

Corporate Governance Through Exit and Voice

Finance Working Paper N° 633/2019

October 2019

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Abstract

How do active managers engage with portfolio firms? And, what role does monitoring and engagement play in their trading decisions? We use proprietary data from a large UK active asset manager with a long-standing commitment to stewardship to answer these questions. Our sample, based on nine years of daily data, provides a detailed picture of how fund managers' decisions are influenced by monitoring target firms, especially through private engagements. Internal analysts and a centralised stewardship team monitor the board and management and place portfolio companies on a watch list when there are governance or other concerns. The asset manager engages more intensively with the watch list, abstaining or voting against management proposals in a third of meetings. More intensive engagement and negative votes against are associated with internal analyst downgrades and with exit by fund managers. We provide evidence that monitoring and engagement generate information advantages, which in turn contribute to alpha. Our results provide strong support for voice influencing exit.

Keywords: Asset management, active ownership, corporate stewardship, shareholder monitoring, shareholder engagement, analyst research, institutional investors, corporate governance, voice and exit

JEL Classifications: G11, G14, G23, G34

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Abstract

How do active managers engage with portfolio firms? And, what role does monitoring and engagement play in their trading decisions? We use proprietary data from a large UK active asset manager with a long-standing commitment to stewardship to answer these questions. Our sample, based on nine years of daily data, provides a detailed picture of how fund managers' decisions are influenced by monitoring target firms, especially through private engagements. Internal analysts and a centralised stewardship team monitor the board and management and place portfolio companies on a watch list when there are governance or other concerns. The asset manager engages more intensively with the watch list, abstaining or voting against management proposals in a third of meetings. More intensive engagement and negative votes against are associated with internal analyst downgrades and with exit by fund managers. We provide evidence that monitoring and engagement generate information advantages, which in turn contribute to alpha. Our results provide strong support for voice influencing exit.

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1. Introduction

How do active managers engage with portfolio firms? How do they integrate stewardship into the investment process? And what role does monitoring and engagement play in fund managers' trading decisions? We know little about these questions since most of the interactions between institutional investors and their portfolio companies are private and therefore unobservable. We address these points using proprietary data from one of the world's 30 largest active asset managers – Aberdeen Standard Investments.¹ This paper is one of the very few to use proprietary data on private contacts with portfolio companies to assess the importance of monitoring and engagement for trading decisions, sometimes described as the impact of voice on exit.

Our data include a wide range of the internal day-to-day activities inside the asset management organization. Specifically, they relate to the activities of the UK Equities Team. The UK Equities Team is composed of fund managers, internal analysts and a dedicated Governance & Stewardship (G&S) Group. The data include roughly 12 million observations of fund-level stock holdings at daily frequency, all votes cast at shareholder meetings, all contacts between portfolio firms and the asset manager (with extensive notes accompanying those meetings), and private internal analyst recommendations.

To illustrate the activities of the UK Equities Team, consider the year 2015. Among the 646 stocks included in the FTSE All Share index at year-end 2015, the asset manager held 5,106 positions in 385 stocks, across 133 funds. Among these, the Team had direct responsibility for 48-

¹ Aberdeen Standard Investments is the asset management brand of Standard Life Aberdeen Plc, that was created in March 2017 by the merger of Standard Life Plc and Aberdeen Asset Management Plc. As of June 2019, it manages \$670 bn, making it the largest active manager in the U.K. Our data relate to the operations of Standard Life Investments, the asset management arm of Standard Life Plc that was set up in 1998.

60 UK equity funds. The roughly 13 internal analysts held 650 meetings with portfolio firms, mostly with the CEO and CFO. In addition, the G&S Group had 616 contacts with portfolio companies, of which 165 were personal meetings handled by five senior staff; in total there were 12 members.

We find that G&S engages more intensively with companies that are flagged as posing a governance risk for fund performance, with what is termed as a “Governance Health Warning” (GHW). G&S abstains or votes against company resolutions at shareholder meetings in 33 percent of all meetings in companies with a GHW, compared with 14 percent for companies not on the GHW watch list. Disagreement with management is concentrated in, but not limited to, three key areas: compensation (executives, board members), board composition (e.g. reappointment of directors, independence) and socially responsible investment (e.g. environmental disclosure, diversity).

The intensity of engagement with the portfolio firm increases substantially around shareholder meetings, particularly where there are abstentions or votes against. Compared with votes in favour of management proposals of portfolio firms, votes against management involve roughly three times more frequent contact with G&S prior to the vote, and the interactions are characterised by a significantly more negative tone of voice in meeting notes.

The asset manager is frequently among the largest investors and in aggregate across all funds holds a stake of almost 3 percent in the average portfolio company. The considerable influence of the asset manager is reflected in high-level interactions with portfolio firms, which frequently involve the CEO, the CFO, or the Chairman of the target firm. The holdings are significant even when compared with some of the largest institutional investors worldwide. The Norwegian Government Pension Fund Global invests in 427 UK stocks averaging 1.8 percent and

BlackRock, the global investment manager, invests in 363 UK stocks averaging 4.1 percent (all at year-end 2015).

The G&S Group manages voting decisions for all funds and governance related interactions. It takes the lead on director appointments, auditor appointment and remuneration and also promotes environmental and social goals. G&S is centralised and regularly meets the head of equities, analysts and fund managers, to discuss portfolio firms. One objective of those meetings is to provide information that is relevant for analysts, who in turn produce information for fund managers' trading decisions. Any member of the UK Equities Team can flag problem cases that will be reviewed by analysts and G&S Group members when taking voting decisions.

We focus our analysis around three events related to shareholder engagement: changes in internal analyst recommendations, shareholder votes and additions to the GHW watch list.² Changes in analyst recommendations, for example downgrades from "buy" to "sell", have a high probability of revealing new information. These private signals are observable only by fund managers, and in addition to all available external sources, like broker meetings and research, they also incorporate any information obtained during the asset manager's engagement process as described above. As such we conjecture that they should drive trading decisions. Similarly, shareholder votes at shareholder meetings are important events since they crystallise opinions about decisions taken by portfolio firms, for example, setting management compensation. Governance health warnings signal dissatisfaction with portfolio firms' governance.

We first examine changes in internal analyst recommendations, that we interpret as sell signals and buy signals. We find that some fund managers trade significantly in windows around

² The next version of the paper will include an analysis of trading around company meetings and other information events.

those events. The magnitudes of those trades are large. Fund managers that trade following “sell” recommendations, reduce their stakes by roughly a third during a seven-day window around the recommendation, while fund managers that trade following “buy” recommendations increase their bets similarly by roughly a third for the same window.

Around shareholder votes, we also find a significant amount of trading. We focus on the disagreement reflected in voting decisions, both votes against and abstentions. We show that these disagreements influence trading decisions. First, we show that trades react more negatively to voting disagreements than abstentions, and even more so when internal analysts downgrades coincide with votes against. These results add to the findings by Li, Maug and Schwartz-Ziv (2018) who, like us analyse daily trading around shareholder meetings; however, they do not link this to engagements with the portfolio firms and they do not observe the size of daily holdings.

For GHW events, when portfolio firms are placed on the internal watch list, we examine the extent to which they are related to buy and sell decisions of fund managers. We find a significant impact of these events on trading; a striking 99.8 percent of fund positions trade the stocks upon receiving a GHW.

Finally, we examine the extent to which these three events are related to performance. We examine the possibility that engagement with portfolio firms is one way for an active manager to generate information advantages, trading decisions and alpha. We measure abnormal returns around each of the three types of trading events analysed so far. We find that economically by far the largest contributor to abnormal returns are trading decisions around analyst recommendation changes. These changes are also significantly associated with voting decisions.

For an average position, fund managers through larger bets on upgrades gain 68 bps during a 6-day window around the internal publication of new buy signals. On the downgrades, fund

managers avoid losses of 48 bps during the same window. These abnormal returns are economically large and statistically significant, and are, depending on the conviction of the analyst signal, between two to four times larger than the abnormal returns one would obtain by implementing similar trading strategies based on sell-side analyst recommendations (i.e. analysts with I/B/E/S coverage). The abnormal returns do not appear to be driven by price pressure, liquidity or basic market inefficiencies.

This evidence suggests that monitoring and engagement affects trading. There are a number of channels through which information is collected and the G&S group is a significant contributor. For example, we know that the analyst reports contain G&S information and that the group is critical in formulating and executing voting decisions. We also know that the group primarily monitors the board, managerial incentives and strategy while the analysts predominantly monitor management and execution. To the extent that the G&S function contributes to trading it is a potential profit centre for an active asset manager.

The UK setting of our data is particularly suited for testing theories of monitoring, engagement and trading. UK equity markets have a high degree of efficiency and the listing rules favor independent shareholders, setting a high bar against which to test whether active investment strategies that incorporate stewardship are able to beat the market.

Our paper adds to a large literature on institutional investors, within which few studies have explored how large, mainstream institutional investors engage with their portfolio companies. The empirical papers closest to ours are Li, Maug and Schwartz-Ziv (2018) on voting cited above, Green, Jame, Markov and Subasi (2014) who show that analyst meetings reveal valuable information, and Dimson, Karakas, and Li (2015) who analyze engagements of a sustainability-

focused equity ownership service. The former two do not use non-public engagement data, whereas the latter does, although it does not link engagement with trading decisions.

Our paper also relates to the literature on shareholder activism that mostly focuses on hedge fund activists (Brav et al., 2008).³ Hedge fund activism differs since its primary purpose is to take positions in stocks so as to exert influence and affect change, whereas mainstream asset managers will very rarely buy stocks with the explicit goal of activism.⁴ We extend this literature by showing how the tactics of a mainstream active manager differ from those of a shareholder activist, and yet note their similarities in producing information that drive trading decisions.

Our paper builds on the theoretical work on the trade-off that investors face between exit, voice and loyalty (Hirschman 1970)⁵ and adds to the survey evidence of McCahery, Sautner and Starks (2016) by showing that voice influences the exit decisions taken by fund managers. Our results also relate to the role of skill and information in fund managers' trading decisions (Chen, Jegadeesh, and Wermers 2000)⁶, that rely on quarterly US filings data to proxy for trading decisions. We contribute by providing direct evidence on daily trading decisions and the interactions of the entire asset management team with portfolio firms. Finally, our findings relate to the literature on private access to management through shareholder meetings (Green, Jame, Markov and Subasi 2014)⁷ and other types of information acquisition (Iliev, Kalodimos, and

³ See also Becht, Franks, Mayer and Rossi, 2009; Bebchuck, Brav, and Jiang, 2015; Becht et al. 2017.

⁴ While hedge fund activism, because of its business model, tends to be highly visible, it is a highly specialized and relatively small market. In 2015 it represented less than 1 percent of global equity AUM.

⁵ See also Kahn and Winton 1998; Admati and Pfleiderer, 2009; Edmans, 2009; Edmans and Manso, 2011; Levit 2014; Dasgupta and Piacentino 2014; Norli, Ostergaard, and Schindele 2015; Gantchev and Jotikasthira 2017.

⁶ See also Barber, McNichols and Trueman, 2001; Jegadeesh, Kim, Krische, and Lee, 2004; Banegas, Gillen, Timmermann, and Wermers, 2013; Rebello and Wei 2014.

⁷ See also Soltes, 2014; Solomon and Soltes, 2015; Bushee, Jung and Miller 2017.

Lowry 2019). We contribute by showing that despite high regulatory standards in the UK, private meetings with boards and management can provide valuable information for active investors.⁸

2. Stewardship and Investment Setting

Institutional investor stewardship and corporate governance principles originate in the United Kingdom and have been adopted globally, including in the U.S. Like in the U.S., ownership of U.K. markets is dominated by institutional investors, which play an important role in shaping listing rules, financial market regulation and company law. Important shareholder rights include an ability to requisition extraordinary meetings, binding resolutions passed by majority vote and directors appointed individually. In addition, institutional investors must approve capital issuance, delisting, related party transactions and major acquisitions; they also pass advisory votes on remuneration.

These arrangements allow institutional investors to delegate monitoring to corporate boards while giving them the power to hold directors accountable and to ensure that corporate governance functions properly. The resulting engagement culture encourages private contacts with boards and management that are not observable to the general public.

Our proprietary data are provided by Standard Life Investments (SLI), one of the largest institutional investors in the United Kingdom (Mallin, 2006).⁹ The firm has invested in corporate governance and stewardship since the inception of the Cadbury Code in 1992. The data we analyze is for a single institution for the period 2007-2015 and whose governance team has a high profile

⁸ See the Appendix for a more detailed review of the prior literature.

