Institutional investors: Recent developments and stewardship considerations

The 2010 Meeting of the Latin American Corporate Governance Roundtable

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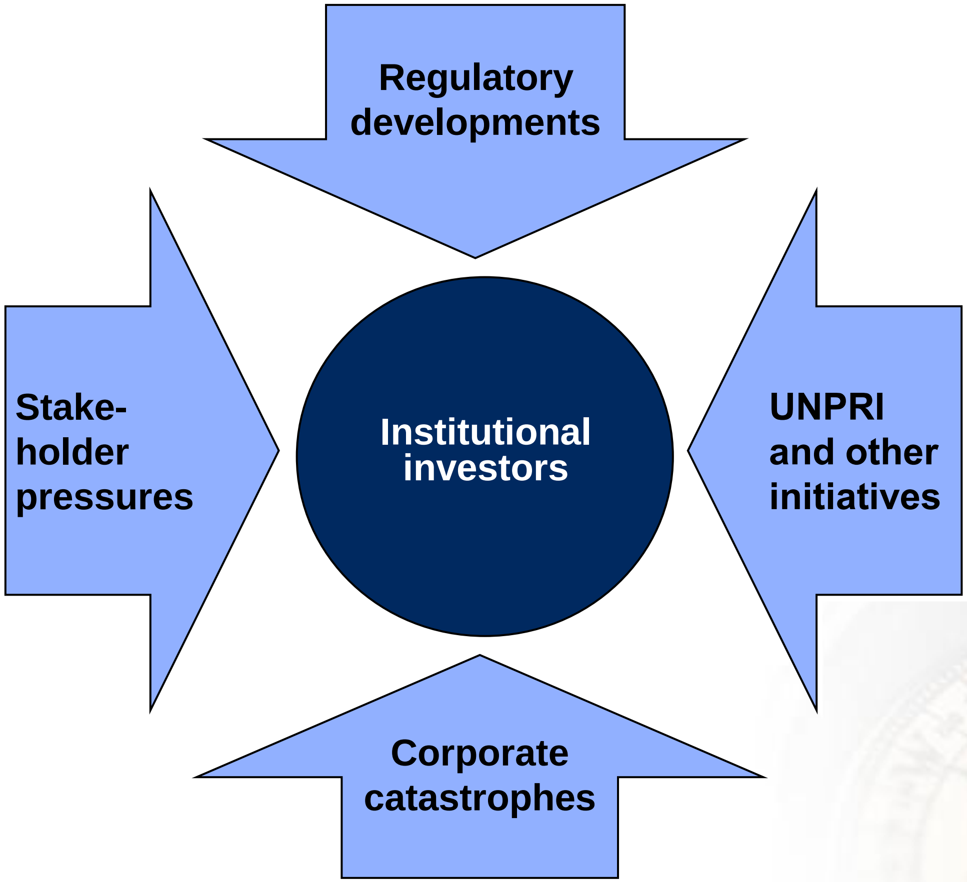
FORCES DRIVING INCREASING INSTITUTIONAL INVESTOR FOCUS ON ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) ISSUES

- Regulations (e.g., UK - Pensions Act, Denmark - investment firm ESG reporting requirements) have increased focus on ESG

- NGOs are targeting asset owners and asset managers in social, ethical and environmental campaigns (e.g., cluster bombs, access to medicine)
- Greater media coverage of ESG activities of investors



- UNPRI has been highly influential in sparking interest in ESG
  - UNPRI is a threshold requirement in some mandates
  - Signing up to UNPRI to differentiate from competitors
- Other initiatives, such as the UK Stewardship Code, are also expected to spur interest in ESG activities

