european corporate governance institute

London Business School

AQR Asset Management Institute

First Results Seminar

Corporate Governance Through Voice and Exit: Evidence from Standard Life Investments

3 October 2017

Hosted by London Business School, London

New research findings presented at London Business School drew a large audience of asset managers, investors, policy advisors and academics who were particularly interested in the influence of corporate governance on the actions of a large asset manager.

The study, which was funded by the Norwegian Finance Initiative and conducted by Professors **Marco Becht** (Solvay Brussels School of Economics and Management), **Julian Franks** (London Business School) and **Hannes Wagner** (Bocconi University), is part of an ongoing project based on a unique data set provided by UK asset manager, Standard Life Investments (which has subsequently merged with Aberdeen Asset Management to become Aberdeen Standard Investments). It covers the period 2003 - 2015 and documents the active ownership as exercised by its fund managers and governance and stewardship team.

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Event Report

by **Caroline Villiers**

The presentation of initial findings from the study described the internal governance and stewardship workings of a large active owner, how voice and exit interact in practice, which topics stirred the most frequent engagement activities, and how corporate governance influences fund manager decisions.

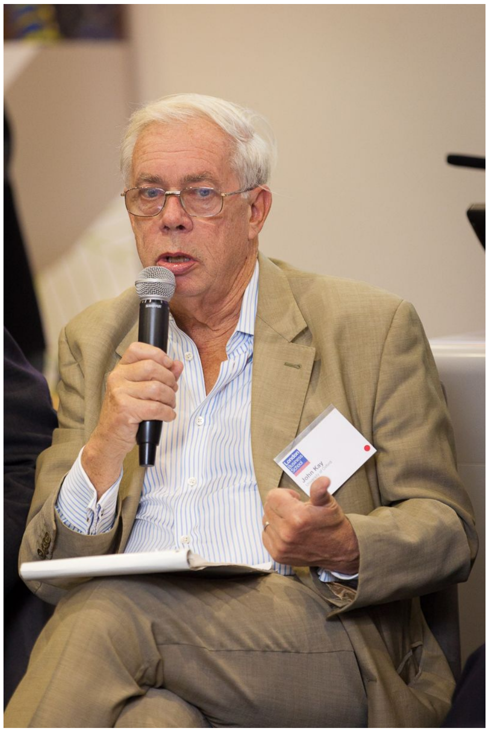
Julian Franks opened by referring to an influential 1989 Harvard Business Review paper by Professor Michael Jensen called ‘The Eclipse of the Public Corporation’, which correctly predicted that listed companies would cease to be so predominant. Franks suggested that the reason for this trend is a failure of governance and this topic became a basis for later debate.

He described Standard Life Investments’ policy as an active asset manager of using Governance Health Warnings for those companies in their portfolio that they need to have a more intense engagement process with. **Marco Becht** then went into further detail on the decision-making process within Standard Life Investments and what impact a Governance Health Warning will have on the investment decisions. The presentation raised a few methodological questions from the audience and the point was made that conclusions drawn could not necessarily be applied to the market as a whole as Standard Life Investments’ procedures may be unique.

Panel Discussion

The presentation was followed by a panel discussion chaired by **Professor Colin Mayer CBE FBA** (University of Oxford). Participating on the panel were **John Kay CBE FRSE FBA**, Supernumerary Fellow in Economics, University of Oxford; **Sir Richard Lambert**, Chairman of the British Museum; **Keith Skeoch**, CEO at Standard Life Aberdeen; and **Euan Stirling**, Head of Stewardship and ESG Investment at Aberdeen Standard Investments.

John Kay started by referring to the Michael Jensen paper and pointed out that the number of listed domestic US and UK companies may have halved since the 1980s but the overall market cap of public companies has by no means declined. He posited that the fall in numbers is due to a dramatic decline in the number of domestic IPOs as those small companies that in the past might have been expected to IPO are now likely to find a private equity or trade sale a more attractive exit. This could only to some extent be attributed to the regulatory burden of being a listed company.

