An agenda for concerted action

Introduction

In this section we set out the road map for future progress. We describe how better investor stewardship will be achieved in a pincer movement between industry leadership and government policy, both informed by a common underlying approach to stewardship.

Stewardship works by multiple channels of influence. The current Stewardship Code tends to focus on the activities of asset managers and their interactions with companies. Better stewardship will be achieved only when there is a search for stewardship solutions across the entire investment chain that links ordinary clients and savers at one end of the chain with boards and companies at the other. Critical mass will be created by a synergy between multiple decisions and interactions spanning boardrooms, analysts, advisors, assert owners and asset managers. This in turn will lead to a pervasive culture of stewardship across the whole system, and the emergence of a common language for good stewardship and a recognised evaluation framework, rather as a commitment to total quality became pervasive in the 1980s and 1990s. However, if this is to be achieved quickly, sceptical pension trustees and clients of the system need to understand in simple terms what's in it for them. This will only be done by a combination of industry leadership – illustrating the benefits by track record – and government and regulatory action which creates an environment that rewards stewardship.

Industry leadership

We cannot expect too much from the Stewardship Code on its own. There is a difference between the letter and the spirit of the regulation. A code may provide improved accountability through its focus on reporting of policies, but it can only achieve real progress where there are active champions who lead by example. Reporting on process alone achieves little, particularly if it risks encouraging quantity rather than quality of stewardship.

If a fund manager or analyst asks a CEO a valuable question in a one-on-one meeting, the positive influence on the company will always be private. Ways need to found to celebrate good stewardship even when these cannot be assessed or disclosed. The ICSA Award for Best Investor Engagement (as experienced by company secretaries in their work) is a valuable first step in this direction.

The success of the quality movement may provide useful lessons. The Malcolm Baldrige awards in the USA, and the awards made by the European Foundation for Quality Management and the British Quality Foundation are all the fruits of a determined effort to define and compare best practice in areas which were previously thought impossible to quantify. The European Business Excellence Model was developed in the 1990s. Companies invested time in creating these quality bodies because they recognised that otherwise there would be no robust basis for benchmarking and stimulating progress. The first step on the journey to such celebration of excellence is to have a rigorous and agreed definition of all the elements that go to make up excellent practice in a previously indefinable area. A national investor stewardship award could then be one valuable way of rewarding those in all parts of the value chain who have demonstrated excellence, and creating a virtuous circle of learning and continuous improvement.

Success for investor stewardship will be assured when a common language has been developed and adopted for describing and ranking investment institutions, advisors and companies on the basis of their stewardship. The Carbon Disclosure Project (CDP) is an impressive example of an organisation developing a common language to compare performance in a vital area that was once thought hard to measure, albeit dealing with a more tangible issue. CDP has taken a non-financial issue and elevated the ability to measure it, while in the process stimulating the sharing of experience and good practice.

The common language for better stewardship would need to draw in turn from a synthesis of understanding which already exists in other areas. For example, there is a growing understanding of human capital management and how to assess it which is championed by bodies like the Chartered Institute of Personnel and Development. The stewardship 'movement' needs to be connected with all those organisations which can offer the specialised knowledge that can underlie better engagement and stewardship by investors. Imagine how much more positive the investor process of influencing remuneration might be if it had been grounded from the start in thoughtful research and dialogue with the HR profession about the key to attracting and developing talent, and motivating performance in organisations and teams, and all the other factors apart from salary and bonuses that may need to be in place to achieve it.

Increased collaboration will be another sign of progress towards critical mass. The IA survey for 2016 reports that 33% of asset manager respondents had been involved in collective engagement in the course of the year. The Investor Forum has been established to promote and facilitate collaboration and has published a Collective Engagement Framework.[28]

Where will the industry leadership come from?

Progress is often stalled by the complexity of the investment chain where there is a tendency to blame the lack of progress on other parts of the chain. This can be simplified by each individual asking themselves – *how are my actions helping improve the performance of the underlying assets over the longer term?* The barriers can sometimes seem insurmountable, but change will come from the many small actions of individuals. These actions reinforce each other to form the habits, values and ultimately culture of stewardship across the investment chain.