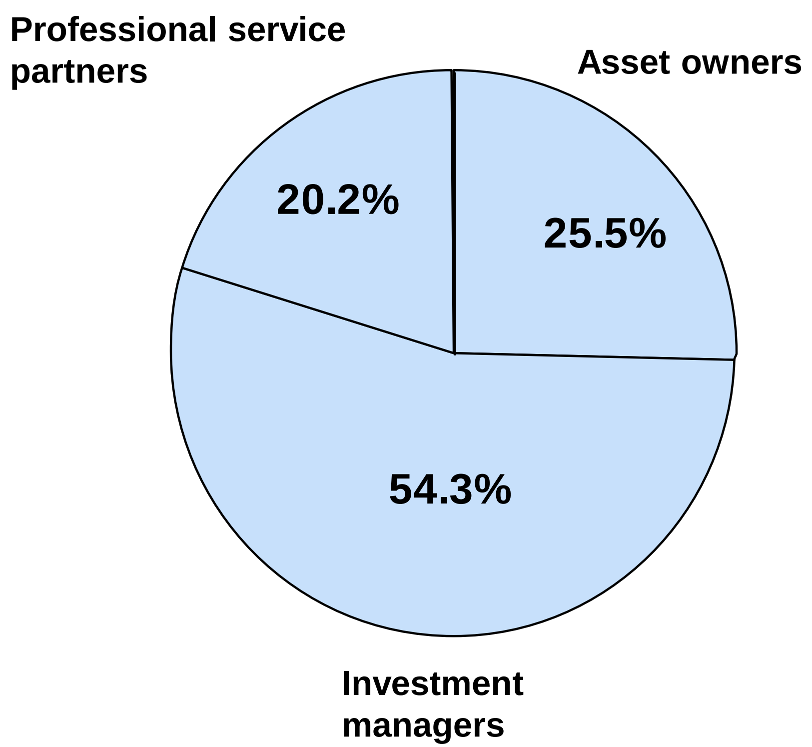
- Corporate catastrophes (e.g., RBS bailout, BP oil spill) have impacted focus on and approach to ESG

UNITED NATIONS PRINCIPLES FOR RESPONSIBLE INVESTMENT – OVERVIEW

Description

- Developed in 2005-2006 by institutional investor working group under auspices of UNEP FI and UN Global Compact
- Signatories commit to implement 6 principles covering
  - Incorporation of ESG* issues into investment decision-making
  - Active ownership
  - ESG disclosure by investee firms
  - Promotion of UNPRI
  - Investor collaboration
  - Reporting of UNPRI implementation
- Membership has grown rapidly – from 550 to 820 during Jul 2009-Sept 2010. Signatories drawn from 45 countries with aggregate assets under management of US$22 trillion
  - Top 5 countries by signatories: US (120), Australia (114), UK (106), France (59), Brazil/Netherlands (44)
  - Other Latin American countries listed: Ecuador (1), Mexico (1), and St Vincent & the Grenadines (1)

Membership by category
September 2010 (N=821)



Source: UNPRI

THE UK STEWARDSHIP CODE

Best practice guidance for UK institutional investors* on engagement

Overall objective

To enhance the quality of the dialogue of institutional investors with companies to help improve long-term returns to shareholders and assist with the efficient exercise of governance responsibilities