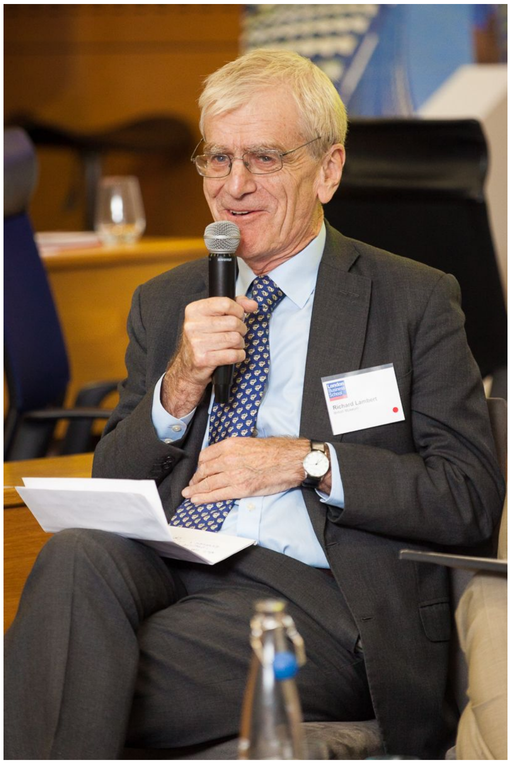


He described the big change as being in how listed companies are valued. In the past, value would be associated with the underlying value of the operating assets but now the largest companies in the world, Apple and Google, are valued at US$600 to US$800 billion but their operating assets are less than 5% of the total. Today, capital does not need to be owned by the company and there is only one manufacturing company, Johnson & Johnson, in the top 10 companies worldwide. Value now depends on the people who operate the company and a claim to future profit. This implies that the decline is not about Corporate Social Responsibility (CSR) but something larger.

Contrary to Jensen, he also believes that investment partnerships are about long-term allocation and relationships, of which loyalty is an increasingly important component (unless it is tested beyond endurance). It is not about the traditional content of governance reports but a genuine relationship. The aim must be for governance and investment decisions to be part and parcel of the same process.

The needs of the 21st century asset manager are very different to those of the 20th century and we have not yet fully taken on board those changes.

Since the publication of his report in 2012, which advocated for more engagement between asset managers and portfolio companies, he believes that asset managers are keen in general to move in the direction of more engagement, exemplified by Standard Life Investments' participation in this study.



Richard Lambert pondered the purpose of a public equity market now that companies no longer IPO in order to raise capital. It has become more a question of stewardship as the preoccupation is the management of capital within companies rather than across companies. He surmised that the impact of engagement on companies is considerable and that a Governance Health Warning, as imposed by Standard Life Investments, would certainly get a reaction from management.

On the other hand he pointed out that an enormous amount of effort is focused on the area of compensation to no discernible overall effect. There must have been individual successes but no sign of a trend. He also wondered how practical it would be to look beyond the influence of xxx on governance matters to those of strategic planning. With the growth of Artificial Intelligence perhaps a way of taking judgement out of decisions will be found. If not, it is difficult to guess the direction of public equity markets as they continue to conglomerate around a small number of very large firms over which it is impossible to have much influence.

He underlined the importance of encouraging loyalty from investors to avoid the frustration of companies when investors place little value on those that take more than 3 or 4 years to pay off and the pressure to act unwisely in the short term as a result.

Keith Skeoch raised his concern for the paucity of appetite for loss-absorbing equity despite the lessons learnt over the past decade about the consequences of over-leverage and not taking a long-term view. He suggested that

Jensen did a great disservice by focusing on the conflict of interest between companies and investors. As people allocate savings for long-term benefit it makes sense to be supportive of the long-term aims of management. As a long-term investor, governance is very important at Standard Life Investments and the starting point for any investor is to be largely supportive of management but within a given framework.

Sometimes long-term strategy is idiosyncratic so this needs to be justified by detailed explanation; it is a code of comply or explain. If the explanation lacks substance the engagement process begins and through a strong relationship it is possible to support management by holding them to account with necessary conditions in place.

A strongly operating secondary market is a means of getting companies to put the necessary conditions in place for a revival in the issuance and acceptance of the loss-absorbing equity. This research comes at an important juncture following 10 years of compressed volatility and we need to continue to learn and deliver the lessons of engagement with companies lest we find ourselves in the same position again.

When asked whether Standard Life Investments was an outlier of investors who have active engagement with their portfolio companies, he agreed that it may be so but there are certainly a significant number of investors who do actively engage. He concluded that it is often necessary to have the courage to take an unpopular decision over many years to get traction with the company. Standard Life Investments' aim is to look over 20 - 30 years at a company to achieve capital gain for investors. There has to be a mind-shift in the delivery of long-term returns to the end customer as the supply of long-term savings is disappearing.

Euan Stirling, who recently came into his role as Head of Stewardship and ESG, was a fund manager at the time the data was taken for the study so might be assumed to be guilty of looking with a more short-term point of view. However as a member of the equity team, he was an avid consumer of the governance arm's output and they were very closely aligned. He underlined that companies need to get one message from the investor so there must not be any chink of light between the governance and investment arms, particularly if the shareholder is in disagreement with the company. If the aim is to influence companies, it is important to do it with one voice.

