View from the market – investors' attention turns to stewardship

Against the background of MiFID II, fund managers are also focusing on a number of other urgent issues, with stewardship at the head of the list, as **Cynthia Alers** explains.

As we all rush to put the finishing touches on our preliminary results presentations and put the annual report to bed for another year, thoughts should be turning to planning investor relations messaging for the annual general meeting and the next 18 months, post-Brexit and post-MiFID II. What are the key issues for investors?

Morrow Sodali recently published its third annual institutional investor survey which asked 49 global investors, with combined assets under management of $31 trillion, their views on a wide range of global trends and emerging issues. These focused on the annual general meeting, ESG engagement, board practices, executive pay, activism and investor stewardship strategies. Several key themes emerged.

Spotlight on investor stewardship and corporate governance

Following several high-profile corporate scandals, corporate governance is moving into mainstream investment criteria. All institutional respondents to our survey were signatories of both the Principles for Responsible Investment (PRI) and the UK Stewardship Code. The Investment Association now compiles a public register on its website that lists all companies in the FTSE All Share Index that have faced significant investor opposition to a proposed AGM resolution. Sacha Sadan, director of corporate governance at Legal & General, one of the UK's largest investors, said at a recent Morrow Sodali conference that LGIM was discussing formulating a similar register of companies with poor governance structures.

The Financial Reporting Council (FRC) is consulting on its white paper on reforming the UK Corporate Governance Code, with the '20% rule' gaining strong support. Any company resolution that is either withdrawn or receives greater than 20% of votes opposed will be required to publish an explanation and proposed actions to address investors' concerns. And politicians are increasingly calling companies to account for poor stewardship policies.

A company's reputation is now a board-level risk, with the associated reputational risk for individual directors. 93% of investors Morrow Sodali surveyed confirmed that environmental, social and governance (ESG) policies were fully, or progressing towards being fully, integrated into portfolio investment decisions, with 54% stating that they will 'focus on climate change disclosures'. Yet, many companies still separate ESG issues from financial reporting statements. ESG is often added to the annual report as a 'stand-alone' section and is not reported in financial presentations. As investors pose more questions on ESG reporting, companies and boards will need to rethink how they manage ESG disclosure around CEO pay ratios, diversity in the workplace, and investment in climate change.

Mark Carney, governor of the Bank of England, highlighted in his Davos interview, the potential investment cost to companies to comply with the Paris Climate Change Agreement, and many investors are focusing on the financial aspects of compliance with the agreement. Disclosure requirements around ESG will continue to increase, and companies need to start thinking how they will meet this communications challenge.

Board composition, disclosure around sustainability metrics and activism

Unsurprisingly, the most important metric for investors continues to be the 'quality and completeness of explanations relating to business strategy and disclosure of material issues impacting performance'. However, investors are increasingly focused on the role of individual directors in evaluating, challenging and monitoring corporate strategy crisis planning, with

VIEW ON STEWARDSHIP

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- **Composition of the board will be an important issue in the AGM season.**
- **Activism and shareholder collaboration are increasing scrutiny of underperforming companies.**

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97% of investors citing this as an important point.

A further 66% of investors believe that 'composition of the board' will be an important issue in the upcoming AGM voting season. This year, 59% of investors said that they will prioritise 'board skills and experience' – a huge 50 percentage point increase on our survey last year. Investors said that they will be critically evaluating director accountability, contribution to the board and oversight skills, as well as looking at broader issues such as technology transformation, disruptive events and wider stakeholder considerations. Clearly, a brief description in the annual report of the business model and standard risks is no longer sufficient to inform investors.

The FRC is currently consulting on a draft Corporate Governance Code which will have far-reaching implications for IROs and company secretaries as well as boards. One recommendation is that all boards undertake an annual audit of skills and succession. Many companies already conduct regular board audits. Companies that wish to get ahead of the curve should consider setting this up as part of the annual board cycle, as well as considering debating these emerging investor topics at board 'away days'.

Another draft recommendation proposes extending the nine-year limit on board appointments to all board members, including board chairs. This will drive significant turnover in board appointments, making the annual skills audit even more pertinent, to ensure smooth succession.

Finally, activism and shareholder collaboration are increasing scrutiny of underperforming companies. Some startling facts: 59% of investors said that they now collaborate with other investors around the AGM on corporate performance. Forums fostered by the Investment Association and others make it much easier for investors to share concerns and agree a concerted plan of action around the AGM. 61% of investors now claim that they would be open to an activist approach that offers a sensible strategic plan.

Companies seldom consider this threat, yet boards need to be aware of activism approaches as well as dissident shareholder views, much as they discuss cyber security and other crisis planning issues. 'Poor capital allocation', 'weak board', 'poor governance' and 'failed engagement' are all issues investors mentioned as making them open to an activist approach. Proactive boards are now undertaking vulnerability audits as part of their annual board cycle to monitor company performance and plan a response to these activist issues.

Proxy adviser influence reports can help identify potential shareholder issues ahead of AGMs, helping to avoid disclosure under the 20% rule. Vulnerability audits can assess how your company compares to a selected peer group, not only on corporate governance parameters, but also on financial performance and shareholder value. All these tools can ensure smooth and effective investor communications.

Action points for a response strategy

- **Review the narrative of your business model**
  - Is the explanation of value creation clear?
  - Is sustainability of value creation credible in the longer term, considering the challenges of growth, Brexit, MiFID II and global markets?
  - Is the tie between future strategy and current performance credible and clearly linked?
- **Involve the board in IR strategy**
  - Does the board regularly undertake a board skills audit and succession planning and is this incorporated into investor communications?
  - Does the chair and/or SID take part in regular ESG roadshows to build relationships with stewardship managers in addition to PMs?
- **Environment, social, governance**
  - Do you have a robust strategy around ESG communications, including clear benchmarks and metrics?
  - Is ESG integrated into the company's reporting narrative along with financial measures?
  - Are you planning communications around climate change compliance?
- **Activism**
  - Have you conducted a vulnerability assessment on your susceptibility to an approach by an activist or dissident shareholder?
  - Have you commissioned a proxy advisers influence report to manage communications around your AGM resolutions?
  - Is activism incorporated into your crisis communications?

Executive pay still concerns investors

Executive pay continues to be a touch point for investors, as in previous years. Pay for performance, CEO pay ratios, gender pay gap and stretching performance targets in LTIPs are all measurements investors cited, with 88% stating that unjustified pay would come under intense scrutiny, up from 75% in last year's survey.

83% of investors want to see a detailed explanation of how compensation is linked to long-term strategy, with another 76% demanding information on the value board members bring to the boardroom. Executive and board compensation will be an important point to consider in investor communications, in view of the IA's 20% rule on companies disclosing significant votes against AGM resolutions.

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How should IROs respond?

The demands on IROs to educate, communicate and promote their companies and management teams continue to grow. The rise of index-linked investors, which now account for almost half of total invested funds, means that corporate governance is one of the few ways passive investors can influence company performance. Investor focus on corporate governance, ESG and board responsiveness to IR is therefore set to increase, and IROs – and CoSecs – need to start planning a response strategy. ■

If you would like a copy of our 2018 Institutional Investor Survey, email c.alers@morrowsodali.com