Thanks Pedro & for the invitation

Background Yale University/banking JPMorgan/ML/GSAM
Deputy CEO Hermes Investments - big on shareholder rights.

After being CEO of a few independent investment firms, my family & I have moved here….now filling some of my time with a variety of investment related non executive type roles in Lisbon & London.

While I have my own experiences and opinions of investment and shareholder issues – you will have your own experiences formed in very different ways – so my talk hopefully to be with a discussion and questions about topics that arise.

What are everyone's Background? Board? Chair? CEO? Investor?

The title of this talk is around the concept of there being good shareholders and bad shareholders.

Can a board or the chief executive or chairman make such a distinction?

As a chief executive of a public company one might be simplistic and say that the long-term minority shareholder - who never expresses any type of view and never votes against any board resolution is the very best type of shareholder.
That is the silent or passive shareholder.

Surely isn't that the type of shareholder one wants?

And therefore - the flip side of that is to say that the opinionated and activist shareholder – the one who seeks to engage with the board and even goes so far as to challenge board resolutions is the unwelcome shareholder?

Increasingly, when a shareholder does seeks to engage with a company today - it will be on what is called an ESG issue.

So let's look at what ESG is about.

E = Environmental - ie all things relating to the impact that the corporate entity is having on the world around us - now and into the future.
This will be about sustainability in all senses of the word.

S = Social ie all things relating to the company's people and the broader communities that the corporate entity is effecting and interacting with. This encompasses everything from how suppliers are treated to employee's human rights - up to the CEO's compensation.

G = Governance - a catch-all word which - when distilled means the multitude of processes and procedures by which the corporate entity manages & conducts itself.

Of the 3, I personally think Governance is the most important.
If you have good governance, the rest follows.

If a company has effective governance it most likely means an intelligent, diversely experienced, empowered and partially independent board....will help oversee all the company's critical activities.

It should be able to- challenge and hold to account the executive management,
consider issues of societal and environmental impact and ensure that the value creation proposition being offered to shareholders is being executed in a sustainable manner - and crucially it should represent the interests of all shareholders - including minorities,
ultimately ensuring capital is allocated wisely and in line with the stated vision, mission and purpose of the company.

So now let us imagine a corporate entity with poor governance and a weak, ineffective board - things can quickly spin out of control.

- Vested interests might be given preferential treatment,
- employees, customers, suppliers, minority shareholders and other constituent communities are taken advantage of and sometimes systemically abused,
- executive management could treat the balance sheet and P&L as if it were there own,
- and ultimately "crony capitalism" becomes the norm.

All of the above is sadly too familiar in poorly developed capital markets and the global investor market recognises this quickly - quickly giving those companies and markets steep discounts.

And if the above happens - who arrives on the scene as the most hated type of shareholder...- the antichrist of shareholders – of course it's the short seller.

The short seller is worse than the active shareholder - who simply might sell your shares and walk away.

No, the short seller borrows your stock in the market, sells it - but unlike a normal seller, he lingers on the sidelines fully hoping for the company to continue to do the wrong thing - to continue to destroy shareholder value.

And it is only when the share price has fallen to rock bottom will he then buy back the shares, return them to whom he borrowed them and book his profit.

The short seller wants the company to fail.

Is this pure shareholder evil or what?

Or....is it the most powerful message any shareholder can send to the Chief Executive and a governing board of a public company - who are doing the wrong thing?

If the CEO listens and takes heed of a short sellers actions, might there be a chance to correct the problem while a deaf CEO simply watches the share price sink lower.

If one looks back over the entire history of public company scandals and collapses from the very beginning of time when joint stock companies were first created to our current day examples of large listed companies failing - they all, in my opinion, have one very specific thing in common.

While the actual physical symptom of failure can be different in each case from -

corporate or accounting fraud to executive greed or financial misappropriation, to strategy misdirection or bad capital allocation

- there is almost always the same issue at the top of the organisation and that will be the hubris shown by the chief executive.

Hubris is a wonderful ancient Greek concept.

They considered it to be a dangerous character flaw capable of provoking the wrath of the gods.

In classical Greek tragedy, hubris was often a fatal shortcoming of excessive arrogance that brought about the fall of the tragic hero.

Typically, overconfidence led the hero attempting to overstep the boundaries of human limitations and assume a godlike status, and the gods inevitably humbled the offender with a sharp reminder of his or her mortality.

