Stewardship- more than just best practice

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Where does corporate governance end and stewardship begin? What's the difference? These were two key questions that Paul Lee, Head of Corporate Governance at Aberdeen and formerly Head of Investment Affairs at the National Association of Pension Funds, answered in his presentation at a Pensions Intelligence seminar in May.

The concept of stewardship stems from the times when a steward was left in charge of his master's estate. His responsibility was to look after his master's assets, preserve and enhance value, over the long term. This is precisely the challenge we, as asset managers, have on behalf of our clients. The fund management industry is looking after assets that belong to others and has a fiduciary duty to make the most of those assets.

There is a portion of this role that is concerned with the buying, selling and trading of assets but a significant part of it is about making the most of the assets that you hold at any given time.

Companies can sometimes have a tendency towards short term decisions that might not drive value in the long run. Good corporate governance and stewardship involves calling to account the boards of companies in which pension schemes and others are invested, to challenge those shorter term tendencies, and to argue for long term value creation and preservation. It is putting the interests of the long term owner into effect.

An answer to the agency problem

The challenge modern stewardship must rise to is not new. Adam Smith, the pioneer of political economy and renowned stalwart of the Scottish Enlightenment, highlighted the agency problem back in 1776. This is the recognition that, where you have split between ownership and control, as we have in the modern corporate world, you have the risk that those in control (the managers of the companies) may at the margins be tempted to feather their own nest – be that by way of pay, empire building or simply making judgements that are protective of their own interests and not those of shareholders.

Of course, this is not true of every company. Most companies are well run, are managed for long term value and meet their responsibilities; but we need to be aware that not all do, and certainly not all do all of the time. Stewardship can close that agency gap and help remind managers and directors that they are accountable.

Putting it into practice

What does good stewardship require? It starts with an active and engaged dialogue between the shareholder and the board, including the non-executive directors. If there is an agency problem, that is, a gap between those who control and those who own, the aim is to close that gap, to help remind those in control that their owners continue to be interested and want to be involved – a calm, constructive, honest dialogue. It needs to take into account a wide range of issues that feed into value creation over the long term: strategy, capital structure, board structure, board effectiveness and skills, audit, remuneration, and risk management.

I would also suggest that this approach needs to be closely aligned to the investment process. If not there is a danger that companies receive two different messages. A close relationship between the two enables you to gain a much more holistic understanding of strategy and the ongoing needs of the business.

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As regards voting, it is a part of the process – a formal part of the conversation – but that dialogue needs to continue the entire year round, not just for the brief voting season. In the same way, conversations should not take place only at the point at which a crisis has arisen. This is a time when shareholders can often provide very little input of value and sometimes actually inhibit companies from getting on and addressing the problem. If there is an active and engaged dialogue over time it is more likely that such crises can be avoided.

Creating and preserving value

There is an ongoing debate about the value of governance and a number of studies that question the extent to which good governance drives corporate performance. If you view governance as a box-ticking exercise in order to obey guidelines you will not find a link between governance and value; stewardship is the bridge from governance to value.

It is an active, dynamic process clearly focused on driving value, which extends far beyond compliance, a way of understanding how best practice interacts with the real world. Successful family businesses are often fine exemplars in this respect; they rarely tick every governance box but are often the best stewards, driving value for the long term as a consequence of a holistic view and deep understanding of what it takes to make the business successful.

The right governance and stewardship framework also supports the investment approach: seeing a board thinking about the issues that matter, and actively engaged in delivering performance over the long term, reinforces investment decisions. Shareholder rights may be viewed as an asset like any other. The right to vote, meet management, have a dialogue with the corporation, and attend shareholder meetings – these are important facets of a relationship that we, as stewards of our clients' money, need to be prepared to use, and use wisely.

If we are not using those assets and putting them to good use we are neglecting an opportunity to create value for our clients. In short, stewardship is part of the investment process. At Aberdeen, it is built into the investment approach from the outset, and through continuous engagement, contributes significantly towards enhancing company quality, which ultimately drives value.

Stewardship and pension schemes: regulator expectation

There is often an unfortunate expectation among some regulators that the pension schemes will undertake this process themselves. For the vast majority, this is unrealistic.