⁹ SLI was the investment arm of Standard Life Plc, and was created in 2006 through the demutualization of Standard Life Assurance, one of the largest life insurance mutual companies in the world. SLI built on the reputation of the parent company for in depth research (Moss 2000, pg. 332). Black and Coffee (1994) provide a detailed description of the significant role played by insurance companies and the asset managers they own in the governance of U.K. companies, unlike their U.S. counterparts.

among investors and companies.¹⁰ Therefore the results could be interpreted as a relatively high watermark of what level of stewardship a large active manager with a long-term, actuarial corporate culture can achieve.

2.1. SLI Internal Organization and Investment Process

This section describes the structure and activities of the UK Equities Team that manages almost all of SLI's UK equity holdings (Table 1). Figure 1 illustrates the team's stylized monitoring, engagement and trading process. There are three main groups of individuals: Internal analysts, fund managers and the G&S Group. The overall team is led by the Head of UK Equities who is both an analyst and a fund manager.

Figure 2 shows the timeline of the main sources of information and key events in our sample. Analysts, fund managers and the G&S Group conduct personal meeting with portfolio companies. The information from these meetings is recorded in databases and reports. This internal research and outside information are condensed into quarterly analyst reports and continuously updated buy/hold/sell recommendations that are distributed across the whole team. Based on this information and their own assessments, fund managers make trading decisions. Voting decisions are executed by a voting manager, who is a member of the G&S Group. Below, we describe in detail the roles of (i) the G&S Group; (ii) the internal analysts; (iii) the fund managers; and (iv) the voting manager.

2.2 The Governance and Stewardship Group

¹⁰ For example, in 2013 the Head of the SLI G&S Group was elected Chair of the UK's Corporate Governance Forum, an informal network comprising leading UK institutional investors "committed to best practice principles of governance and stewardship". In a joint effort with the GC100, a grouping that brings together the UK's largest 100 listed companies, the Forum published influential remuneration guidance; see Jones (2013).

The G&S Group engages with portfolio firms and keeps detailed records of those engagements. The group consists of a senior manager and a supporting team of up to 12 other individuals. The responsibilities of G&S include conversations with the portfolio companies' management and their boards relating to remuneration, board composition, including appointments of Chairmen, non-executive directors and CEO. G&S engages on these issues with the goal of gathering information and bringing about change. Portfolio firms also approach the team to consult on governance issues, in particular on remuneration, typically preceding an advisory vote.¹¹

The information gathered by G&S is passed on to analysts and fund managers both in writing and at joint meetings. In particular, G&S can internally flag a company with a "Governance Health Warning" (GHW). A GHW is included on the first page of analyst reports received by fund managers. GHWs are also linked to the internal voting data, as discussed below. A detailed description of the GHW process is contained in Internet Appendix F. Our paper accesses all data recorded by the G&S Group.

2.3 Internal Analysts

Internal analysts arrange and often chair company meetings that are attended by fund managers and, at times, by members of the G&S Group. The majority of meetings are attended by the company CEO and/or the CFO. Analysts use information provided by G&S, the company meetings, broker contacts and other information to make buy and sell recommendations on stocks. Analysts also produce quarterly industry reports and occasional company reports. The buy and sell recommendations as well as detailed company research reports and the quarterly industry reports are accessible to both fund managers and the G&S Group. The recommendations are not made

¹¹ In 2013 a three-year binding vote on the company's remuneration policy came into effect. The annual vote on the remuneration report remained advisory.

public. We also refer to these internal analysts as buy-side analysts, to contrast them with sell-side analysts whose recommendations are made public. Analyst recommendations include three levels: “buy”, “hold” and “sell”. Our sample references all data produced by analysts, including detailed company reports, quarterly industry reports and the full history of recommendations. We also had access to the dates and attendance records of the analyst-led company meetings. At the end of 2015, 13 analysts made recommendations for 323 portfolio companies across 40 industries. Most analysts also serve as fund managers: 9 out of 13 in 2015.

2.4 Fund Managers

During our sample period, there were between 11 to 13 fund managers, usually managing multiple funds; almost all fund managers are also analysts. As described above fund managers engage with target companies through private meetings. An important difference between fund manager engagements and G&S engagements is that the former meet with all companies at least once a year, whereas G&S focus their engagements on a subset, particularly those with a Governance Health Warning or a negative vote in a previous year. While the G&S Group interacts with target firms on governance and compensation related issues, as described above, fund managers are responsible for non-governance issues, including raising capital, M&A, divestitures, under-performance and voluntary delisting. When these decisions involve governance, the G&S Group will accompany the fund manager to a meeting with target management. The G&S Group will also raise performance issues with the non-executives, if necessary. The fund managers and the G&S Group sit on the same floor and meet regularly both formally and informally.

2.5 The Voting Manager

Voting is carried out across all funds by a dedicated voting manager who is a member of the G&S Group. The holdings of all funds for the same company are voted in the same direction,

and votes are never split.¹² Internal voting recommendations arise from a conversation between the voting manager, the G&S Team and the relevant analyst. A detailed description of the voting decision process is contained in Internet Appendix E. Our sample includes all voting data.

2.6 Descriptive Statistics

In Table 1, we provide summary annual statistics for the holdings of the asset manager. In Panel A, the number of funds managed by the UK equities team decreased from 64 in 2007 to 48 in 2015.¹³ The size of the average individual stake was stable and around 3 percent. Total assets in our sample of UK equity positions were \$67 billion in 2015, halved to \$33 billion during the financial crisis and recovered to \$48 billion at the end of the observation period. ASI is the third largest UK asset manager, with total AUM of roughly \$375 billion in 2015 (see Appendix B).¹⁴

Panel B shows the total number of analyst meetings and the number of companies met per year. After 2012 SLI engaged all portfolio companies at least once a year. In most cases the meeting was attended by the CEO, the CFO or both. Meetings with the Chairman were less frequent.

Panel C shows the engagement activity of the G&S Group on an annual basis. For brevity, we focus on the last year, 2015. During that year, the Team had 564 unique contacts with portfolio firms, where the most frequent type of contact is a meeting. In those contacts, the Team raised 430 issues, indicating that discussions of issues was typically complex and extended over more than one contact. The Team had 15 members, who engaged with portfolio firms. G&S only met with a

¹² We exclude from the sample a single institutional client who gives separate instructions; the voted amount is negligible.

¹³ ASI also has other funds that hold U.K. equities including European, Asian, Multi-Strategy and Private Equity funds. SLI also managed an index tracker fund that was dissolved in 2012. These funds represent less than 5% of the total value of U.K. equities in any one year.

¹⁴ Note that AUM in Appendix B are \$806bn which includes the assets arising from the merger with Aberdeen Asset Management in 2017.

fraction of the portfolio companies, suggesting that the meetings are more targeted than those arranged by the analysts.¹⁵ To illustrate the differences in business models between active asset managers and activist hedge funds, the equivalent figure for the largest European hedge fund activist, Cevian Capital, is roughly 1 team member per 1 portfolio firm.¹⁶ Even when counting all members of the UK equities team this ratio is lower than for SLI.

About 4 percent of firms have an outstanding GHW flag in 2015. This number is lower than during the earlier sample period, where it fluctuates around 9 percent.

In Panel D, we report votes cast by the Voting Manager at shareholder meetings. In 2015, SLI voted against or abstained on at least one resolution in 22 percent of meetings. Although not shown in the table, disagreement with management is concentrated in three key areas: compensation (executives, board members), board composition (e.g. reappointment of directors, independence) and socially responsible investment (e.g. environmental disclosure, diversity).

In Figure 3 we show for a subsample of funds, where the benchmark is the FTSE All Share index, their active share, as defined by Cremers and Petajisto (2009). Active share serves as a measure of how much the portfolio choices of a fund manager deviate from the fund's benchmark. The large funds, represented by the larger circles, suggest an active share of between 25 and 35 percent, which is low by the standards of an active fund as defined by Cremers and Petajisto. These funds were managed on behalf of the Standard Life insurance company.

Finally, in Table 2, we report summary statistics for the proportion of buy, hold and sell recommendations made by analysts, and compare them with those made by sell-side analysts reported by I/B/E/S. In Panel A, sell recommendations by SLI in 2015 account for 24.6 percent of

¹⁵ The G&S Group engaged in 2015 with only 32.2 percent of portfolio firms, engagements are not random and contacts are more frequent among targeted companies.

¹⁶ Informal estimate based upon discussions with Cevian Capital.

all recommendations, compared with only 10.6 percent in I/B/E/S. Hold recommendations are remarkably similar in the two cases. It is clear that SLI's internal analysts are more aggressive in assigning sell recommendations. Given the well-established bias exhibited by sell-side analysts, this may suggest that internal analyst opinions reflect less bias or possibly better information. This is consistent with prior US evidence that buy-side analysts are more likely to issue sell recommendations and less likely to issue buy recommendations than sell-side analysts (Rebello and Wei, 2014).

Panel B focuses on changes in analyst recommendations during our sample period, disaggregated into new sell signals—which include changes from buy to hold, buy to sell and hold to sell—and new buy signals, which include sell to hold, sell to buy, and hold to buy. Because stocks that are newly downgraded or upgraded by internal analysts are typically held by multiple funds, there are large numbers of positions in all categories of upgrades and downgrades. For example, in the buy to sell category of new sell signals, there are 86 unique cases where a stock that was originally a “buy” became a subsequent “sell”. These stocks are held in 1561 positions across all funds.

2.7 Illustrative Case Studies

Three case studies illustrate monitoring and engagement by the UK equities team and their connection with voting and trading (exit). The three case studies include, Vodafone, a large widely held telecoms company (Appendix D1), EasyJet, a low-cost airline that transitioned from founder/family control to an independent board with outside management (Appendix D2), and Sports Direct, a sports retail company that is *de facto* controlled by its controversial founder (Appendix D3).

In the case of Vodafone, the company was placed on a governance health warning early during the observation period because of concerns about board composition, succession and the performance of the CEO. Analysts and the fund managers regularly met the CEO and the CFO, while the G&S Group mostly engaged with the leading independent director and the Chairman. The governance engagement actively contributed to board changes and to the replacement of the CEO. The analyst recommendation was “hold” during the period and there was relatively little trading or change in the size of the holding in the expectation that the engagement would be successful.

In the case of EasyJet there was a confrontation between the founder and the company’s board and management. In private meetings and several important votes, the G&S Group sided with the board against the founder and helped to make the company become more independent. However, lingering concerns about the influence of the founder and an unfavorable analyst opinion about the competitive position of the company in the airline industry resulted in exit.

Sports Direct was a failed engagement. The company was on a governance health warning almost during the entire observation period. SLI increased its stake significantly after positive analysis about the company’s future earnings prospects. Press reports about unacceptable working conditions in the retailer’s central warehouse and ongoing governance concerns caused a major engagement at all levels. The intransigence of the founder and SLI’s inability to bring about change resulted in the complete and widely publicized, simultaneous exit across all SLI funds.

3. Results

In this Section, we analyze the effect of stewardship engagement on trading of fund managers around three events: how analyst recommendations influence trading by fund managers; analyzing shareholder voting decisions and trading around those shareholder meetings; and,

analyzing trading around Governance Health Warnings, where the G&S Group expresses explicit dissatisfaction with governance performance of portfolio firms. Finally, we measure abnormal returns on trades around these events to determine if active trading by the asset manager contributes to alpha.

3.1 Analyst Recommendations and Trading

Table 3 in Panel A describes the trading activity of fund managers around the internal publication date of analyst recommendations. We find that for any sell signal (previously a buy or a hold), the fund managers reduce their holdings in 22.1 percent of all positions. In the case of buy signals (previously a sell or a hold), fund managers increase their holdings in 13.5 percent of all positions. Therefore, a significant proportion of trades is in line with recommendations made by analysts. However, a majority of positions are unchanged in response to a change in recommendation by the analyst. The lack of trading in response to these signals may be due to many of the funds being relatively passive, consistent with the evidence shown in Figure 3. An alternative explanation is that fund managers do not believe these signals contain information relevant for trading, at least not in the short term. Perhaps more surprising than the lack of trading is the trading activity of contrarians. In the case of sell signals, fund managers actually increase their holdings in 3 percent of positions, and in the case of buy signals, fund managers sell in 4.1 percent of positions. The pattern of this trading activity illustrates the decentralized nature of decision making by fund managers, and heterogeneity in beliefs.¹⁷

¹⁷ Discussions with fund managers suggest that these contrarian trades are at least partially explained by differences in opinion about market timing, i.e. when buy and sell signals should be traded upon. Fund managers are well aware of these differences.