In our case the tragic hero is the deaf CEO and the gods are the market.

Stop and think just for a moment about the handful of corporate Titans who have overseen recent company collapses - and in every case I would suggest that they suffered from hubris.

But what does hubris mean when it comes to the issue of good and bad shareholders?

I would summarise this in 2 words: not listening.

And by not listening I do not necessarily mean that a CEO has to follow every suggestion or opinion of any shareholder.

Many times the CEO can rightly disagree with a shareholder because they may have non-public information or perhaps a different time frame.

But the point is, gone are the days when shareholders sat back and simply reaped the dividends from the companies they invested in - with little or no concern about the potential long-term affects of the businesses that they were financing.

Today many shareholders increasingly care and are looking beyond cold hard profits.

In November last year Anne Richards, the boss of the fund management group Fidelity International said to a gathering of 200 executives;

“ We as shareholders and investors must adapt to the realities of today. To slow this rapid destruction of our shared home, we will need to rethink the very purpose of our economic systems. The pressure is coming from all around and it’s hard to find voices that defend business as usual and actually even capitalism as a concept“.

This is astounding.

Here is the head of one of the largest investor groups in the world saying that companies must learn to listen and adapt.

There has always been a small group of investors who have thought about trying “to do good while doing well”.

As far back as 1800 the Quakers and Methodists religious groups established investing guidelines for their followers and sought to purge their portfolios from the evils of alcohol and tobacco.

But for most of history these type of selective and opinionated shareholders were the minority.

No longer.

Last autumn the bosses of 200 of the US’s biggest companies represented by the US Business Roundtable - which collectively has $7 trillion in revenues, including names such as Amazon, JPMorgan and Apple changed the official definition of “the purpose of a corporation”
from making the most money possible for shareholders -
to “improving our society” by also looking out for employees, caring for the environment and dealing ethically.

This radical change to the mantra of corporate America comes after decades of following Nobel Prize-winning economist Milton Friedman’s philosophy, which dates from 1970, that “the social responsibility of business is to increase its profits”.

Additionally, in October 2019 the Financial Reporting Council launched a revised UK Stewardship Code -

and introduced rules in the UK demanding that pension funds, by far the biggest investor base in the UK, consider environmental, social and governance factors in their investment decisions.

Younger investors too are driving change - either directly or as in the US and UK by forcing their massive university endowments to consider their concerns.

According to a report last year by Cerulli Associates 2/3rds of investors under 30 want their investments to have a positive social and environmental impact.

This factor is sufficiently important that a report from the Bank of England last year said that any company failing to adapt to a low carbon future will “fail to exist“.

So fail to listen at your peril.

But it’s not all about shareholders seeking to reduce the damage to our planet.

In fact, in the UK last year most shareholder revolts were around excessive executive compensation and board room greed.

Last year, there were 33 shareholder votes among the U.K.’s largest 350 companies against Executive compensation plans - which was double the number from only three years before.

And the same is true amongst the S&P 500 companies in the US - where shareholder revolts over pay rose last year to 61 occasions from approx 40 in 2014.

Increasingly, key shareholders are caring about more and more things than simply their investment return.

Anne Simpson, the investment director at CalPERS, the US‘s largest public pension fund said last year;
“ The reason is simple. The long-term drivers of risk and return ride on companies ability to manage their human capital and the physical resources. It is not enough simply to deploy finance with flair“.

Today it’s believed that a company that can motivate and reward its employees properly, support their communities and have a robust governance structure will be better placed to outperform in the long run.

CalPERS for instance is a founder of the Human Capital Management Coalition which pressured fast food and retail companies to tackle low pay last year.

Companies including McDonald’s have been forced to raise their wages in response.
Think about that...shareholders demanding that the company wage bill increases.

In Europe, investors have gone to the extreme example of selling their stakes in companies with bad ESG records.

Union Investment - Germany’s third largest asset manager sold out of Vale after the Brazilian dam collapse- as did the £6 billion pension fund of the Church of England.

And Norways $1 trillion oil fund sold their entire stake in for G4S after stories emerged of worker’s human rights in the Middle East being abused.

But a key question is, are the majority of financially literate fund managers & stock pickers - who represent the shareholder sufficiently trained, skilled and resourced to understand and consider all the complex and non-financial ESG issues.

And do they all care?

Remember, different shareholders have different timeframes.