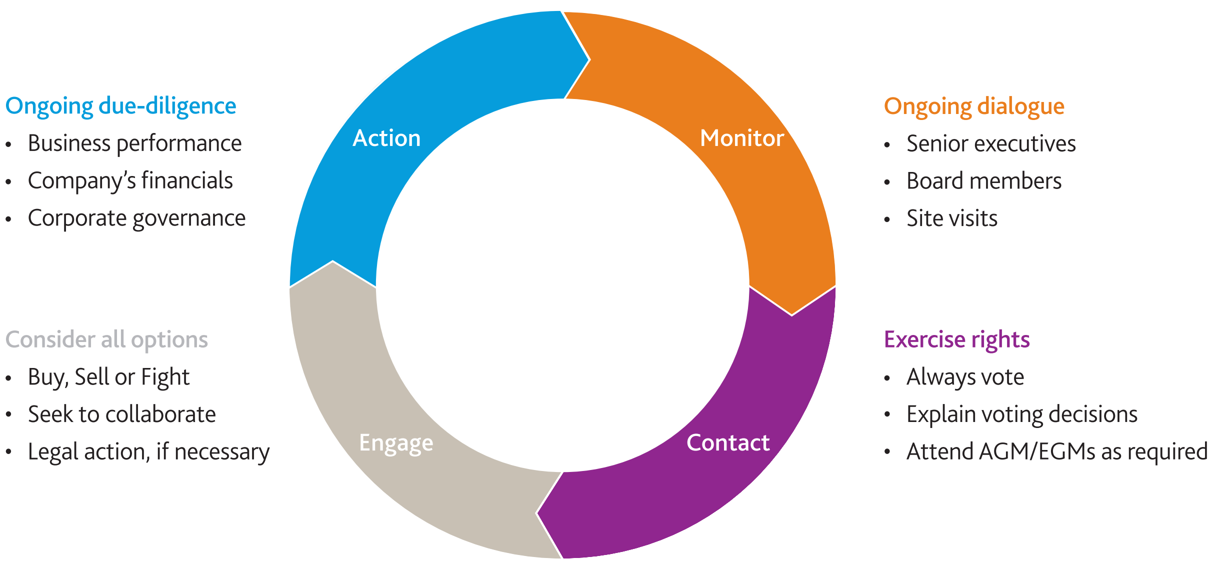
The pension scheme's role is to call to account the fund managers and within our industry, we need to ensure that we provide trustees and managers with insights into our stewardship activities so that they have the capacity to raise questions, challenge us, and importantly, learn exactly how good stewardship can contribute to value creation and preservation.

This is less of a challenge than it once was but remains a challenge nonetheless. There are still places where some institutions need persuasion to embrace good practice, but stewardship is increasingly becoming recognised internationally as an effective process that offers tangible benefits.

The future

This is a time of considerable change for those entrusted with the stewardship of pensions – an important pillar of UK retirement saving. The better investors understand stewardship, the better placed they will be to take advantage of the opportunities it offers, and in turn satisfy the best interests of their sponsors and members. Aberdeen is wholeheartedly committed towards ensuring that we play our part in supporting trustees and pension managers, and to working with the wider investment community to lead best practice.

Enhancing company quality through continuous engagement



Maintaining value through stewardship - examples

Case study 1: Succession planning

Issues With a squeezed business model, stretched balance sheet, operational performance weakening, and international expansion undermanaged, there was a clear requirement for a new voice in discussions with this major FTSE company, where its relationship with regulators and politicians was unstable.

Activity Two conversations on succession planning were held with the chair, to discuss the need for a new CEO with relevant operational experience, toughness and political nous. Aberdeen also discussed retention issues with the broader executive team. We covered succession and retention issues with the current CEO, and held talks with the remuneration committee chair on recruitment and retention in light of the CEO change.

Outcome Within a few months, the new CEO was announced, took up the role within the year and Aberdeen embarked on a series of agenda-setting discussions with the new CEO. While challenges remain, the company now seems better placed to deal with them.

Case study 2: Remuneration

Issues A demand from the board following remuneration consultation that the CEO be paid £2m more a year.

Activity Aberdeen replied promptly, setting out plans for dialogue with chair and remuneration committee chair, together with a firm expression of concerns. We were informed by our insights into the CEO, the broader executive team and our awareness of other shareholders' positions. Our follow-up message made clear our considered view: that this proposal was not in the best interests of the shareholders or the company overall.

Outcome The proposal was withdrawn, without any apparent effect on the stability of the management team.

Case study 3: Board skills and structure, succession planning, remuneration

Issues The respected chair of this very successful company was reaching retirement age, and there was a concern that the company would move the CEO, who lacked the appropriate balance of skills, into the chair position. The board, which includes too many individuals with a banking or financial background and too few with operational knowledge of the business, was faced with a number of important decisions. Furthermore, its weak pay structures were rewarding underperformance and failed to reflect the underlying operations.

Activity Following a detailed analysis across a range of governance issues, we held talks with the chair and company secretary, politely but forcefully focusing on the issues identified and proactively highlighting the importance of these key points through meetings and correspondence that we shared with other concerned investors.

Outcome Having made our position clear, the impact of this intervention so far looks promising. We are encouraged that the active and engaged dialogue that stems from our approach to stewardship will pay dividends in the long run.

This article has been produced based on a discussion which took place during a Pensions Intelligence Seminar on 11 May 2015.

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