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We’re All Activists Now - Unlocking the Stewardship Potential of Investors

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The application of sub optimal governance practices and the inadequate oversight of risk can have a significant toll on shareholder returns. The continued difficulties and challenges faced by a number of banking companies, for example, around the world are a timely reminder to investors of the necessity for owners of companies to ensure high standards of stewardship. In the highly complex world of the modern financial corporation in particular, the risks of governance and stewardship failure are magnified.

What can shareholders do? Potentially, a lot but only if we can overcome the current impediments to shareholder engagement and embrace an alternative model that is more relationship based as opposed to rules based.

Activists and Confrontation

The many victories and occasional defeats of shareholder “activists” in the U.S. market make for good headlines but whether it is a sustainable model for corporate engagement and the protection of owners’ interests over the longer term is debatable. The argument about whether activists create value has had a thorough airing, not least in the world of academe, and the results seem pretty reassuring when measured over time intervals of up to five years.

Look closely, though, and activism often yields its greatest rewards in situations where the stewardship of the company already has degraded value for the existing base of investors. In effect, shareholder inaction leaves value on the table for activists to exploit.

Research shows that institutional investors are not averse to activists doing the heavy lifting when it comes to the optimization of governance or the unearthing of hidden value. But given that the sum of activist and hedge strategies, at $2.5 trillion, is less than 5% of the value of the global stock market, their influence would seem limited.

The portrayal of the role of the activist in a media that thrives on controversy has also contributed to the perception that company engagement in the U.S. market is frequently confrontational in nature. It also appears highly rules-based and overly reliant on regulatory and law enforcement bodies to deliver stewardship outcomes beyond simple deterrence to chicanery and fraud.

Lawyers as Fellow Travellers

The tightly and densely drawn regulations relating to corporate disclosure and a legacy of hostile engagement from activist greenmail to the fights over proxy access have also placed a premium on the role of lawyers working with companies and their owners. In particular, the evolution of the regulatory requirements attached to corporate reporting has given rise to reams of data that might be compliant from a legal standpoint, but is of limited use from an investment perspective. A narrow legal approach to disclosure risks getting in the way of effective communication between companies and their shareholders. The Securities and Exchange Commission is planning to look at this very problem with a review of regulation S-K*.

These are not the only impediments to effective shareholder engagement. Arguably, the consequences of inertia can also be added. The strictures of Regulation FD** are often cited as an excuse for investor passivity. This is despite frequent clarifications by the SEC that explicitly encourage dialogue between companies and their owners. In other jurisdictions, regulators have also provided helpful guidance relating to collective shareholder engagement on matters of legitimate concern or matters of governance. Non-specific angst about rules relating to market abuse and shareholder’s acting in concert is thus no longer an excuse for inaction.

Asset Owners and Asset Managers

A less frequently discussed but subtle impediment to effective corporate engagement is contained in the mandates given by asset owners to their money managers, the institutional investors. Investment strategies that eschew company contact are perfectly legitimate. There is, however, plenty of scope for disappointment in the grey area of those mandates where stewardship and engagement activities are assumed rather than specified.

The role of benchmarking in the delivery of client objectives has also come in for some long-overdue scrutiny. Here the debate has focused on whether adherence to these benchmarks promotes asset manager behaviours to the long term detriment of the clients. Oddly, most of the debate has centred on so-called short-termism, as if the achievement of a return over a long period was somehow intrinsically better than over a short one.

Yet the real source of the disappointment of the client's expectations lies in the asymmetry of risk between asset owner and money manager; for the latter, the risk in these mandates is performance relative to the benchmark, whether up or down. For the owner, who after all cannot eat a relative bagel, the risk is that the liability or required return will not be met. For those owners made poorer because they are looking at a negative nominal return, but positive in a relative sense, corporate engagement and the assurance that it provides becomes a second order priority.

The Relationship-Based Model

An alternative model is emerging which casts engagement in a wholly different and arguably more constructive framework, with potentially better outcomes for its participants. Here engagement is relationship based, which is an exemplar based on the mutual understanding of objectives by the companies, their owners and the money managers.

Such a model is non-adversarial yet still purposeful and allows company management to manage while keeping the owners abreast of changes to the risk profile of the business. It aims to restore the proper character and purpose of a company, whether quoted or not;

namely, a joint enterprise between the company directors (the agents) and the providers of the perpetuity capital (the owners or shareholders).

At the heart of this relationship is the application of the principles of good stewardship. As each company is different, the source of good governance and stewardship is not to be found in un-yielding rules but in principles that can be flexibly applied. This permits understanding while minimizing the potential sources of friction.

For the owners of companies, the key stewardship principle is the accountability of the agents that they employ on their behalf to run the company. For the latter, the key principle is the persuasive articulation and delivery of the purposes of the company. For both, good governance and stewardship are those business practices that contribute to the delivery of value on a sustainable basis and contribute to the company's competitive position.

Of course, all this is easier said than done, and it requires a far better understanding and appreciation of the costs of agency by key participants in the investment chain between asset owners and companies – as the experiences of the banks demonstrate. The observable improvements in the governance and stewardship practices of US corporations has arguably been the function of regulatory intervention and law enforcement vigilance post crisis; but that there has been an improvement is not in doubt. A broader base of asset managers and owners now need to examine how it can contribute to the further evolution of best practice. We should all be activists now.

* Regulation S-K lays out the reporting requirements for the SEC filings used by publicly listed corporations.

** Reg FD is Regulation Fair Disclosure which was introduced by the SEC in 2000. It says that publicly listed corporations must disclose material information to all investors at the same time.