Sometimes short-term returns are not affected by ESG factors, whose drivers such as regulation, investor awareness, and
social habits are constantly, but slowly changing – especially compared to the periodic volatility spikes of the stock market.

A day trader, a high frequency trader, a hedge fund manager and a short seller
really don't care about being an involved shareholder.

The analogy is, "who ever washed a rental car?"

But for the long term shareholder, there are now various ESG scoring systems provided by people like MSCI and Sustainanalytics - but the commonality of factors, data used and correlations tend to be very different.

So, for an average shareholder this can be a source of confusion and even mispricing.

When I was deputy CEO at Hermes Investments - which managed approximately $85bn, exclusively for corporate pension funds, we oversaw a very large portfolio of index stocks in all the developed large cap markets around the world- but recognising that as index managers we could not sell these shares we built up an activist arm that took large, over-weight positions in key target stocks - which we thought could be improved by means of intelligent engagement.

These were named the Focus Funds and we had versions for UK, Europe, the US and Japanese markets.

The Focus Fund team was staffed by ex-management consultants, lawyers, and corporate strategists.

These were the people who were able to engage intelligently with company boards where we owned up to 5% of the target. The idea was potentially to help improve a company's valuation by guiding them away from value destruction pitfalls, poor governance and other issues that the market disliked.

The fact remains that while most in the investment industry focus on the key decisions around buying and selling stocks, the responsibility of a shareholder must continue throughout the life cycle of the holding.

One good, but simple example was a lengthy dialogue we had around encouraging the Sainsbury's supermarket board to divest itself of its large, costly and unprofitable US acquisition that was consuming capital for no good reason.

Off the back of these efforts, we then created an offshoot governance and stewardship business called EOS - which stands for the "equity ownership service".

Realising that we had built some unique resources to properly engage with companies and that many investment managers and all pension funds did not have such resources, we set out to offer a type of corporate governance overlay service -

So, when an investor owned a stock, the EOS service was contracted to help engage with the company on all issues relating to ESG.

While a fund manager is trained to understand a discounted cash flow and various valuation models and can make a decision around buying and selling - they are not necessarily well equipped to be responsible for the stewardship of that stock.

Many investment houses argued against the creation of EOS (and some still do).

But I argued that there are precedents for such outsourcing arrangements where the investment professional recognises the limits of their skill.

Currency overlay managers are common, recognising that managing the foreign exchange exposure in a portfolio is a different skill set than buying an international stock.

Likewise, the custodian of client's assets - which until the early 80s was also handled by the fund manager is now entirely outsourced to professional custodial firms.

Likewise, Hermes believed that a shareholder's ownership interests are subtly distinct from their investment requirements.

Therefore, Hermes EOS provides this discrete service and now has over $650 billion under advice.

So, what is the outcome of all this good stuff?

Hermes itself points to studies which have shown that constructive engagement with portfolio companies by shareholders can generate higher annualised returns of up to 7.1% - that's on total return - a year while lowering downside risks.

Another way to look at this is the cost of getting it wrong.

A Bank of America analysis last year looked at 24 separate corporate governance controversies among the S&P 500 - covering various accounting, fraud, data breaches, sexual harassment and other significant ESG missteps.

The net result of these 24 controversies resulted in a peak to trough market value loss of $534 billion as the share prices of the companies involved sank relative to the S&P 500 over the following 12 months.

Hence, the cost of doing wrong is significant and importantly the impact can be long-lasting.

It can take well over a year for a stock to reach a trough following an ESG controversy.

Poor governance headlines stick in a potential shareholder's mind for many years and additionally 'Impact' or ESG funds will sell controversial stocks fast and might exclude them from their portfolios for many years to come.

And that brings us to shareholders who actively seek to exclude certain types of stocks from the investment world?

Some shareholders have sought to exclude "sin" stocks – those dealing in alcohol, tobacco, armaments and increasingly fossil feels.

This can be a difficult and sometimes unhealthy debate as it introduces personal morality issues into the world of investments.

Ask yourself the question are all armaments manufacturers bad?

Surely we need to equip our police forces and security services to properly defend our societies?

In 2019 Al Gore demanded that index funds sell their fossil fuel holdings – which is technically not possible - for as long as a stock is in an index and conducting a legitimate business, the index fund is required to own all components of the index.

Furthermore, we need to recognise that it's the large fossil fuel companies that are investing into the next generation ideas such as carbon capture and renewable energies.