Key elements of code

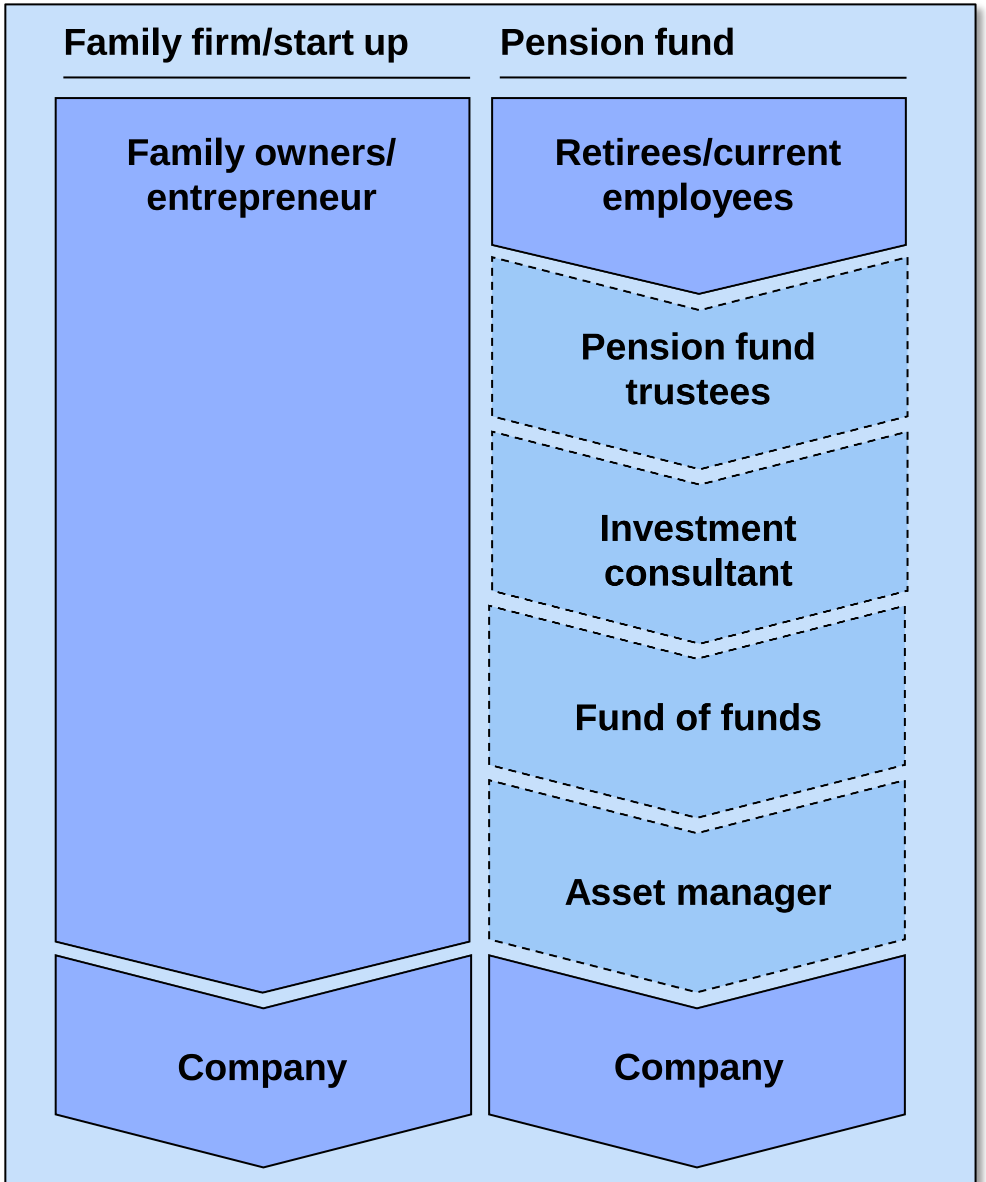
- ***Principle 1:*** Institutional investors should publicly disclose their policy on how they will discharge their stewardship responsibilities
- ***Principle 2:*** Institutional investors should have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed
- ***Principle 3:*** Institutional investors should monitor their investee companies
- ***Principle 4:*** Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value
- ***Principle 5:*** Institutional investors should be willing to act collectively with other investors where appropriate
- ***Principle 6:*** Institutional investors should have a clear policy on voting and disclosure of voting activity
- ***Principle 7:*** Institutional investors should report periodically on their stewardship and voting activities

* Pension funds, insurance companies, and investment trusts and other collective investment vehicles and any agents appointed to act on their behalf.