In Panel B, we focus on only those fund managers whose trades are in line with recommendations; that is, we consider those fund managers that sell in response to sell signals and buy in response to buy signals. We report the magnitude of trading for the seven days around the internal publication of the new analyst opinion. In the case of sell signals, selling fund managers reduce their stake on average by 31.6 percent. There is small selling in the day prior to the publication. There are significant sells on the publication day (day 0), where about 8 percent of the stake is sold, and a further 6.5 percent on day +1. Selling continues in the subsequent 4 days (+2 to +5), totaling about 14.5 percent. In the case of buy signals, buying fund managers make similarly large trades, increasing their stake on average by 40.26 percent. Overall, the responses to sell and buy signals are similar in magnitude and timing.

In Table 4, we report the abnormal returns around this trading activity, and roughly quantify the size of abnormal performance achieved through active trading. In Panel A, we report negative abnormal returns both before and after the internal publication date of sell signals. On the day of publication, there are negative returns of -1.52 percent, and in the subsequent five days there are further negative returns of -1.73 percent. Both of these returns are statistically significant at the 1 percent level. Since we do not have the intraday time stamps of trades, we make assumptions on when fund managers are executing their trades during the day. We also assume that fund managers cannot trade on day minus 1, which is borne out by the data. SLI is a large and sophisticated institution, with all trading done by internal traders, and no equity trading outsourced. Below, we consider two alternative assumptions, that trades are either made at the opening price (the optimistic scenario) or at the closing price (the pessimistic scenario) on the day of publication. Since we observe daily positions, we are sure that the pessimistic scenario is a lower bound of

realized performance. We further assume that traders move both from and into cash when buying and selling equities.

With respect to buy signals, price patterns are the opposite of those for sell signals, and absolute abnormal returns are slightly less pronounced than for sell signals. From day zero to day +5, we observe abnormal returns of 1.88 percent, again significant at the 1 percent level.

For comparison, we report abnormal returns for all those positions that are subject to sell signals and buy signals where fund managers do *not* trade on those signals. Recall from the previous table that this category of non-trading positions represents the majority of the sample. The abnormal returns for sell signals where fund managers do not trade are smaller than the ones where fund managers do trade, but continue to be negative and statistically different from zero. For example, on day zero there are negative abnormal returns of -1.01 percent for non-trading positions compared with -1.52 percent for positions with sell trades. Note that the reason for these differences is that the portfolio composition of the two samples is necessarily different; for example sell trades may be concentrated in a different set of stocks than those stocks that are not sold down. We analyze (unreported) abnormal returns during the 20 days subsequent to the internal publication of analyst recommendation changes and do not find evidence of mean reversion in returns, which suggests that these abnormal returns are unlikely to be due to price pressure effects. Interestingly, the results suggest that the signals produced by internal analysts are of such quality that even those signals on which fund managers do not trade, would allow profitable trading if they were undertaken.

In Panel B, we attempt to quantify the impact of trading on performance, while acknowledging that we do not know the intraday timing of trades made by fund managers. Starting with sell trades, as before we consider only those positions where a trade was made, i.e. a fund

manager sells in response to a sell recommendation. To provide a measure of trading-induced gains and losses, we compare a hypothetical passive strategy with the actual active strategy of fund managers.

We first focus on the sell trades, in columns 1 to 5. The hypothetical passive strategy is shown in column 1. If fund manager had not traded, their cumulative abnormal returns would have been -3.51 percent for the sell trades, for the six day window from zero to +5. In column 2, we calculate the actual abnormal change in value of the position held. This abnormal change captures both the return during the trading window and the reduced position that the fund managers has at stake due to the significant sell trades. Given the performance and trades, the losses on those positions – assuming optimistically that trades were made at the opening price – are lower at -3.03 percent. Thus, trading managed to avoid losses of approximately 48 bps during the six day window. Based on the pessimistic assumption that the trades are made at the closing price, the avoided losses are reduced to about 22 bps.

The corresponding outperformance for the buy trades are gains of 68 basis points due to trading (based upon the opening price) and 22 basis points (based upon the closing price). Active trading around analyst recommendation changes thus appears to contribute to alpha. In the next draft of this paper we intend to focus on the persistence of fund manager skills, by reporting the extent to which trades are undertaken by specific fund managers, and whether such differences are related to fund performance.

In Panel C, we disaggregate the abnormal returns for sell and buy signals into return quintiles, to confirm that the observed negative and positive returns are not due to outliers. The table shows the averages of the performance quintiles. The average of the third performance quintile is roughly equivalent to the average performance reported in Panel A.

In Panels D and E we perform robustness tests. In Panel D, we split trades by market cap of the portfolio firm and by the size of the aggregate stake held by the asset manager. Broadly, there is no discernible pattern of returns across firm size and stake size. For example, for sell signals, the smallest quintile of firms exhibits abnormal returns of -5.71 percent for the seven day window around the recommendation change, while the largest quintile exhibits returns of -3.49 percent. These results suggest that abnormal returns are not concentrated in large or small stocks, or large or small stakes, implying that liquidity or mispricing effects are unlikely to explain our results.

In Panel E, we split trades by the size of the aggregate trade (measured as the percentage of the stake previously held) during the -1 to +5 window. Again, there is no clear pattern of returns across trade sizes, consistent with fund managers facing restrictions on larger trades when larger price changes occur.

In Table 5 we compare the sell and buy signals in our data with signals constructed from comparable analyst recommendation changes based on publicly observable analyst opinions in I/B/E/S. Within sell signals, we distinguish switches from buy to hold, buy to sell, and hold to sell separately, and do the same for buy signals.¹⁸ For sell signals, the abnormal returns in our data are consistently more negative than those attributable to I/B/E/S analysts. For example, for buy to sell changes, our data report abnormal returns of -5.22 percent for the three day window, while I/B/E/S changes report -1.19 percent. For buy signals the pattern is similar, with the exception of sell to hold changes in our data. Overall, the larger abnormal returns in our data, combined with our finding that abnormal returns around internal analyst recommendation changes are significantly

¹⁸ Note that while our data only contain three recommendations levels - “buy”, “hold” and “sell”, recommendations in I/B/E/S contain usually five levels, adding “strong buy” and “strong sell”. To make the data comparable, we combine in I/B/E/S “strong buy” and “buy” into “buy”, and “strong sell” and “sell” into “sell”.

different from zero for 5 days after the event, suggest that the signals produced by internal analysts do not simply capture publicly available information. As mentioned earlier, the abnormal returns also do not appear to be primarily related to market impact. This leaves superior information as a plausible hypothesis to explain the abnormal returns. An important question is how much of this information is contributed by analysts, fund managers and the G&S Group. In the next section, we examine voting data and the extent to which they are correlated with both analyst recommendations and fund manager trades.

3.2 Shareholder Votes and Trading

In this section we analyze the intensity of engagements around shareholders meetings, particularly when SLI expresses dissatisfaction by voting against or abstaining on resolutions proposed by management. We also analyze trading around the voting decisions of SLI at those meetings and in particular the extent to which voting is correlated with internal analyst recommendations. As we described in the case studies, negative votes or abstentions indicate an engagement escalation. We test whether voting decisions influence exit.

Table 6 in Panel A describes the trading activity of fund managers around shareholder meetings in which SLI votes, and agrees or disagrees with management. We refer to ‘No disagreement’ as those shareholder meetings where the asset manager does not vote against or abstains from voting on any proposal. ‘Any Disagreement’ refers to shareholder meetings where the asset manager votes against or abstains from at least one proposal in the shareholder meeting. We find that where there is no disagreement around 20 percent of positions involve buyers and 20 percent involve sellers. In contrast, where there is any disagreement, 22 percent are buyers and 25 percent are sellers. The proportion of positions that do not trade is higher at 59 percent when there is no disagreement than the 52 percent where there is disagreement. This suggests that

disagreement prompts shifts from buying to selling, but while statistically significant the differences are modest.

In Panel B we consider the size of the trades in those positions where there is trading. We consider a relatively long window of 51 trading days around the shareholder vote, since the voting decisions and the voting dates are known in advance. All positions that trade accumulate an additional 5.6 percent in their existing stakes around the vote. The positions with disagreement buy 3.3 percent less than position that trade where there is no disagreement, significant at the 1 percent level.

In Figure 4, we compare engagements by the G&S Group around those votes. We consider four measures of engagement activity: the number of topics discussed with the target firm, the number of contacts with the target firm, the number of times that negative words are mentioned in G&S Group notes, and the negative tone share in those notes (the number of negative words divided by the total number of negative and positive words). All four measures of engagement activity show the same pattern. Engagement activity is higher both prior to the votes against, and subsequent to them, compared with engagement activity without votes against. As expected, SLI engages more intensively when they vote against or abstain. The results for tone of voice are consistent with the G&S Group learning through their interaction with target companies. This interpretation is confirmed by Figure 5 where we show cumulated engagement activity with cumulated trading activity. The figure shows that the asset manager buys large quantities of stocks, roughly 6 percent, around shareholder meetings where there is no disagreement. In contrast, the asset manager sharply reduces buying around votes where there is disagreement, to about 2 percent. The lack of buying in cases of disagreement almost perfectly coincides with increased engagement activity, as illustrated in the other panels. This suggests that engagement influences

trading. For example, in the third panel of Figure 5, where there are votes against the number of contacts is three times higher (1.8 contacts with the portfolio firm during the 51 days around the shareholder meeting) than in those cases where there is no disagreement (0.6 contacts for the same period).

Figure 6 provides additional evidence on how the intensity of disagreement between the asset manager and the portfolio firm influences trading decisions. In the figure, we partition trading activity into three categories: shareholder votes without any disagreement (No Disagreement), shareholder votes where the asset manager abstains or votes against (Any Disagreement), and votes where the asset manager votes against (Vote Against). In the SLI voting database, abstain votes are often described as a warning to the target firm; unless it changes its ways, SLI will vote against in the next round of voting. The first panel of the figure shows that trading activity significantly depends on the degree of disagreement. Over the 51-day window, fund managers reduce their buying activity by roughly 2.5 percent where there is any disagreement, compared with No Disagreement; and, by 4 percent where they vote against (strict disagreement). These differences similarly appear in other panels in the figure: more frequent engagement, more issues raised, and more negative tone are all associated with stronger disagreement around the vote. This is consistent with more intensive engagement by the G&S Group influencing voting decisions and trading decisions.

Finally, in Figure 7 we combine shareholder votes with analyst recommendations, to obtain a cross-section of disapproval as follows: Shareholder meetings with no disagreement and no analyst sell signal around the vote indicate the lowest level of disapproval, while shareholder meeting with votes against and analyst sell signals indicate the highest level of disapproval. We consider analyst sell signals to be related to the shareholder meeting if they are issued within the -

25 to +25 windows, but do not require them to exactly coincide with the date of the vote. The highest level of approval is associated with buys of around 7.5 percent over the 51-day window, while the highest level of disapproval is associated with sales of 5 percent over that window. The gap of 12.5 percent between the approval and disapproval is economically large and statistically significant at the 1 percent level.

3.3 Governance Health Warnings and Trading

We consider trading activity around GHW events, when GHWs are switched on, in Table 7. Since we sometimes have only monthly frequency data on when GHWs are switched on, we consider two alternative event windows, one from -25 to +25 days around the event, and a longer one from -50 to +50 days, where the event is either the daily date (where available) or the beginning of the month during which the GHW is raised.

In Panel A and compared with the two event types discussed earlier – analyst recommendation changes and shareholder votes – the high levels of trading activity are striking. For the -25 to +25 event window, only 0.25 percent of all positions do not trade. Instead 78.1 percent of all positions are net sellers, and 21.7 percent are net buyers, and as such contrarian traders. Percentages for the -50 to +50 window are very similar, and to conserve space we focus the remainder of the table on the shorter window.

Considering only net sellers in Panel B, the changes in positions are economically large. We calculate abnormal trades as trades in the positions subject to the new GHW minus average trades across all positions held by a given fund at the time that are not subject to a new or existing GHW. During the 51-day period around the GHW event, net sellers sell 16.6 to 17.2 percent of their positions relative to others, depending on whether we consider shares held or market cap held, respectively.

4. Conclusion

In this paper we use proprietary data from SLI, one of the largest UK active asset managers, to empirically assess the extent to which monitoring and engagement affects trading decisions. The evidence on the engagement process of asset managers with their portfolio firms is sparse, particularly relating to the influence of voice on exit. This paper provides a detailed description of the activities and role of the governance and stewardship function with portfolio firms as well as their interactions with internal analysts and fund managers.

