A WAY TO PROVIDE EXTRA VALUE

INVESTOR ENTHUSIASM FOR CORPORATE GOVERNANCE IS GROWING EXPONENTIALLY. **COLIN MELVIN** OF HERMES CONSIDERS THE REASONS FOR THIS AND EXPLORES THE IMPLICATIONS.

Other things being equal, we can expect a property's value to be lower when subject to the negligence of an absentee landlord than if an active interest is taken in its upkeep. In a similar way, we can expect the value of a company to be greater if it has active and interested shareholders. Prudently managed, the cost of maintaining the property in good order – equivalent to the cost of the shareholder's corporate governance activity – should be less than the long-term benefits that accrue to the owner.

Corporate governance as an investment discipline addresses the gap between the interests of shareholders as part owners of companies and the interests of the directors who control these same companies. It is thought that the 'agency costs' associated with this gap (perhaps caused by directors pursuing self-aggrandising strategies that destroy shareholder value) may be reduced by investor action and good governance structures and practices. In this context, we can see the importance of two of the most high-profile corporate governance issues – the need for sufficient independent non-executives to represent shareholders' interests and the importance of well-designed, long-term incentive schemes, which can align the aims of management with those of shareholders.

ENHANCING VALUE. So the first reason for the recent growth in investors' corporate governance activity is their realisation that this can enhance the value of their investments (something Hermes realised many years ago).

Allied to this is the notion that good governance practices are an indicator of the quality of corporate management, itself a fundamental tenet of stock selection for active managers. However, empirical evidence for the link between increased company value and corporate governance is not abundant, in part because it is difficult to demonstrate causality in any aspect of investment. Nevertheless, Caton, Goh and Donaldson in their paper *The Effectiveness of Institutional Activism* (*Financial Analysts Journal*, Vol 57, No 4, July/August 2001) found that under-performing companies which had the tools necessary to improve performance responded to institutional activism in relation to their governance. Also, in two separate studies, McKinsey has found that investors are prepared to pay a premium of between 19% and 28% for well-governed companies. The size of the premium varies by market. Share-ownership also confers rights and responsibilities, which are of interest to the government, press and public.

This has provided significant external pressure on institutional investors to take corporate governance more seriously. A shareholder's principal right is the vote attached to the share, which, in all but the most extreme of circumstances, has been largely neglected over many years. This is changing, however, as active share ownership is increasingly linked to long term shareholder value and voting is seen as the main formal lever by which shareholders can effect change in a company.

In addition, most UK pension fund managers now have a duty to their clients to vote their shares in a considered fashion. This duty was prompted by an amendment to the Pension Act, introduced in 2000, which requires a fund's trustees to disclose, in a statement of investment principles, the extent to which the fund incorporates social, environmental and ethical considerations and voting into its investment process and decision-making. Most trustee boards made positive statements and have delegated the operation of their approach to their investment managers. I will return to investors' role in corporate social responsibility (CSR) below. For now, it is sufficient to note that more shareholders are voting and in a considered fashion.

WHAT DO CLIENTS EXPECT OF THEIR FUND MANAGERS? A further pressure on institutional investors has arisen from the Myners review and the Government and industry's response. The recent Institutional Shareholders Committee (ISC) *Statement of Principles on the Responsibilities of Institutional Shareholders*, published in October 2002, which was widely seen as an attempt to avoid legislation on shareholder activism, is likely to have far-reaching consequences. The Myners review and the ISC principles set out the responsibilities of shareholders in relation to the companies in which they invest. The basic duty of shareholders, outlined in these documents, is to intervene or 'engage' with the management of companies where this is likely to increase the value of the investment concerned. The documents also provide examples of what such intervention or engagement might entail. In fact, they go farther than some investors would like and many are now reassessing the way in which they approach their investments as a consequence. Moreover, they are realising that this type of active engagement requires significant effort and resources to undertake effectively.

Fund managers' clients now expect them to either have or have access to expertise on corporate governance, to vote their shares intelligently according to agreed guidelines, and to take account of corporate governance concerns within their investment processes. Increasingly, clients are demanding regular reports on voting and on their investment managers' discussions with companies on strategic or corporate governance matters (now known as 'engagement'). They are quizzing their managers at investment meetings and some now expect an annual meeting with their corporate governance personnel. The extent and speed of the changes in investor attitudes to corporate governance has surprised many commentators. At Hermes, we are encouraged by these developments, as we expect them to give us additional opportunities to work with other shareholders.