The obvious question this raises is about industry leadership. In 2010 the Institutional Shareholders Committee announced its intention to create an Institutional Investor Council (IIC) to '*build a single voice for the institutional investor community and strengthen its profile*'. With the merger of the investment interests of the insurance industry with the Investment Association, this body was wound up, leaving the Investment Association as the voice of the institutional investor community, with the Investor Forum intervening in specific cases. Of course, issues of stewardship go much wider than the span of the IIC. There is, to take one example, a divergence of perspectives between the corporate and the investor view. Just as total quality needed championing by a dedicated body drawn from all relevant business practitioners across a wide span of activity, so future stewardship may need championing by a dedicated body connected with all parts of the investment and corporate community, and other stakeholders.

Government policy and regulation

The second part of the pincer movement to improve investor stewardship needs to come from government policy and regulation.

It is crucial for the UK government, from the Prime Minister downwards, to set out a clear vison and policy for wealth creation, and then to insist that relevant departments of state respect the policy. Given the economic challenges ahead for the UK, it is important for all government decision-making to take account of the impact of policies on long term wealth creation by companies, small, medium and large.

Long-term investment institutions and frameworks

In '*Promoting long-term wealth*', a report in 2017 for the All Party Parliamentary Corporate Governance Group, Tomorrow's Company made a series of recommendations for action by government. These included:

- The creation of Long Term Capital Trusts – (LTCT's) – a new tax-efficient trust structure that has a mandate to support UK economic growth by being an engaged stewardship investor in UK companies.
- A new framework providing LTCTs and other shareholders in UK companies with an ability to designate a specific stake as a stewardship stake. Institutions would commit to a two-year lock-up of shares after which they would be required to observe a 3-month rolling notice period to unlock. In return they would enjoy double votes on remuneration only. They would also be entitled to access to companies through stewardship meetings along the lines of the Stewardship and Strategy Forum now organised by the Investor Forum.[29]

This is one example among many of policies which a government might adopt if it wanted to promote long-term wealth creation in companies in line with the principles of stewardship. It may not be the best: what matters is that government recognises that it has a vital role to play in creating the conditions in which stewardship influence becomes stronger and counteracts the short-term pressures which currently deflect companies from sustainable value creation.

Revised terms of reference for regulators

A clear wealth creation vision would, in turn, be reflected in the terms of reference for regulators. Asset managers are regulated by the FCA. The FCA's strategic objective is 'to ensure that the relevant markets function well'. Its operational objectives are to *protect consumers, to protect financial markets and to promote competition*.

But what is meant by a market that functions well? Is it one that facilitates the highest frequency of trading? Nowhere in these objectives is there anything that directs the FCA to align its functions with the need for stewardship – the responsible management of inherited resources so that they are passed on in better condition. This needs to be changed.

The FRC's stated mission is *'to promote high quality corporate governance and reporting to foster investment.* In explaining why it has this mission it goes on to say that *the capital markets are important to the health and growth of the economy. Our functions contribute to the effective functioning of the capital markets. We help ensure that investors have what they need to place their money with reasonable confidence that any risk is taken on an informed basis and managed as well as it can be. In turn, the entities in receipt of that investment can have the confidence to invest in their own strategies and workforces.*'

Again, this statement of purpose does not necessarily point the FRC towards influencing capital markets in ways which protect the stakeholders of tomorrow from the effective functioning of capital markets today. It does not suggest any preference for long term wealth creation by companies.

Reassuringly the FRC has interpreted its brief in managing the UK Governance Code and the Stewardship Code as being linked to the creation of long term wealth. Nonetheless it would be helpful if its stated mission mentioned the importance of stewardship in the functioning of capital markets.

Revised Stewardship Code

In its December 2017 paper The Purposeful Company project (TPC) has offered detailed recommendations under four headings:

1. The Code should reinforce the criticality of an integrated approach to stewardship throughout the investment chain (i.e. not just asset managers, but also individual investment funds within asset management companies, asset owners, ultimate owners, and service providers – 4 entities in the chain).
2. The Code should recognise the diverse role stewardship plays in the purpose of investment chain entities. (i.e. don't hold funds to a 'one-size-fits-all' benchmark).
3. Investment chain entities should define their approach to stewardship as part of their purpose, including at the fund level.
4. The Code should cover not only stewardship policies but the actual delivery of stewardship with organisation and reporting tightly linked to the stewardship approach to assure genuine implementation. This is because 'currently there are widespread concerns that the Code's tiering is based on the quality of the signatory's Code statements, rather outcomes.[30]

TPC goes on to recommend the component parts and principles for a new code for all four entities in the chain. It also suggests that the Code signatories should report against their stated purpose on the basis of Apply and Explain, rather than Comply or Explain.