We show that the asset manager engages in significant monitoring of portfolio firms, captures this information in internal notes and reports and places firms that give rise for concern on watch lists. Engagement intensity reflects dissatisfaction with portfolio firms and drives shareholder voting decisions, specifically votes against management proposals and abstentions. Voting and engagement are also reflected in analysts' assessments and dissatisfaction is a significant contributor to analyst downgrades of specific stocks and reductions in positions by fund managers. Our results show that engagement with portfolio firms has a significant influence on trading decisions. One conclusion is that monitoring and engagement by the asset manager contributes to an informational advantage, which in turn contributes to alpha.

While the focus of this paper is on voice and exit, the results naturally lead to the question whether the contribution to alpha from monitoring results from an informational advantage or from changes in the portfolio firm that result from engagement. We will address the issue of outcomes in a separate paper.

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Table 1
Summary Statistics for Holdings and Engagement

This table reports summary statistics for our sample. Panel A shows funds that are managed by the UK equities team, hold at least one UK stock and their aggregate UK equity holdings. Statistics are shown at the end of each period. Panel B shows the number of meetings analysts had with portfolio companies and who participated from the company side, the CEO, the CFO, both CEO and the FD or the Chairman. Panel C shows activities of the stewardship function vis-a-vis portfolio firms. *Contacts* is the total number of unique contacts with portfolio firms. *Issues* is the total number of unique topics being discussed. Team members involved is the total number of unique individuals handling engagements. Workload is the total number of target firms handled per team member. Percent of all stocks held engaged is the number of portfolio firms with which the G&S Group has been in contact at least once during a given year over the total number of portfolio firms. Percent of all stocks held with GHW indicates the share of portfolio firms where a Governance Health Warning is in effect during at least one month in a given year. Panel D shows all shareholder meetings in which the asset manager voted, restricted only to management proposals. Panel E disaggregates shareholder meetings by voting stance and shows portfolio exposure counts.

Panel A: Holdings

Date	FTSE All Share Stocks	Stocks Held by asset manager	Average Aggregate Stake Held	Number of Funds	Number of Positions across all Funds	Aggregate TA (\$ billions)
2007m6	692	369	2.98	60	5356	66.5
2007m12	706	379	3.02	64	5880	63.0
2008m6	670	378	3.19	63	6266	53.1
2008m12	671	376	3.10	61	6287	28.7
2009m6	624	364	2.94	60	6485	30.4
2009m12	626	366	2.88	57	6183	38.8
2010m6	645	367	2.87	57	6098	31.1
2010m12	630	367	2.67	52	5730	40.8
2011m6	643	359	2.65	49	5475	42.6
2011m12	628	352	2.65	48	5121	35.5
2012m6	628	343	2.61	46	4939	33.0
2012m12	606	325	2.61	46	4746	37.5
2013m6	618	316	2.69	46	4416	39.1
2013m12	622	323	2.66	44	4156	46.9
2014m6	649	327	2.77	43	3966	47.2
2014m12	647	329	3.23	51	4343	51.0
2015m6	659	333	3.17	50	4092	50.8
2015m12	646	323	3.22	48	3713	45.8

Panel B: Analyst Meetings

Year	Number of Meetings	Companies Met per Year	Coverage (%)	CEO Present	CFO Present	Chair Present	CEO and FD Present	CEO, CFO or Chair Present	(in %)
2007	668	338	89.2	393	348	39	273	486	72.8
2008	622	334	88.8	332	303	24	227	417	67.0
2009	693	337	92.1	364	330	31	258	451	65.1
2010	666	319	86.9	368	361	29	275	469	70.4
2011	688	327	92.9	387	335	32	261	479	69.6
2012	674	338	100.0	368	321	31	236	466	69.1
2013	685	336	100.0	355	281	14	215	426	62.2
2014	663	331	100.0	360	263	10	195	431	65.0
2015	650	330	100.0	331	237	15	182	394	60.6

Panel C: G&S Engagement – Contacts, Issues, Workload, Governance Health Warnings

Year	Contacts (<i>N</i>)	Issues (<i>N</i>)	Team members involved (<i>Avg</i>)	Workload - target firms handled per team member (<i>Avg</i>)	Percent of all stocks engaged (<i>Avg</i>)	Percent of all stocks with GHW
2007	542	504	10.0	31.8	0.39	0.07
2008	567	526	8.0	36.5	0.43	0.09
2009	534	460	11.0	24.5	0.46	0.09
2010	454	418	10.0	25.6	0.46	0.10
2011	556	494	11.0	25.5	0.46	0.11
2012	552	486	13.0	20.5	0.44	0.11
2013	492	427	12.0	21.4	0.44	0.10
2014	612	507	16.0	17.4	0.40	0.08
2015	564	430	15.0	17.4	0.32	0.05

Panel D: Voting

Year	Number of meetings voted at	% of meetings where asset manager casts a vote on at least one management proposal		
		Vote against	Abstained	Any Disagreement
2007	766	6.8	10.1	13.4
2008	764	5.9	9.8	12.7
2009	487	14.0	17.9	27.9
2010	452	8.4	11.7	18.6
2011	442	11.1	14.0	21.7
2012	418	20.8	12.0	28.7
2013	392	13.5	11.0	23.0
2014	433	10.9	15.7	24.7
2015	445	9.9	14.2	22.0

Panel E: Voting and portfolio exposure

	No Disagreement	Vote against	Abstain	Any Disagree (Vote against or Abstain)
Number of shareholder meetings	4081	411	499	791
Number of outstanding positions	42,161	11,582	11,123	18,317

Table 2
Summary Statistics for Internal Analysts

Panel A reports summary statistics for stocks tracked by internal SLI buy-side and external sell-side analysts included in the Institutional Brokers' Estimate System (I/B/E/S), January 2007 to December 2015. For SLI, Buy, Hold, and Sell indicate the fraction of stocks with such recommendations. For I/B/E/S, Buy, Hold, Sell indicate the average fraction of such recommendations among all analysts covered by I/B/E/S, across all trading days, averaged per year. Differences in recommendation fractions between SLI and I/B/E/S with statistical significance levels of 1%, 5%, and 10% are indicated with ***, **, and *, respectively. Panel B shows all unique instances of recommendation changes in individual stocks, the number of positions held by the asset manager across all funds for those instances, and the number of trading days the analyst recommendation is in place prior to the change.

Panel A: Analyst recommendations

Year	Buy			Hold			Sell		
	SLI	I/B/E/S		SLI	I/B/E/S		SLI	I/B/E/S	
2007	50.7	48.9	ND	36.5	38.5	ND	12.8	12.6	ND
2008	43.1	49.2	***	39.8	37.4	ND	17.1	13.4	***
2009	45.3	47.6	ND	36.4	36.1	ND	18.3	16.3	*
2010	49.5	53.8	***	37.2	35.1	***	13.3	11.1	***
2011	43.7	52.8	***	41.2	35.6	***	15.1	11.6	***
2012	41.3	51.1	***	38.6	36.8	*	20.1	12.1	***
2013	37.7	48.4	***	40.1	39.8	ND	22.2	11.8	***
2014	34.7	50.2	***	38.5	40.5	ND	26.9	9.2	***
2015	33.3	47.4	***	42.1	42.0	ND	24.6	10.6	***

Panel B: Analyst recommendation changes, frequencies

Signal	Buy to Hold	Buy to Sell	Hold to Sell	Sell to Hold	Sell to Buy	Hold to Buy
Number of unique changes	772	86	519	480	81	722
Number of affected positions	16133	1561	7027	6072	884	12385
Days	235.1	210.8	129.4	126.8	138.7	127.0

Table 3**Analyst Recommendation Information Content and Fund Manager Trades**

The table reports trading activity around internal analyst recommendation changes. Any Sell Signal aggregates downgrades of the stock (Buy to Hold, Buy to Sell, Hold to Sell); Any Buy Signal aggregates upgrades (Sell to Hold, Sell to Buy, Hold to Buy). Panel A reports aggregate net trades for all fund-stock positions owned during the -1 to +5 day window around the internal publication of the recommendation change. Panel B reports details of trades during the -1 to +5 window for net selling positions in case of Any Sell Signals and net buying positions in case of Any Buy Signals. Trades are measured as percentage changes in holdings, alternative based on the change in number of shares held (Shares Held) and the change in market capitalization held (MCap Held). Standard errors are in brackets. 1%, 5%, and 10% statistical significance is indicated with ***, **, and *, respectively.

Panel A: Trades for Sell and Buy changes, -1 to +5 window

	Any Sell Signal		Any Buy Signal	
	<i>N</i>	Percent	<i>N</i>	Percent
No stake	6	0.0	6	0.0
No trade	18510	74.9	15,975	82.4
Trade - net buyers	748	3.0	2,624	13.5
Trade - net sellers	5460	22.1	785	4.1
Total positions	24724	100.0	19390	100.0

Panel B: Trades of net sellers and net buyers

	-1 to +1	-1	0	1	+2 to +5
		Any Sell Signal			
Shares Held – net sellers	-17.10*** [0.255]	-0.971*** [0.0401]	-8.026*** [0.171]	-6.469*** [0.134]	-14.46*** [0.270]
MCap Held – net sellers	-20.0*** [0.28]	-2.19*** [0.092]	-9.80*** [0.19]	-7.30*** [0.15]	-15.0*** [0.31]
	Any Buy Signal				
Shares Held – net buyers	24.69*** [0.608]	0.0393* [0.0216]	4.667*** [0.279]	6.117*** [0.202]	15.57*** [0.474]
MCap Held – net buyers	29.8*** [0.80]	0.21 [0.21]	8.35*** [0.39]	7.93*** [0.27]	17.1*** [0.62]

Table 4
Analyst Recommendation Changes and Performance

The table reports abnormal returns and trading activity around analyst recommendation changes. In Panel A, percentage market-adjusted returns are measured during the -1 to +5 day window around the internal publication of the recommendation change. Abnormal returns are buy and hold returns less the return on the FTSE All Share index. Any Sell Signal and Any Buy Signal are as defined in Table 3. Panel B shows performance in response to those trades, split between Sell trades and Buy trades. As if passive indicates the abnormal return incurred by positions if no trading had occurred; Active Trading indicates the change in value per fund position adjusted for observed trading, where optimistic assumes that intra-day trades all occur at opening prices and pessimistic indicates closing prices. Dif optimistic and Dif pessimistic indicate the difference between passive and active trading. Panel C splits abnormal returns by return quintiles and reports averages of those quintiles. Panel D splits abnormal returns by firm size (market capitalization) and stake size (in dollars). Panel E splits abnormal returns by size of trades (in percent traded). Standard errors are in brackets. 1%, 5%, and 10% statistical significance is indicated with ***, **, and *, respectively.