Some years ago when at Goldman Sachs, I was responsible for a large pension portfolio for a local UK government entity.
Prior to my involvement the client - seeking to be politically correct had dictated tobacco holdings were excluded from their portfolio.
Prior to a portfolio review meeting, I was advised that some questions would come up about the client's tobacco exclusion policy as all tobacco stocks had performed well.
....and so we had calculated how much the pension fund had given up or lost out on by not investing in the handful of tobacco stocks which we might have owned for them.

When we advised the pension board that, had we held a few of our preferred tobacco holdings and not excluded them, the pension fund would have been approximately $5 million better off, the question arose as to what the core purpose of the pension fund was.

Surely it was to create as much capital as possible to pay out pension benefits to its members and it was not a tool to campaign against smoking.

After the meeting, the exclusion on tobacco stocks was lifted - and GS along with other shareholders continued to pressure big tobacco to cease selling discounted products to underage smokers in developing markets - which at the time was a core strategy to build market share.

Divestment does not bring quick change. Engagement does.

Furthermore, long-term shareholder engagement drives long-term change.

Among the UK FTSE 350 index shareholder engagement has resulted in 30% of board make-up now being female and one third of all FTSE 100 companies have brought in new controls on executive compensation and climate change is now a core consideration for boards.

This has been achieved through considered and constructive engagement - not disinvestment.

Earlier, I touched on Al Gore's suggestion to index managers that they should sell fossil fuel stocks.

Over the years it has been a truism in the investment industry that only active managers have the motivation and ability to engage with companies in their portfolios.

It was also believed that for index – or passive managers – this means passive ownership.

I would argue the complete reverse.

An active manager has the easiest and the ultimate sanction on a company doing the wrong thing.

It can sell the stock and simply walk away.

An index shareholder can do no such thing. They are obliged to remain a shareholder of the company for as long as the stock remains a constituent part of the relevant index.

Therefore, all the more reason why passive investors must be active shareholders.

As more and more invested shareholder capital around the world tilts towards ETFs and indexation, this issue becomes ever more critical.

Active managers are now losing market share in all key segments of the industry. Does this matter?

The challenge here is one of economics.

The profit margins involved in indexation - and even more so in the exploding world of ETFs is very thin and allows little room to hire the necessary skills & resources to engage with corporate boards.

You can't trust a 25-year-old MBA graduate in an analyst position to lead an appropriate and constructive conversation with a large corporate board.

The necessary skills to be an intelligent shareholder are expensive skills.

There is no easy solution to this challenge other than through working together and perhaps using outsourced providers…such as EOS.

At least however, the largest passive, index and ETF managers have immense scale - so can and are investing in this area.

Recently there have also been new entrants into the ESG area with KKR, Blackstone and TPG all launching 'impact' PE funds.

And as one might expect politicians have weighed into the argument relatively recently.

Last year the US Congress asked both KKR and Blackstone specific questions about the environmental and social concerns within their huge healthcare businesses.

At a supranational level, the IFC – part of the World Bank - has recently issued new principles on ESG standards.

When running a listed company, as chief executive or a member of the board, you want to stand out from the crowd and competition in order to attract shareholder interest and capital.

But as Shami Nissan, director of a responsible investment at Actis Capital said in last week's FT:

"If you are silent on your company's impact and how you behave, you will be conspicuous. You will stand out…but for the wrong reasons."

So, to summarise I think there is no such thing as a good or bad shareholder.

There are simply those that care and those that don't.

I think as corporate leaders or investors acting on behalf of shareholders, we need to think carefully about the former grouping as they are not going away, they are growing in number and the list of items they care about is growing longer all the time.

The fact is that with technology and social media, their voice and influence and the issues that can ignite their passions are all things that investors in times past never had access to, cared about or bothered with.

My simple belief and recommendation from both corporate and investor perspective is start with a properly equipped board.

Don’t allow cronyism or complicity. Look for talent, seek out complimentary skills and value independence.

A properly diverse, suitably skilled and well equipped independent board heading a listed corporation will go a long way to considering all these issues, doubtless seeking to do the best thing for all constituents…and in doing this they will help both protect and guide the executive management and build shareholder value.

So, do the right thing for all shareholders and take the advice on corporate boards from Mr Howard Shultz, the genius who turned a single cup of coffee into the $140bn global Starbucks empire:

“You can't build any kind of organization if you're not going to surround yourself with people who have experience and a skill base beyond your own.”