These suggestions are a sensible starting point for revising the code, and moving it away from the focus on process. They are consistent with the recommendations made by Tomorrow's Company with Standard Life Investments in the 2014 report '*Building the Momentum for Effective Investor Stewardship*'.[31] Here the emphasis was on clarity – clarifying the law so that pension trustees knew where they stood; clarifying the way in which asset owners set out their stewardship expectations to asset managers; clarity in asset manager description of their stewardship intentions and achievements; clarity in a strengthened preamble to the Stewardship Code reinforcing the focus on the long-term success of companies.

Section 4: Stewardship tomorrow – consultation questions

Purpose of consultation

At the start of this consultative report we describe a troubling disconnect between our system of wealth creation, and the society which it serves, and noted that too often the attempt to tackle these problems deals only with individual symptoms. A systemic response is needed. That means:

- Leaders and practitioners at all points in the stewardship chain developing a shared agenda and each doing what they can to move the system in a concerted way towards better outcomes for shareholders and society.
- Government, regulators and others creating conditions in which people can see the benefit from these actions, and even have incentives or rewards from doing them well.

This not a formal consultation. The questions which we are asking are intended to achieve two things:

- First, to stimulate and influence all those involved in the debate prompted by the FRC around the future of the Stewardship Code to take a more systemic view in considering how they can contribute to the progress of stewardship. Success in this first objective would be a critical mass of investors and others with a strong and shared commitment to long term wealth creation.
- Secondly, to provoke a wider dialogue which engages not only investors, companies, advisors and regulators, but citizens, policymakers, politicians, trade unions, consumer groups, and the next generation in a discussion about wealth creation and stewardship. Success in this second aim would be in four parts. First a greater understanding of how consumers, citizens, and retail investors could bring their priorities to bear in influencing the investment system. Secondly a better-informed policy and political debate. Thirdly a greater commercial demand for stewardship from clients. Finally, action by government, regulators and others to encourage better stewardship.

Definition and principles of stewardship

Do we agree that stewardship's importance lies in its ability to contribute to responsible long-term wealth creation by companies? If not, how would we describe its importance?

Do we agree that, overall stewardship is '*the responsible management of inherited resources so as to hand them on in better condition?*'

From our place in the system what might our contribution be to better stewardship? What changes around us might encourage us to improve our contribution?

Do we agree with the four principles of stewardship described in the Appendix?

If so, how could we ensure that we are putting them into practice, and demonstrating this through our measurement and reporting to clients?

Importance and scope of stewardship

How could we as investment institutions deliver greater value to clients and beneficiaries by ensuring that a company is being led and managed in a way that reflects the wider needs and concerns of its customers, employees, suppliers, society and other stakeholders?

How could there be more concerted stewardship action along the whole of the stewardship value chain linking companies with savers and investors through asset owners, asset managers and all advisors?

What more could be done to codify the contribution to better stewardship of:

- investment consultants
- investor relations
- proxy agencies
- research analysts, sell-side and buy-side
- others?

How might any or all of these be incentivised or encouraged to do this?

Leadership actions

Do we agree that the agenda set out in Section 1 is a good description of:

- the actions that we need to take as part of the value chain
- the actions that others need to take?

If so how might we use these questions? What would we change, remove or add?

Do we agree that the best changes come when they are industry-led, with the key players in the value chain working together towards a common goal and a shared definition of quality, reinforced by regulation, law and incentives?

Where do we see leadership coming from to encourage better stewardship? What is the contribution of our organisation to moving things forward? What would encourage us to contribute more to this agenda?

How might the various parts of our 'industry' develop some voluntary standards of best practice around stewardship. Are the actions listed in Section 1 a good foundation for this?

Incentives

What other ideas do we have for encouraging or incentivising better stewardship?

Do we favour the idea of the development of a Better Stewardship Award as a way of creating a common understanding and success language around the practice of good stewardship? What activities or contributions might asset owners or asset managers be rewarded for?

Government policy and regulation

Are we satisfied that, overall, there is a clear and coherent government agenda for promoting long term wealth creation in a responsible way?

The FCA regulates asset managers but stewardship is absent from its terms of reference. Would it make a difference if stewardship were a clear priority across all arms of government?

Do we agree that best regulation occurs when it builds on voluntary standards set within an industry, and secures over time a wider commitment to acting, measuring and reporting against those standards? If so how might the various parts of our 'industry' develop some voluntary standards around stewardship?