Panel A: Abnormal returns

Days	-1 to +1	-1	0	+1	+2 to +5
Any Sell Signal – net sellers	-2.63*** [0.055] 5,552	-0.46*** [0.031] 5,553	-1.52*** [0.034] 5,553	-0.66*** [0.031] 5,552	-1.07*** [0.058] 5,549
Any Sell Signal – no trade	-1.65*** [0.030] 18,508	-0.32*** [0.016] 18,510	-1.01*** [0.019] 18,510	-0.33*** [0.016] 18,508	-0.49*** [0.030] 18,510
Any Buy Signal – net buyer	1.50*** [0.093] 2,539	0.17*** [0.045] 2,546	1.05*** [0.055] 2,539	0.28*** [0.052] 2,546	0.55*** [0.094] 2,546
Any Sell Signal – no trade	1.27*** [0.033] 15,938	0.21*** [0.019] 15,975	0.82*** [0.020] 15,938	0.24*** [0.018] 15,975	0.19*** [0.030] 15,975

Panel B: Abnormal returns to trading, 0 to +5

Sell Trades					Buy Trades				
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
As if passive	Active Trading optimistic	Active Trading pessimistic	Dif optimistic	Dif pessimistic	As if passive	Active Trading optimistic	Active Trading pessimistic	Dif optimistic	Dif pessimistic
-3.506***	-3.029***	-3.287***	0.477***	0.219***	2.291***	2.968***	2.515***	0.678***	0.224***
[0.0865]	[0.0750]	[0.0776]	[0.0262]	[0.0225]	[0.140]	[0.199]	[0.177]	[0.0897]	[0.0628]
4,467	4,467	4,467	4,467	4,467	2,365	2,365	2,365	2,365	2,365

Panel C: Abnormal return quintiles

Quintile	-1 to +1	-1	0	1	+2 to +5	
Any Sell Signal - net sellers	1	-13.41	-5.00	-8.11	-4.12	-7.20
	2	-4.66	-1.24	-2.39	-1.45	-2.38
	3	-2.10	-0.33	-1.06	-0.58	-0.81
	4	-0.47	0.46	-0.26	0.30	0.83
	5	3.05	2.82	1.76	2.46	4.68
Any Buy Signal – net buyer	1	-8.99	-5.36	-4.85	-3.62	-5.30
	2	-0.21	-0.66	-0.07	-0.66	-1.06
	3	1.42	0.27	0.98	0.21	0.78
	4	3.37	1.15	2.21	1.27	2.62
	5	9.37	3.23	7.01	4.21	8.94

Panel D: Abnormal returns by firm and stake size, -1 to +5

Days	1 (Smallest)	2	3	4	5 (Largest)
	-1 to +5	-1 to +5	-1 to +5	-1 to +5	-1 to +5
SIZE by MarketCap					
Any Sell Signal - net sellers	-5.71***	-4.35***	-3.50***	-2.04***	-3.49***
	[0.26]	[0.18]	[0.15]	[0.17]	[0.14]
<i>N</i>	906	1,061	1,087	1,230	1,264
Any Buy Signal - net buyers	3.07***	3.79***	1.33***	0.61*	2.34***
	[0.69]	[0.30]	[0.32]	[0.31]	[0.15]
<i>N</i>	286	395	367	657	834
SIZE by Aggregate stake held					
Any Sell Signal - net sellers	-3.80***	-5.34***	-3.05***	-3.44***	-3.31***
	[0.27]	[0.24]	[0.19]	[0.15]	[0.13]
<i>N</i>	429	959	941	1,789	1,430
Any Buy Signal - net buyers	5.11***	1.13***	4.02***	0.013	2.16***
	[0.53]	[0.32]	[0.37]	[0.31]	[0.16]
<i>N</i>	323	482	329	623	782

Panel E: Abnormal returns by size of trade quartiles, -1 to +5

	1 (Smallest)	2	3	4 (Largest)
	-1 to +5	-1 to +5	-1 to +5	-1 to +5
Any Sell Signal - net sellers	-4.67***	-5.09***	-4.79***	-3.65***
	[0.24]	[0.23]	[0.21]	[0.18]
<i>N</i>	1,362	1,364	1,365	1,364
Any Buy Signal - net buyers	2.40***	2.24***	1.10***	2.78***
	[0.29]	[0.36]	[0.41]	[0.44]
<i>N</i>	525	524	525	539

Table 5**Buy-Side and Sell-Side Analyst Recommendation Changes**

The tables shows a comparison of abnormal returns during the -1 to +1 day window around analyst recommendation changes. Where SLI indicates private recommendations made by internal analysts in our sample and I/B/E/S indicates publicly available recommendations made by sell-side analysts. To make the data comparable, I/B/E/S “strong buy” and “buy” recommendations are combined to “buy”, and “strong sell” and “sell” into “sell”. Standard errors are in brackets. 1%, 5%, and 10% statistical significance is indicated with ***, **, and *, respectively.

	Buy to Hold	Buy to Sell	Hold to Sell	Sell to Hold	Sell to Buy	Hold to Buy
SLI	-2.80*** [0.095]	-5.22*** [0.39]	-4.96*** [0.20]	-1.59*** [0.44]	3.64*** [0.23]	1.52*** [0.15]
<i>N</i>	3,618	443	1,398	564	143	1,909
I/B/E/S	-0.98*** [0.053]	-1.19*** [0.17]	-1.24*** [0.089]	0.68*** [0.087]	0.80*** [0.15]	1.07*** [0.052]
<i>N</i>	9,956	1,146	3,648	3,683	1,098	9,201

Table 6
Trading around Shareholder Votes

The table reports trading activity and abnormal returns around shareholder votes. Panel A reports aggregate net trades for all fund-stock positions owned during the -25 to +25 day window around the date of the shareholder vote. Trades are measured as percentage changes in holdings, alternative based on the change in number of shares held (Shares Held) and the change in market capitalization held (MCap Held). No Disagreement indicates shareholder meetings where the asset manager votes in favor of all management proposals at that meeting; Any Disagreement indicates shareholder meetings with at least one vote against or one abstention. Panel B reports details of trades during the same window. Difference, positions w/disagreement indicates the difference between No Disagreement and Any Disagreement positions. Standard errors are in brackets. 1%, 5%, and 10% statistical significance is indicated with ***, **, and *, respectively.

Panel A: Trades around shareholder meetings, -25 to +25 window around vote

	No Disagreement		Any Disagreement	
	<i>N</i>	Percent	<i>N</i>	Percent
No trade	24,701	58.59	9,693	52.92
Trade - net buyers	8,624	20.45	3,971	21.68
Trade - net sellers	8,825	20.93	4,652	25.4
Total positions	42,161	100	18,317	100

Panel B: Trading decisions – all positions

	-25 to +25	-25 to -6	-5 to -2	-1 to +1	+2 to +5	+6 to +25
Trades based on Shares Held						
Trades, all positions	5.631*** [0.220]	3.027*** [0.136]	0.667*** [0.0534]	0.394*** [0.0592]	0.593*** [0.0891]	1.576*** [0.111]
Difference, positions w/disagreement	-3.310*** [0.399]	-0.559** [0.245]	-0.498*** [0.0971]	-0.215** [0.108]	-0.631*** [0.162]	-1.915*** [0.202]
<i>N</i>	60,478	59,657	60,241	60,478	60,478	59,489
Trades based on Mcap Held						
Trades, all positions	5.088*** [0.234]	3.493*** [0.149]	0.909*** [0.0602]	-0.169*** [0.0651]	-0.318*** [0.0962]	1.237*** [0.127]
Difference, positions w/disagreement	-1.155*** [0.425]	1.036*** [0.269]	-0.642*** [0.109]	0.485*** [0.118]	0.796*** [0.175]	-2.563*** [0.229]
<i>N</i>	60,478	59,657	60,241	60,478	60,478	59,489

Table 7**Trading Around Governance Health Warning Events**

The table reports trading activity around governance health warning (GHW) events, when GHWs are switched on. The sample includes all portfolio positions with at least one GHW event during the sample period. Panel A reports aggregate net trades for all fund-stock positions owned during the -25 to +25 day (-50 to +50) window around the date of the GHW event. Trades are measured as percentage changes in holdings, alternatively based on the change in number of shares held (Shares Held) and the change in market capitalization held (MCap Held). Panel B reports details of abnormal trades during the same window. Abnormal trades are calculated as trades in the position subject to a GHW event minus average trades across all positions held by a given fund at the time that are not subject to a GHW event. Standard errors are in brackets. 1%, 5%, and 10% statistical significance is indicated with ***, **, and *, respectively.

Panel A: Trades around Governance Health Warnings, alternative windows

	-25 to +25		-50 to +50	
	<i>N</i>	Percent	<i>N</i>	Percent
No trade	11	0.25	7	0.16
Trade - net buyers	970	21.69	823	18.56
Trade - net sellers	3,492	78.07	3,643	81.44
Total positions	4,473	100.00	4,473	100.00

Panel B: Trading decisions – net sellers

	-25 to +25	-25 to -6	-5 to -2	-1 to +1	+2 to +5	+6 to +25
Abnormal trades based on Shares Held	-16.56*** [0.834]	-3.701*** [0.458]	-0.560*** [0.185]	-0.709*** [0.224]	-2.201*** [0.378]	-10.15*** [0.473]
<i>N</i>	4,473	4,455	4,470	4,473	4,473	4,448
Abnormal Trades based on Mcap Held	-17.22*** [0.851]	-4.287*** [0.469]	-0.382* [0.204]	-1.864*** [0.201]	-3.292*** [0.374]	-9.184*** [0.503]
<i>N</i>	4,473	4,455	4,470	4,473	4,473	4,448

Figure 1
Monitoring, Engagement and Trading

The figure shows the stylized monitoring, engagement and trading process of the asset manager. (1) The Governance and Stewardship (G&S) Team engages with portfolio firms, usually separately, through in person meetings, phone calls, emails, and letters; (2) The G&S Group provides governance analysis to analysts in the form of memos, e-mails and binary Governance Health Warning flags; (3) Analysts meet with portfolio companies, in the majority of cases with the CEO; fund managers and other SLI staff can participate; (4) Analysts provide fund managers with quarterly industry reports and occasional company reports; they issue buy, hold or sell recommendations throughout the year; (5) The G&S Group includes a vote manager responsible for preparing voting decisions and notifying portfolio companies. Voting decisions are taken jointly with analysts. (6) Fund managers trade individual stocks within fund mandates. In addition to written communication there were weekly scheduled meetings and ad-hoc meetings between the team members. Important decisions, like a vote against the re-election of a CEO, would have to be approved by the SLI investment committee.

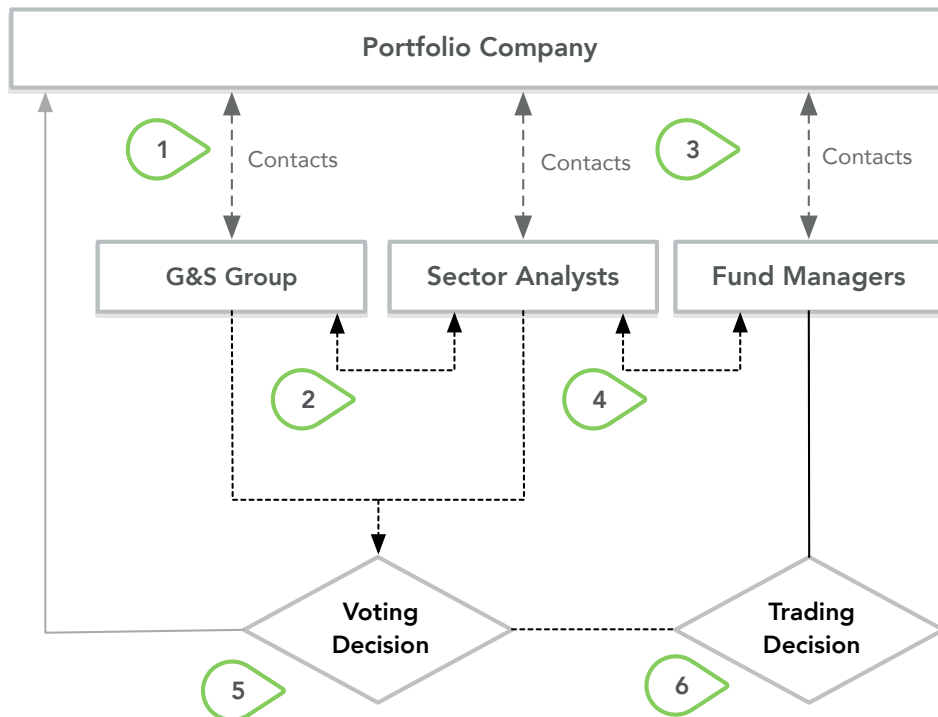


Figure 2
Stylized Timeline of Flow of Information and Events

The figure shows the timeline of main sources of information and key events in our sample. (1) The analyst and fund managers meet with senior management, in most cases the CEO and the CFO; (2) The Governance and Stewardship (G&S) Team conducts its own meetings, usually with the non-executive members of the board, including the lead independent director and the Chairman; (3) The G&S Group engages throughout the year outside of personal meetings, for example through phone calls, emails, and letters. Engagements are very rarely made public. (4) The G&S Group raises, maintains and removes Governance Health Warnings (GHWs) throughout the year, depending on whether or not firms underperform on governance issues. GHWs are not made public. (5) Internal analysts publish industry-wide research reports at roughly quarterly frequency. Reports are not made public. Occasional company reports published during the quarter are appended. (6) Shareholder votes occur roughly at annual frequency in the case of annual general meetings (AGMs) and throughout the year in the case of extraordinary general meetings (EGMs). (7) Internal analysts issue buy, hold or sell recommendations throughout the year. Analyst signals are not made public. Voting is typically communicated to the firm ahead of the vote. (8) Fund managers trade individual stocks within fund mandates. Trades are not made public.