He explained that exit is necessary when value or hope has gone and through operating in a liquid market it is possible to 'run for the hills' if necessary. The Governance Health Warnings at Standard Life Investments are only one factor in an investment decision when looking to buy or sell and generate long-term returns. On the subject of short-termism he agreed that companies can be encouraged to do crazy things by investors but in many cases you get the shareholders you deserve and he highlighted the very interactive dialogue that Unilever has with its long-term investors as an example of where it works well.

Questions & Answers

When questions were opened up to the floor, the focus was on loyalty and how to get investors to be more long-term. One questioner referred back to a study that has shown the importance of loyalty in the success of Renaissance Florence where financial transactions were found to have a correlation with social transactions and wondered how this compares with today's market. This led to a discussion on whether to some extent the desirable relationship processes, such as increased transparency, have become too conflated with those that protect against fraudsters and there should be more of a distinction between them. Added to this, much of current regulation has been designed to protect markets as they have been historically but they no longer serve the function they once did. Keith Skeoch felt that he would like to see a tougher approach to regulation and greater enforcement of Section 172 of the Companies Act but John Kay felt that the only way to get compliance would be to change it to raise awareness.

James Mackintosh of the Wall Street Journal accused the panel of harking back to a golden age of long-termism which may not actually exist. Euan Stirling was quick to rebut this and said it was an equilibrium that was needed as the current situation is too far out of kilter and there is a responsibility to get back into balance before the market catches you out. Richard Lambert felt it was important to look at why companies exist - to produce decent products, good research and motivated employees. The Financial Crisis proved that this had stopped being the case and trust in business has been eroded through short-termism. Savers also need financial institutions they can trust and large sections of the industry have abused this trust. A new sense of corporate purpose needs to be built to restore trust.

One question returned to the fact that a vast amount of energy is spent on tackling remuneration by governance boards but it is having little impact. John Kay was quick to criticise Jensen who was a proponent for aligning managers' interests with those of shareholders, which ironically has become one of the biggest frictions. Euan Stirling agreed that it is a big resource consumer but another related concern that does not get as much attention is succession planning, which can be the real barometer for how a company behaves.

Another question that arose was whether active engagement is such an imperative when passive funds such as ETFs are seeing extremely strong performance. Euan Stirling pointed out that Standard Life Investments now has a large passive book post-merger and that it is important to have a similar degree of oversight to passive funds as well.

The event concluded on a more positive note. Richard Lambert pointed out that we have moved a long way from the gangsterism of the 1980s even if business is still no more trusted. Keith Skeoch said that corporate governance is also massively improved even if we are still learning as we go. Trust is critical and savers need to have a better understanding of their investments so transparent and thoughtful communication with end investors is also important.

The forthcoming paper "Corporate Governance Through Voice and Exit: Evidence from Standard Life Investments" will be published on the ECGI website (www.ecgi.global)

Copies of the slides used in the presentation may be made available on request.

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About the European Corporate Governance Institute (ECGI)

www.ecgi.global

The ECGI is an international scientific non-profit association which provides a forum for debate and dialogue focusing on major corporate governance issues and thereby promoting best practice. It is the home for all those with an interest in corporate governance offering membership categories for academics, practitioners, patrons and institutions.

Its primary role is to undertake, commission and disseminate research on corporate governance. Based upon impartial and objective research and the collective knowledge and wisdom of its members, it can advise on the formulation of corporate governance policy and development of best practice. In seeking to achieve the aim of improving corporate governance, ECGI acts as a focal point for academics working on corporate governance in Europe and elsewhere, encouraging the interaction between the different disciplines, such as economics, law, finance and management.

About Aberdeen Standard Investments

www.aberdeenstandard.com

Standard Life Aberdeen plc is one of the world's largest investment companies, created in 2017 from the merger of Standard Life plc and Aberdeen Asset Management plc. Operating under the brand Aberdeen Standard Investments, the investment arm manages £583bn* of assets making it the largest active manager in the UK and the second largest in Europe. It has a significant global presence and the scale and expertise to help clients meet their investment goals.

Standard Life Aberdeen plc is headquartered in Scotland. It has around 1.2 million shareholders and is listed on the London Stock Exchange. The Standard Life Aberdeen group was formed by the merger of Standard Life plc and Aberdeen Asset Management PLC on 14 August 2017.

* as at 31 Dec 2016

About the Norwegian Finance Initiative (NFI)

www.nbim.no/en/investments/research/the-norwegian-finance-initiative-nfi

Norges Bank Investment Management is the asset management unit of the Norwegian central bank (Norges Bank), with responsibility for managing the Government Pension Fund Global, often referred to as the Norwegian oil fund, and some of Norges Bank's foreign exchange reserves.

The Norwegian Finance Initiative (NFI) aims to strengthen financial economic research and education in areas relevant for the long-term management of the Government Pension Fund Global.