On the Stewardship Code itself how might the code:

- better link stewardship to long term wealth creation
- be extended in an integrated way to all links in the investment chain (i.e. not just asset managers, but asset owners, advisors and service providers)
- deal with the different objectives of different investment funds within asset management companies?

What specific changes would we like to see in government policy towards:

- consolidation of pension funds and asset owners
- fiduciary duty
- other pensions law and pension fund governance
- the law and regulation covering savings
- incentives and rewards for shareholders who take stewardship seriously
- the law and regulation covering the role of asset managers and their advisers
- the law and regulation covering companies, their boards and their advisors.
- the law and regulation covering remuneration and long-term incentives for executives
- other?

Appendix

The Tomorrow's Company Stewardship Principles

Principle 1. Setting the course: attention to clarity of purpose, roles and relationships

Stewardship exemplars insist on clarifying purpose and respective roles and relationships. This includes being transparent about what the organisation is for, what it believes, and to whom it is accountable. The focus is on the arrangements for accountability, and how the different parties which are needed to make stewardship effective will work together and whether they are investing sufficient resources to achieve this. This principle reflects the need to insist on clarity, transparency and consistency in how the company is run.

This means being involved, thorough, honest and uncompromising in upholding the importance of stewardship – defining and publishing the purpose and philosophy of the organisation, making a clear, public statement setting out the relationships between the owners, the organisation and its other stakeholders, and the roles and responsibilities of each party. And it means being both open about and faithful to these commitments, and being accountable for the long-term as well as the short-term health of the company.

Setting the course: questions for companies

- How similar are the views of the board and the shareholders about the future of the company's industry and the company's place in it, and what steps are taken to align these views?
- Does the board create opportunities for effective discussion between the board and shareholders about the company's strategy?
- What are the criteria for adapting the company's purpose and role and how have these been developed with input from shareholders?
- What are shareholders' criteria for the board being effective?
- Is the company clear about the characteristics of the stakeholders it wishes to engage with and the terms on which it will engage with them?
- Do shareholders have opportunities to have effective dialogue with the board?
- Do boards have opportunities to have effective dialogue with the shareholders?
- Are shareholders involved in nominating board members and overseeing remuneration arrangements?
- What mechanisms are there to hold the Chairman and board to account for their stewardship? Does the AGM fulfil this purpose?
- How clear are the executive directors about the different duties and responsibilities they have to the company and to shareholders as board members and as executives?

Principle 2. Driving performance: attention to performance and improvement

Unless an organisation gets the basics right, it will not survive. Stewards have an eye on the current and future operational performance, looking at the organisation's approach to all its relationships and resources and asking whether they are making the most of the opportunities available. They are making sure the organisation is as robust and resilient as it can be and that it is in a position to respond quickly to the unexpected. Good stewards are always looking for improvement – better products and services, better relationships, better suited to the environment. No matter how good things are there is a sense of confident restlessness.

Good stewards engage in uncomfortable conversations that challenge the status quo and the assumptions that underpin the business model. They insist on evidence. They encourage constructive challenges to current practices and adapt readily when required. Outstanding performance is a cause for celebration, but also for challenge, so that the underlying levels of risk are understood and managed.

Driving performance: questions for companies

- How do the board and the shareholders keep abreast of their customers' experience?
- In what ways do the board and shareholders keep their finger on the pulse of the workforce and skill base of the company?
- How does the board review the company's arrangements for dialogue with and learning from stakeholders?
- How do the board and the shareholders monitor the culture of and the behaviours in the company?
- How does the board keep abreast of risks in the supply chain?
- How are leading indicators built into business strategy, planning and reporting and over what horizon?
- What are the board's criteria for changing processes and procedures and how have these been developed with input from shareholders?
- How effective is the management information system at keeping directors and therefore shareholders informed of the company's performance and the changes that need to be made?

Principle 3. Part of the landscape: attention to the wider world

Good stewards look outwards. They act on the basis that they are a part of a system that can be influenced. They recognise that the success of the organisation is bound up with the health of its surroundings. Good stewards engage with key stakeholders, picking up external perspectives. Through this engagement they are aware early of new threats and opportunities that are emerging from the external environment. They handle challenges effectively, acknowledging that others have positive contributions and testing all perspectives for their impact on the future of the company. They see the connections between the prosperity of the organisation and its external context – in terms of training, talent, social stability, environment and all those other factors that affect its capacity to operate, and get involved in those issues. They safeguard the organisation by seeing it as part of something bigger and are clear of its place in the external environment.