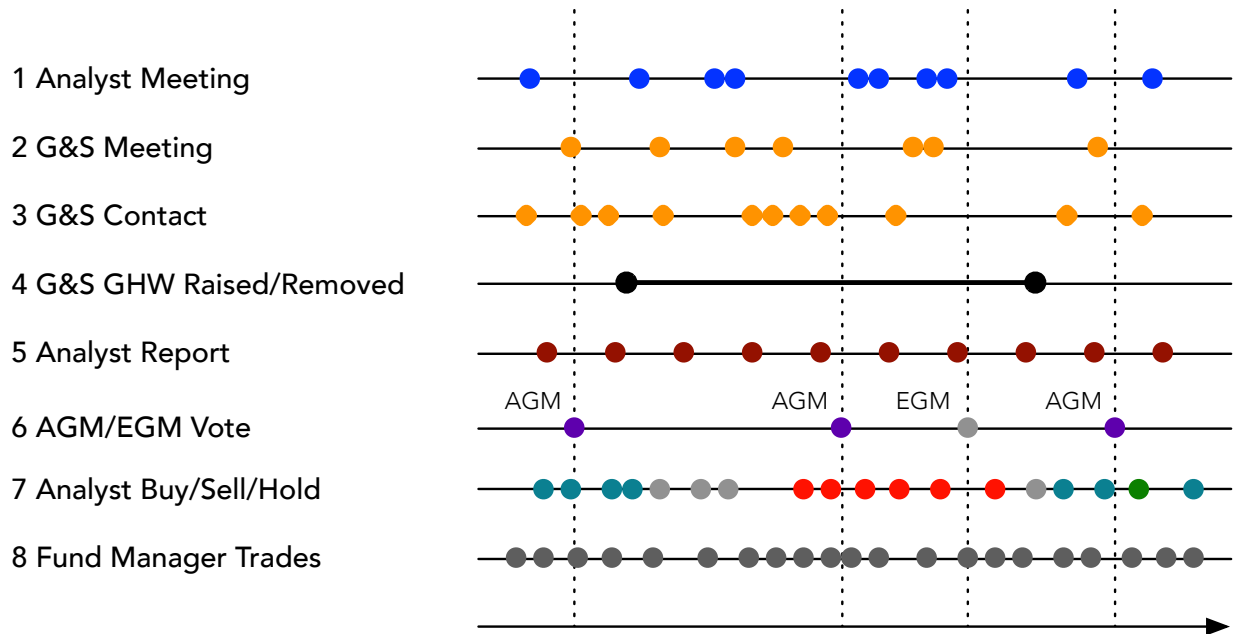


Figure 3
Active Share for 17 Funds with FTSE All Share Benchmark

The figure shows active share and annual turnover for a subsample of 17 funds. Active share represents how much the portfolio choices of a fund manager deviate from the fund's benchmark and is calculated as in Cremers and Petajisto (2009), at daily frequency, using FTSE All Share Index weights. Fund size is in \$ billions, calculated at daily frequency, as the aggregate UK equity holdings of each fund. Fund size and active share are averaged for the entire duration for which each fund is included in the sample.

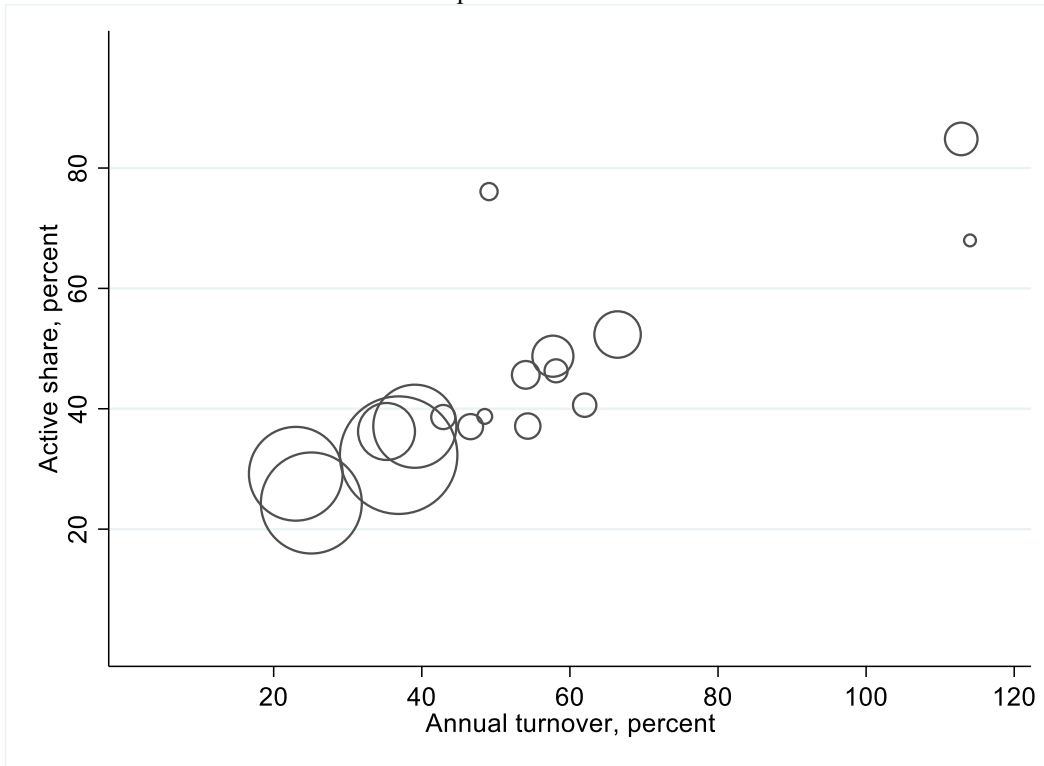


Figure 4
Engagement around shareholder votes

The figure shows engagement activity by the asset manager around shareholder votes for all fund-stock positions owned during the -50 to +50 day window around the date of the shareholder vote. No Disagreement indicates shareholder meetings where the asset manager votes in favor of all management proposals at that meeting; Vote against indicates shareholder meetings with at least one vote against. Engagement activity in the four subfigures is as follows: Number of issues indicates the number of topics discussed with contacts at the target firm, per day; Number of contacts indicates the number of unique contacts with the target firm per day; Negative tone indicates the total number of negative words in analyst notes, per day; Negative tone share is the total number of negative words divided by the total number of positive and negative words in those notes, per day. Negative and positive words are based on the dictionary provided by Loughran and McDonald (2011).

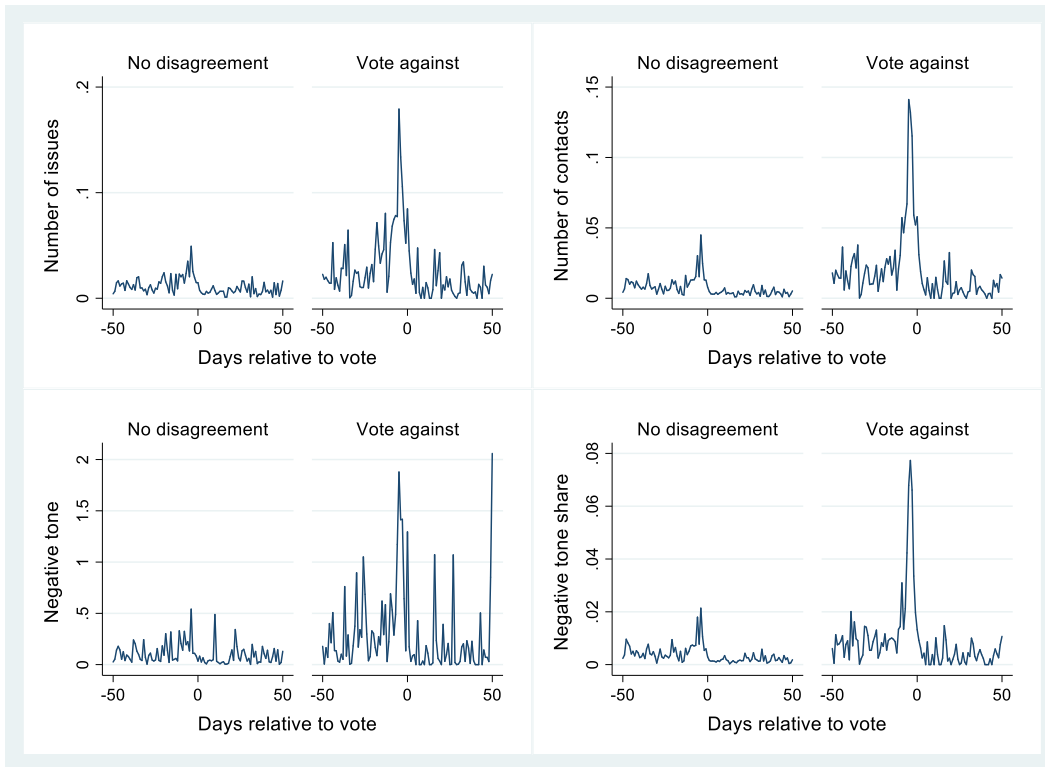


Figure 5

Trading and engagement around shareholder meetings with and without disagreement

The figure shows trading and engagement activity around shareholder votes for all fund-stock positions owned during the -25 to +25 day window around the date of the shareholder vote. No Disagreement indicates shareholder meetings where the asset manager votes in favor of all management proposals at that meeting; Vote against indicates shareholder meetings with at least one vote against. Data shown in the four subfigures are as follows: Trades are percentage changes in holdings, based on the change in number of shares held; Number of issues indicates the number of topics discussed with contact at the target firm, per day; Number of contacts indicates the number of unique contacts with the target firm per day; Negative tone indicates the total number of negative words in analyst notes, per day; Negative tone share is the total number of negative words divided by the total number of positive and negative words in those notes, per day. Negative and positive words are based on the dictionary provided by Loughran and McDonald (2011).

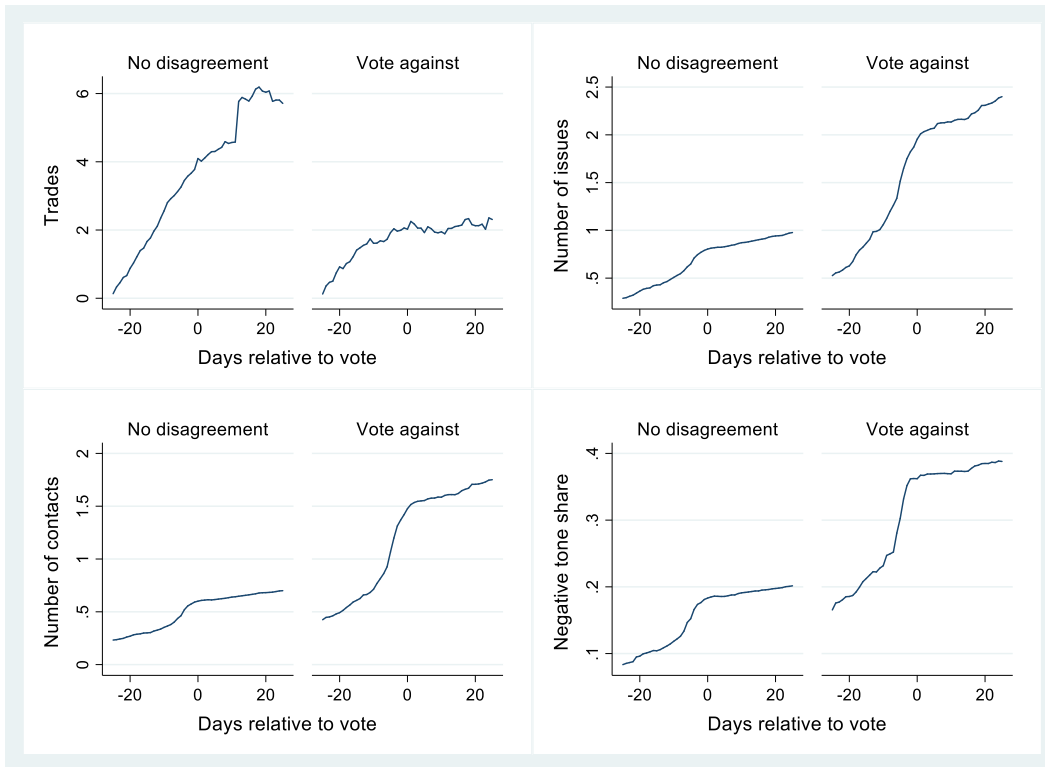


Figure 6
Robustness – trading and engagement around disagreement

The figure shows trading and engagement activity around shareholder votes for all fund-stock positions owned during the -25 to +25 day window around the date of the shareholder vote. No Disagreement indicates shareholder meetings where the asset manager votes in favor of all management proposals at that meeting; Any Disagreement indicates shareholder meetings with at least one vote against or one abstention. Vote against indicates shareholder meetings with at least one vote against. Data shown in the four subfigures are as follows: Trades are percentage changes in holdings, based on the change in number of shares held; Number of issues indicates the number of topics discussed with contact at the target firm, per day; Number of contacts indicates the number of unique contacts with the target firm per day; Negative tone indicates the total number of negative words in analyst notes, per day; Negative tone share is the total number of negative words divided by the total number of positive and negative words in those notes, per day. Negative and positive words are based on the dictionary provided by Loughran and McDonald (2011).