INSTITUTIONAL INVESTOR STEWARDSHIP CONSIDERATIONS

1. Emphasize active ownership ***and*** long-term orientation
2. Align incentives and performance metrics with long-term orientation
3. Be aware of the risks of increasing intermediation of ownership
4. Manage portfolio size to enhance monitoring incentive and quality
5. Accommodate the different stewardship approaches of institutional investors

HAZARDS OF INCREASING INTERMEDIATION OF OWNERSHIP

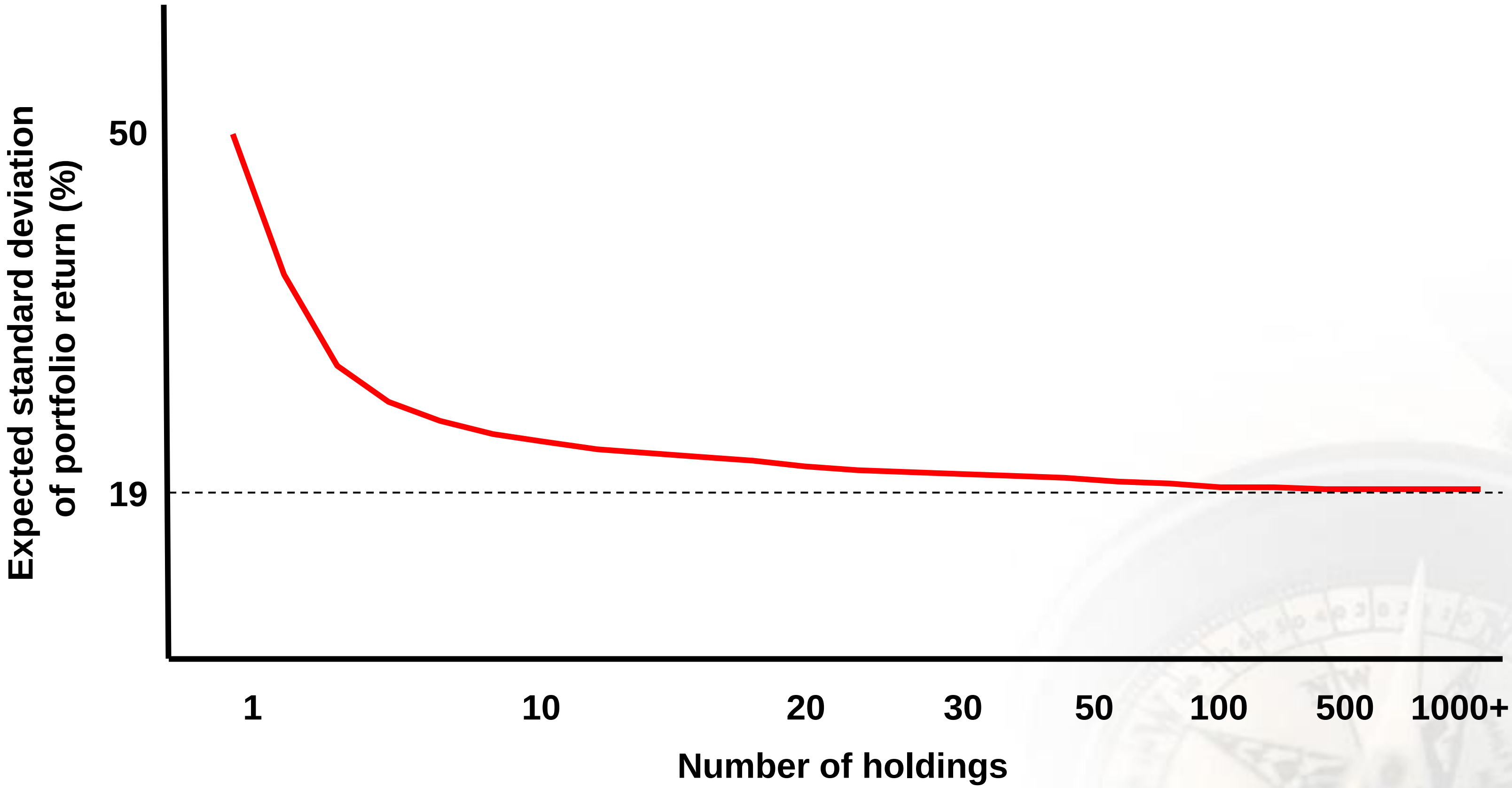


Key concerns

- Existence of intermediaries in the ownership chain means that metrics must be devised to measure their performance
- At present, short-term (e.g., quarterly) and relative measures are typically employed, giving rise to
  - Misalignment in time-horizon
  - Reduced sense of “ownership”
  - Increasing portfolio turnover (trader mentality)
  - Corresponding pressure exerted on companies to focus short-term
- Some intermediaries (e.g., pension fund trustees) possess neither requisite skills nor sufficient incentives to be effective stewards

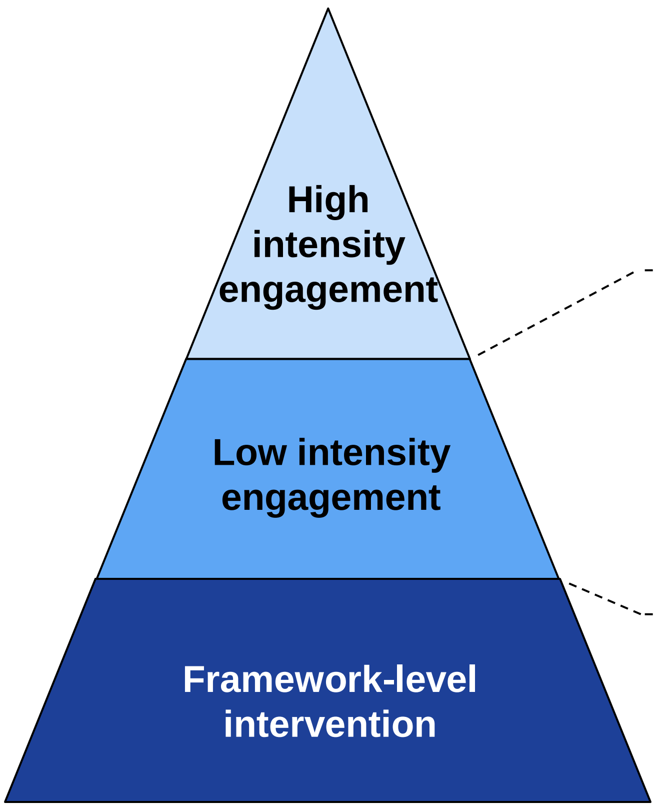
Source: Wong, Why stewardship is proving elusive for institutional investors, 2010 (http://ssrn.com/abstract=1635662)

DECLINING BENEFIT OF DIVERSIFICATION IN TERMS OF REDUCING VOLATILITY OF RETURNS



Source: Elton and Gruber; Statman

SYSTEM SHOULD ACCOMMODATE DIFFERENT STEWARDSHIP APPROACHES OF INSTITUTIONAL INVESTORS



Description of activity	Principal participants/rationale
• Engagements focused on changing core strategy, capital structure and/or operations at poorly performing companies	• Focus funds – small number of holdings, low turnover and relatively high fees mean substantial resources can be deployed to researching and engaging on fundamental business issues
• Regular (annual/semi-annual) meetings with chairmen and CEOs to discuss general strategy, performance and governance • Engagements in response to crisis/scandal (e.g., safety issues, bribery allegations)	• Mainstream institutional investors – interventions of this type do not require deep firm-specific knowledge and, hence, can be applied across many portfolio companies at relatively low cost
• Develop best practice guidelines (e.g., dilution limits, remuneration) • Influence policy-making (e.g., responding to consultation exercises)	• Mainstream institutional investors – with their large portfolios, framework-level interventions are efficient as the need to intervene at individual firms would decrease

Source: Wong - LSE lecture (March 2010)

Thank you.

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