This means achieving the organisation's objectives through paying attention to more than the narrow interests of one group of stakeholders. It means seeing the organisation as something more than the tangible benefits that can be taken from it – and believing that the more you put into an organisation, the more you and all its stakeholders will get out. Some people would describe this principle as enlightened self-interest; others express it as 'we are all in this together'. Others have seen this as being a force for good. Whatever the label, this principle is not about the sacrifice of corporate interests to those of others: it is about the intelligent pursuit of self-interest through mutual advantage, and the fresh opportunities and improved risk management that come from a heightened peripheral vision.

Part of the landscape: questions for companies

- How does the board map the company, and its risks and opportunities, on to its wider environment?
- How does the board define value beyond just financial metrics?
- How does the board anticipate and deal with potential conflicts between different stakeholders?
- How does the board assess the significance of changes in public policy and the wider environment and the potential impact of these changes on stakeholders?
- What criteria does the board employ for engaging with public policy-making processes and how have these been developed with shareholders?
- What account does the strategy take of the opportunities and risks presented by the company's key relationships?
- How well are the key relationships identified, defined and monitored?
- What dialogue does the board have with shareholders or their representatives on these issues?
- Do board and shareholders pay as much attention to the spirit as to the letter of regulations, contracts and obligations?
- How effectively is the management of the company's relationships reflected in the remuneration and incentive scheme for the directors?

Principle 4. Planting for the future: coherence over time

While maintaining a relentless focus on the organisation's current health, good stewards balance this with a sense of its future potential and health. Short-term survival is a part of stewardship, yet there is a consistency and coherence between the actions taken in the short-term and the long-term objectives.

This is not about saying that the long-term is more important than the short-term. Organisations and their boards need to balance both. This principle is about recognising that short-term and long-term success are both important, and ensuring an adequate focus on, and investment in, talent and infrastructure for the future without unduly neglecting the present. Stewards are aware that a series of short-term decisions can undermine a long-term objective and act to maintain the consistency between the short- and long-term.

In the company context, this can sometimes mean boards being robust in resisting the pressure from some investors for premature distribution of profits. For investors, this can sometimes mean supporting the directors' desire to invest in areas which may not immediately be linked to rises in the share price – like talent or leadership development, or health and safety. It may sometimes mean stimulating the company to grow organically or through acquisition, but it could also mean restraining the 'empire building' tendencies of acquisitive CEOs whose desire to run a bigger company may not be in the interests of shareholders.

Planting for the future: questions for companies

- What is the balance between the importance given to short-, medium- and long-term performance indicators?
- Who decides this balance? Does it come from the board or from investor pressures?
- What steps does the board take to ensure that the short-term goals of the company and its shareholders are consistent with the company's long-term strategy?
- Does the board have a clear picture of its shareholders' expectations for the short-, medium- and long-term performance of the company?
- Is the company investing sufficiently in key building blocks that will sustain long-term performance?
- How effectively are the short-, medium- and long-term objectives of the company reflected in remuneration and incentive schemes?

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Promoting Long-term Wealth: Reshaping corporate governance (2017)

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About Tomorrow's Company

Tomorrow's Company is an independent non-profit think tank that exists to inspire and enable companies to be a force for good in society. It believes business can create more value for shareholders and society by adopting an approach that focuses on purpose, values, relationships and the long term. It succeeds in its goal by convening business leaders, investors, policymakers and civil society organisations to develop practical solutions to shared challenges. Tomorrow's Company was founded in 1996 following the RSA inquiry into the role of business in a changing world.

About the Stewardship Alliance

The Stewardship Alliance evolved from the 2020 Investor Stewardship Working Party, convened by Tomorrow's Company. It now comprises representatives of the following organisations:

Aviva Investors
BlackRock
HSBC Global Asset Management
Hermes
Legal & General Investment Management
RPMI Railpen
USS

Earlier research by Tomorrow's Company identified a growing concern that progress following the introduction of the Stewardship Code in 2010 had reached a plateau. In response Tomorrow's Company formed the Stewardship Alliance, a group of asset owners, asset managers and others involved in the quest for better stewardship. In partnership with Tomorrow's Company and building on its work with companies on good governance, the Stewardship Alliance has worked to pioneer excellence in stewardship and thereby enhance the focus on long term value creation. We hope to encourage all participants in the investment chain to add their weight to the movement for better stewardship, which reflects less regulatory push, and a stronger pull from commercial demand.

Work with us to inspire and enable business to be a force for good, join our community at:

www.tomorrowscompany.com

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