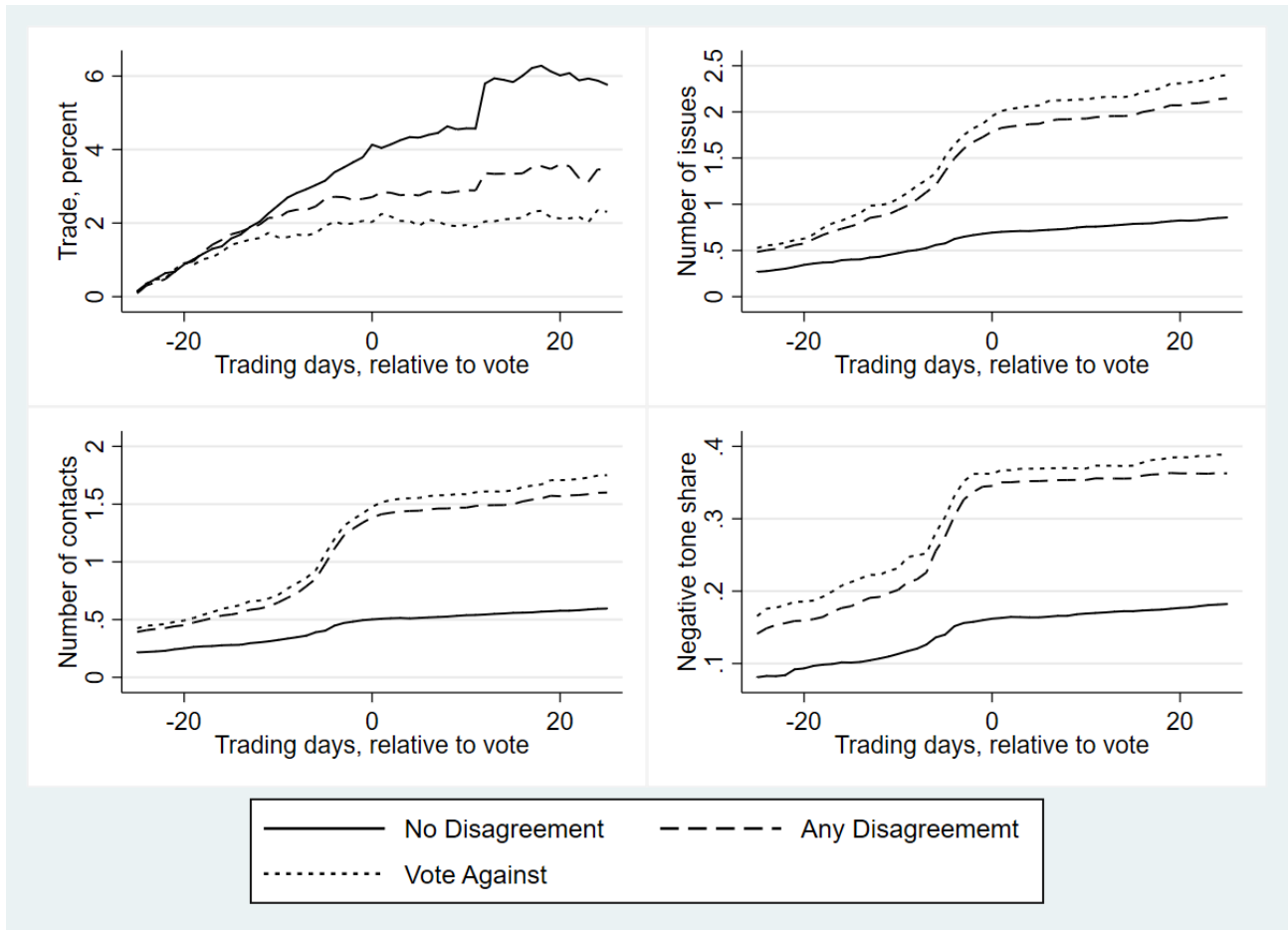


Figure 7
Trading, analyst signals and disagreement

The figure shows trading and engagement activity around shareholder votes for all fund-stock positions owned during the -25 to +25 day window around the date of the shareholder vote. No Disagreement indicates shareholder meetings where the asset manager votes in favor of all management proposals at that meeting; Any Disagreement indicates shareholder meetings with at least one vote against or one abstention. Vote against indicates shareholder meetings with at least one vote against. Data shown in the four subfigures are as follows: Trades are percentage changes in holdings, based on the change in number of shares held; Number of issues indicates the number of topics discussed with contact at the target firm, per day; Number of contacts indicates the number of unique contacts with the target firm per day; Negative tone indicates the total number of negative words in analyst notes, per day; Negative tone share is the total number of negative words divided by the total number of positive and negative words in those notes, per day. Negative and positive words are based on the dictionary provided by Loughran and McDonald (2011).

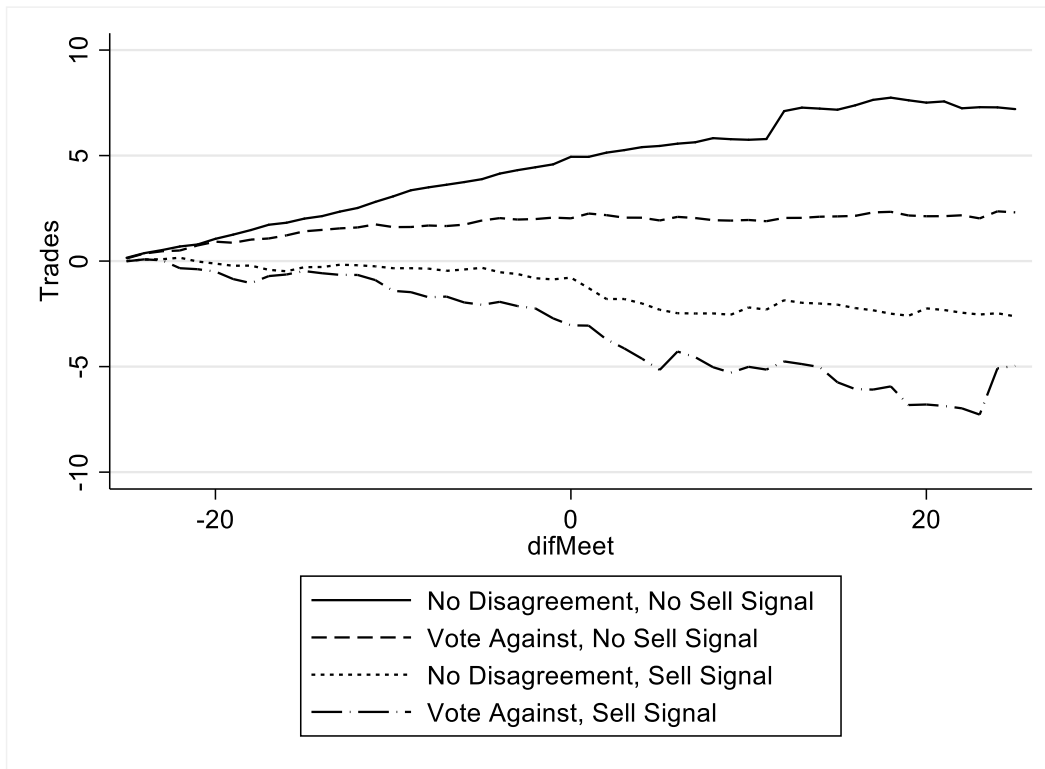
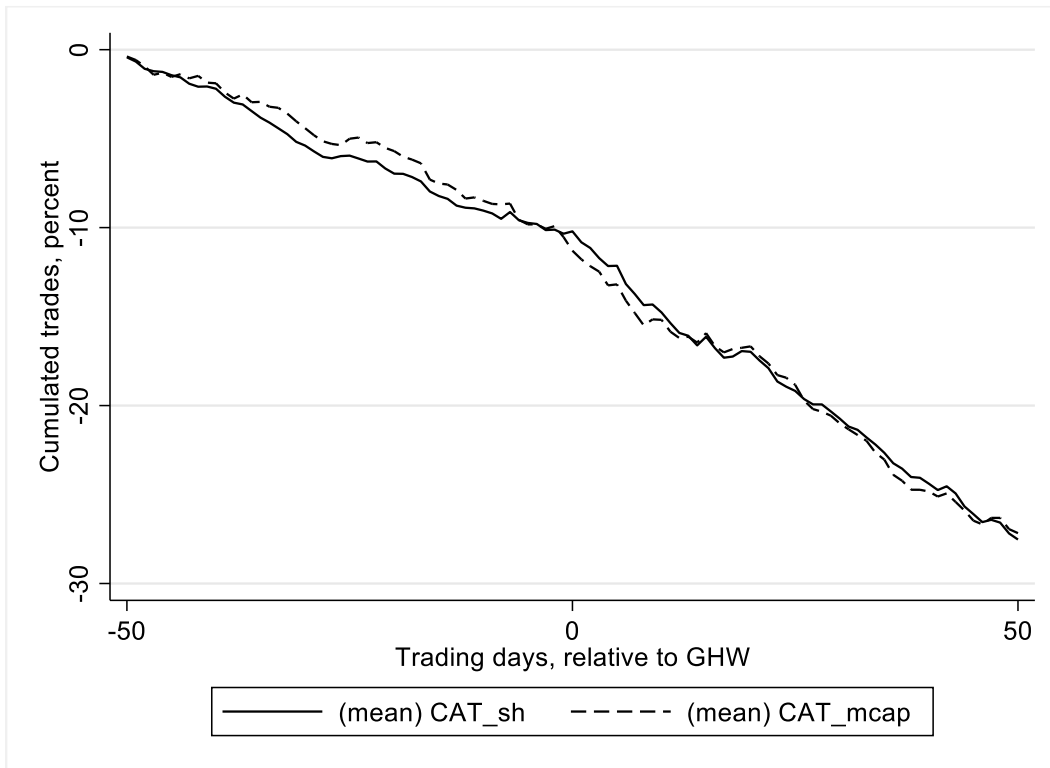


Figure 8
Abnormal trading around Governance Health Warnings

The figure shows abnormal trading activity around governance health warnings (GHWs) being raised, for all fund-stock positions owned during the -25 to +25 day window around the date of the shareholder vote. Trades are cumulated over the event window and measured as percentage changes in holdings, alternatively based on the change in number of shares held (Shares Held) and the change in market capitalization held (MCap Held). Trades are. Abnormal trades are the difference between fund-stock trades subject to a GHW event and the calendar-time matched fund-average trades across all positions in the fund's portfolio not subject to an active GHW.



INTERNET APPENDIX

Corporate Governance Through Voice and Exit

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Appendix A

Table A1. UK Investment Stewardship Guidelines

The table shows some of the most important UK policy developments around the ownership responsibilities of institutional investors as agents of their clients and their direct impact on SLI. The most significant development was the publication of the Cadbury Report in 1992 that endorsed the “Responsibilities of Institutional Shareholders” document published by the ISC created in 1973 “at the behest of the Bank of England” (Black and Coffee 1994: 2019). SLI appointed its first full time corporate governance officer. The next significant step was the publication of the 2010 UK Stewardship Code following the financial crisis. It resulted in the creation of a “Governance and Stewardship Team” and the publication of stewardship reports, similar to the corporate governance reports of listed companies. The 2012 Kay report resulted in the creation of the Investor Forum that has been undertaking collective engagements since 2016. SLI are a member of the Investor Forum.