HERMES AS AN ACTIVE OWNER. For many years, in order to enhance the long-term value of its clients' shareholdings, Hermes has behaved as a consistent and responsible owner of the companies in which it invests and is now considered a global leader in the effective management of shareholder rights and responsibilities. We employ 40 professionals with a range of investment management and business skills focused full-time on governance and stewardship, giving us the largest resource of any institutional investor. We actively engage with companies in our client portfolios on a global basis according to established policies and processes, which fully meet the requirements of the ISC's principles. Hermes Focus Funds, which invest in underperforming companies in the UK and continental Europe, are a good example of this philosophy.

A crucial element of our approach is to monitor the performance of our investee companies and establish and maintain dialogues with their senior management where we believe that this can contribute to the value of our clients' shareholdings. We have ten years experience of reviewing UK companies' published information, including annual reports, circulars and meeting notices, in order to vote our clients' shares intelligently. In doing so, we assess the effectiveness of board and committee structures, and we maintain a record of our voting and company contact.

ADVANCE WARNING. Where possible, we inform companies in advance of our intention to vote against management-sponsored resolutions. We also attend and raise issues at general meetings and occasionally submit resolutions and requisition EGMs. However, we regard these as last resorts and prefer to work with companies towards agreed solutions.

Hermes considers it important that institutional investors communicate their views to company management. For this reason, in September 2002 we published *The Hermes Principles*, which, along with our published corporate governance guidelines, sets out the circumstances under which we might intervene. Our approach to such intervention varies on a case-by-case basis but generally includes separate meetings with company directors, senior management and advisers. Where appropriate, we intervene jointly with other shareholders, both in the UK and overseas, often taking the lead. We are founding members of several networks of institutional investors, which we set up to facilitate such collaboration. We also have extensive global contacts with governments and non-governmental organisations, trade bodies and trade unions as well as the academic world. These resources and contacts enable us to engage constructively on the development of corporate governance, company law and regulatory and market issues in the UK and overseas.

'AS WITH CORPORATE GOVERNANCE ISSUES, WE EXPECT COMPANIES TO 'EXPLAIN AND JUSTIFY' THEIR STRUCTURES AND PROCEDURES IN RELATION CORPORATE SOCIAL RESPONSIBILITY'

Last, we report regularly to our clients on voting and company engagement in a format that we have agreed with them and maintain a computerised database of our contact, meetings and votes.

THE RISE OF CORPORATE SOCIAL RESPONSIBILITY. Returning to the analogy of the absentee landlord, a poorly maintained property is likely to attract criticism and contribute to the degradation of its environment. Both of these factors are clearly linked to the property's value and the same is true of equity investments. Active shareholders seeking to enhance the value of their investment in a company have a legitimate interest in the extent to which the company's directors have taken into account social and environmental risks and opportunities faced by the business. Driven in part by amendments to the Pensions Act in 2000, described above, investors are increasingly taking such factors into account in their decisions and discussions with corporate management.

It seems clear that CSR is a subset of corporate governance. As with corporate governance issues, we expect companies to 'explain and justify' their structures and procedures in relation to CSR. Where we believe a company is not dealing with the issues in an appropriate manner we will contact the company secretary or a board member to outline our concerns and give them an opportunity to defend the position. If the company's explanation is unsatisfactory, we will seek change, often by working with other shareholders.

Colin Melvin is Director of Corporate Governance at Hermes Pensions Management. He is responsible for developing and implementing corporate governance and shareholder engagement policies in relation to Hermes' clients' equity investments in UK and overseas."
cmelvin@hermes.co.uk
www.hermes.co.uk

Hermes recognises that the trustees, elected representatives and officers of many UK pension funds are considering how to deal with their emerging obligations in relation the Myners report and the ISC's Principles on shareholder activism. We would be pleased to share our knowledge and experience of active engagement. If you have any questions regarding the impact of these matters in relation to your own investments or you would like to learn more about Hermes' approach, please contact Colin Melvin on 020 7680 2251.