About London Business School (LBS)

www.london.edu

London Business School's vision is to have a profound impact on the way the world does business. The School is consistently ranked in the global top 10 and is widely acknowledged as a centre for outstanding research.

As well as its highly ranked degree programmes, the School offers education programmes to executives from around the world.

With a presence in five international cities – London, New York, Hong Kong, Shanghai and Dubai – the School is well positioned to equip students from more than 130 countries with the tools needed to operate in today's business environment. The School has more than 42,000 alumni, from over 150 countries, which provide a wealth of knowledge, business experience and worldwide networking opportunities.

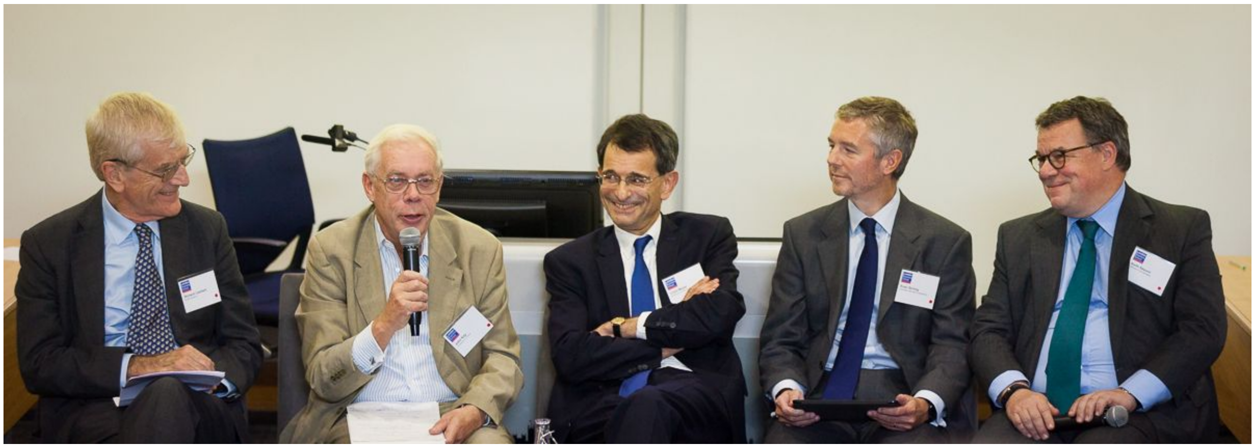
About the AQR Asset Management Institute

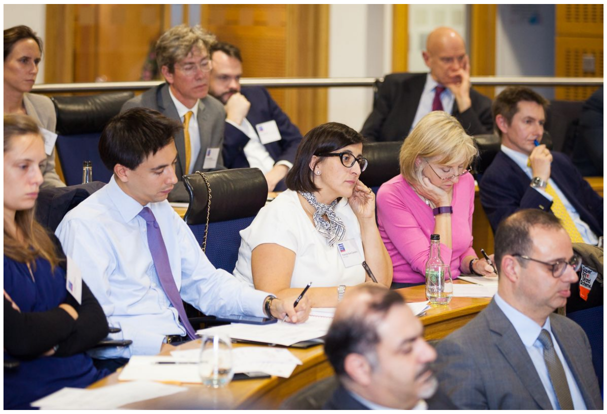
www.london.edu/AQRInstitute

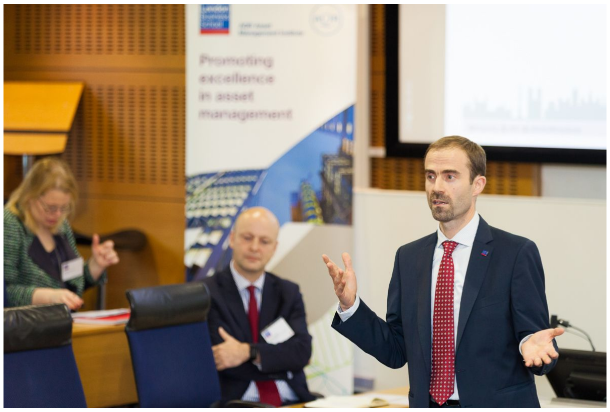
London Business School is the venue of choice for post-graduate asset management research, study and recruitment.

The AQR Asset Management Institute harnesses the School's dynamic combination of academic excellence, global perspective and London experience. The Institute promotes excellence in asset management and furthers its ability to preserve and generate long-term wealth for individuals and societies.

The Institute offers research findings and best practices for the global asset management community, as well as support for future leaders in the asset management field through rewards for global academic talent and excellence. The Institute also provides a platform for policy makers, regulators, academics and practitioners to debate, create, and share ideas through a series of events and networking opportunities.



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