Document/Measure	Date	Provenance	Summary	Impact on SLI
The Responsibilities of Institutional Shareholders in the UK	1991	Institutional Shareholders’ Committee (ISC)	ISC expanded membership in 1989. 2 nd policy document slightly pre-dating Cadbury. ^[i]	Designation of a full-time corporate governance officer in 1992/93
The Responsibilities of Institutional Shareholders and Agents - Statement of Principles ^[ii]	2002	ISC	Major update of 1991 document in response to Myners report (see below)	Significant expansion of internal reporting and status of governance function
	2005	ISC	Further update in response to Myners implementation review	
	2007	ISC	Further update	
ISC Code on the Responsibilities of Institutional Investors	2009	Institutional Shareholders’ Committee (ISC)	Elevation of Principles to a Code	
UK Stewardship Code ^[iii]	2010	Financial Reporting Council (FRC)	Reconciliation of ISC and Combined Code; as recommended by the Walker post-financial crisis Review	Governance function renamed to “Governance and Stewardship” Team; publication of first governance, stewardship and voting report in Q4 2011
	2012 update ^[iv]			
Myners Report ^[v]	2001	Commissioned by HM Treasury	Major government backed report on relationship between companies and shareholders	
	2004 update review		Review of implementation	
	2008 update review			
Kay Report	2012 ^[vi]	Commissioned by the Department for Business, Innovation & Skills (BIS)		Creation of the Investor Forum for improved coordination of engagement on cases of common interest

[i] <http://cadbury.cjbs.archios.info/media/files/CAD-01221.pdf>

[ii] <http://www.ecgi.global/code/responsibilities-institutional-shareholders-and-agents-statement-principles>

[iii] <http://www.ecgi.global/code/uk-stewardship-code>

[iv] http://www.ecgi.global/sites/default/files/codes/documents/stewardship_code_uk_sep2012_en.pdf

[v] <https://www.icaew.com/library/subject-gateways/corporate-governance/codes-and-reports/myners-report>

[vi] <http://webarchive.nationalarchives.gov.uk/20121204121011/http://www.bis.gov.uk/policies/business-law/corporate-governance/kay-review>

[i] For a comparison with the US see <https://www.icaew.com/-/media/corporate/files/technical/corporate-governance/dialogue-in-corporate-governance/shareholder-responsibilities-and-the-investing-public.ashx>

Table A2. Stewardship Codes Around the World

The table shows the proliferation of stewardship codes since the publication of the first UK Stewardship code in 2010. Data are from ECGI Stewardship Code Database (ecgi.global/content/codes-stewardship).

Launch year	Country	Framework
2010	United Kingdom	The UK Stewardship Code
2012	United Kingdom	The UK Stewardship Code (Revision)
2014	Japan	Japan's Stewardship Code
2014	Malaysia	Malaysian Code for Institutional Investors
2016	Brazil	Brazil AMEC Stewardship Code
2016	Denmark	Danish Stewardship Code
2016	Hong Kong	Hong Kong Principles of Responsible Ownership
2016	Italy	Italian Stewardship Principles
2016	South Korea	Principles on the Stewardship Principles of Institutional Investors
2016	Singapore	Singapore Stewardship Principles for Responsible Investors
2016	Taiwan	Taiwan Stewardship Principles for Institutional Investors
2017	Kenya	Stewardship Code for Institutional Investors
2017	The Netherlands	Dutch Stewardship Code (Draft)
2017	United States	Stewardship Framework for Institutional Investors, Investor Stewardship Group

Stewardship codes are the “mirror image” of corporate governance codes addressed at institutional investors rather than at listed companies. They try to avoid regulation and rely on “comply or explain”. The UK code and its thinking have been successful internationally. Numerous countries have published stewardship codes following the UK example and many international investor have subscribed to them. The culmination of this development was the creation of the “Investor Stewardship Group (ISG)” in the United States “a group of 50 U.S. and international institutional investors that in aggregate invest over \$22 trillion in the U.S. equity markets”.¹⁹ In May 2017 Aberdeen Standard issued a policy statement with respect to Global Stewardship Codes.²⁰

¹⁹ <https://isgframework.org> (accessed 25 July 2018)

²⁰ Aberdeen Standard (2017), “[Our Stewardship approach](#)”

Appendix B

Table B1. 50 Largest Asset Managers Worldwide

This table reports characteristics of large asset managers. Assets under management (AUM) are from P&I/Willis Tower Watson (2016) and represent data as of year-end 2015; other data are hand collected from industry and company publications.

Rank	Asset manager	AUM (\$ bn)	Publicly traded	Home market	Operations outside home mkt	Centralized stewardship
1	BlackRock	4,645	yes	USA	yes	yes
2	Vanguard Group	3,399	no	USA	yes	yes
3	State Street Global	2,245	yes	USA	yes	yes
4	Fidelity Investments	2,036	no	USA	yes	yes
5	Allianz Group	1,926	yes	DEU	yes	yes
6	J.P. Morgan Chase	1,723	yes	USA	yes	NA
7	Bank of New York Mellon	1,625	yes	USA	yes	NA
8	AXA Group	1,489	yes	FRA	yes	yes
9	Capital Group	1,390	no	USA	yes	NA
10	Goldman Sachs Group	1,252	yes	USA	yes	yes
11	Deutsche Bank	1,217	yes	DEU	yes	yes
12	BNP Paribas	1,196	yes	FRA	yes	yes
13	Prudential Financial	1,184	yes	USA	yes	NA
14	UBS	1,150	yes	CHE	yes	yes
15	Legal & General Group	1,106	yes	GBR	no	yes
16	Amundi	985	yes	FRA	yes	yes
17	Wellington Mgmt.	927	no	USA	yes	yes
18	HSBC Holdings	896	yes	GBR	yes	yes
19	Wells Fargo	890	yes	USA	yes	NA
20	Northern Trust Asset Mgmt.	875	yes	USA	yes	yes
21	Natixis Global Asset Mgmt.	870	yes	FRA	yes	NA
22	TIAA	854	no	USA	yes	yes
23	<i>Standard Life Aberdeen (Merged)</i>	806	yes	GBR	yes	Yes
24	MetLife	779	yes	USA	yes	NA
25	Invesco	776	yes	USA	yes	yes
26	Aegon Group	773	yes	NLD	yes	yes
27	Franklin Templeton	764	yes	USA	yes	NA
28	T. Rowe Price	763	yes	USA	yes	NA
29	Prudential	755	yes	GBR	yes	NA
30	Morgan Stanley	712	yes	USA	yes	yes
31	Legg Mason	672	yes	USA	yes	no
32	Sun Life Financial	643	yes	CAN	yes	yes
33	MassMutual Financial	642	no	USA	yes	no
34	Sumitomo Mitsui Trust Hldgs.	641	yes	JPN	yes	yes
35	Ameriprise Financial	629	yes	USA	yes	NA
36	Affiliated Managers Group	611	yes	USA	yes	no
37	Nippon Life Insurance	596	no	JPN	yes	yes
38	Mitsubishi UFJ Financial Group	594	yes	JPN	yes	yes
39	Principal Financial	527	yes	USA	yes	no
40	New York Life Investments	498	no	USA	yes	NA
41	Old Mutual	486	yes	GBR	yes	yes
42	Generali Group	471	yes	ITA	yes	NA
43	Great-West Lifeco	471	yes	CAN	yes	NA
44	Schroders Investment Mgmt.	462	yes	GBR	yes	yes
45	<i>Aberdeen Asset Mgmt.</i>	431	yes	GBR	yes	yes
46	Aviva	430	yes	GBR	yes	yes
47	Crédit Suisse	414	yes	CHE	yes	NA
48	Royal Bank of Canada	411	yes	CAN	yes	yes
49	DZ Bank	392	no	DEU	yes	NA
50	Dimensional Fund Advisors	388	no	USA	yes	yes
51	<i>Standard Life</i>	375	yes	GBR	yes	yes

Appendix C – Prior Literature

Institutional investors have become more active in corporate governance in the United States trying to implement the type of shareholder engagement developed in the early 1990s in the United Kingdom.²¹ Corporate voting has become compulsory for many institutional investors and there is broad commitment to “stewardship” through voluntary codes of conduct (see surveys by Gillan and Starks, 1998; Denes, Karpoff, and McWilliams, 2017).²² Yet evidence on the nature, extent, incidence and impact of “stewardship” is more elusive. Many of the largest institutions are index trackers, and while they are passive investors, they certainly claim to be active owners. These include many pension funds, index mutual funds, and exchange-traded funds. Because these institutions usually do not have the option of selling their shares when dissatisfied with management’s performance, they might be expected to invest more in governance. In practice, intensive engagement is expensive and is likely to be incompatible with the lower fees of passive management. While indexed investors have signed up to stewardship codes and are committed to more engagement, there is limited evidence on the nature of their monitoring and engagement, beyond self-selected case studies in stewardship reports. One exception is Appel, Gormley and Keim (2016), who provide evidence that greater ownership by passive investors is associated with more independent boards and improvements in shareholder rights.²³

Active managers potentially have an incentive to invest in stewardship since they can benefit directly from monitoring and engagement with portfolio companies; they can use the information to

²¹ In their influential study of UK institutional investor behaviour Black and Coffee (1994, pg. 2002), observed that “[n]ot only is the United Kingdom context similar to that of the United States, but British patterns of corporate governance may foreshadow future developments in the United State”, which they did. As they showed, the Institutional Shareholders’ Committee (ISC) recommended the use of voting rights as early as 1991. The Cadbury Report (1992) observed that “Because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders’ Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the Code” (para. 6.16). In the context of our study, SLI appointed a head of corporate governance for the first time in 1992/93.

²² The UK Stewardship Code sets out the governance responsibilities of institutional investors. It was first published in 2010 and reconciled the ISC and corporate governance code recommendations. Since 2010, over a dozen countries have introduced stewardship guidelines, including the US in 2017. See Appendix A, Table A2.

²³ There is also evidence that index funds support hedge fund activists in proxy fights (Brav et al. 2019) and that they differ in their attitudes towards management and other issues, as revealed by their general voting behaviour (Bolton et al. 2019).

guide their own trading decisions.²⁴ Active managers can be active owners in two respects. First, we would expect the fund to diverge from an index fund and be overweight in some securities and underweight in others.²⁵ Second, active managers may also exercise a governance and stewardship function in the decisions of the portfolio firm and thereby influence corporate outcomes. The two activities are linked since the active manager can gain valuable information for trading from their stewardship activities; at the same time the ability to trade can enhance the fund's influence by explicitly or implicitly threatening exit. While, active managers differ from hedge fund activists in the sense that they do not buy stakes in order to exert influence, they may choose to exert influence in firms they already own. Active managers also differ from passive ones in not only being able to exit from the company in the event that they are dissatisfied with the response of management to their governance and stewardship concerns, but they may also take larger bets in response to price changes, particularly if the company responds positively to the engagement.

A theoretical strand of literature has focused on voice and exit as substitutes or complements. The older strand of the literature has argued that the ability of active managers to exit undermines incentives to intervene and engage. The fund can use information obtained from monitoring to exit, thus avoiding expenses associated with governance interventions (Bhide 1993). The ability to exit can also have the opposite effect. The fund can use exit as an implicit or explicit threat by exerting downward pressure on stock prices (Palmiter 2002; Admati and Pfleiderer, 2009; Edmans, 2009; Edmans and Manso 2011). In

²⁴ Active management of institutional equity holdings has interested financial economists since the efficient market hypothesis was first formulated. Empirical evidence provided by Jensen (1968) finds no supporting evidence that mutual funds earn abnormal returns. Many subsequent studies have confirmed these results, analyzing the performance of mutual funds (e.g. Hendricks, Patel, and Zeckhauser, 1993; Carhart, 1997). The literature has expanded beyond mutual funds, to all institutional investor holdings that are subject to disclosure rules.

²⁵ Underweight includes not investing at all in a company included in the index, attributing an index weight of zero. Active Share is a measure of the extent to which an active manager deviates from its index benchmark, i.e. a passive manager (Cremers & Petajisto 2009). They find considerable heterogeneity among U.S. funds that changes over time. This has been confirmed internationally (Cremers, Ferreira, Matos and Starks 2016). Active funds also differ in their average holding periods.

these models the blockholder's ability to trade on negative information and the target firm's concern with the short-term stock price might cause the manager to respond more positively and, thereby improve governance. There is only limited information on the extent and effectiveness of active asset managers as "stewards" of their clients' portfolios. An important exception is McCahery, Sautner, and Starks (2010) who find that survey respondents working at active asset managers claim that they had contacts with the company prior to trading i.e. exit, and that the ability to exit is a primary governance mechanism.

The evidence on institutional engagement and performance is also indirect. A large number of studies use quarterly US filings data to establish that changes in institutional equity holding, especially around index inclusion or exclusion events, is positively correlated with future stock returns (Daniel, Grinblatt, Titman, and Wermers, 1997; Wermers, 1999; Chen, Jegadeesh, and Wermers, 2000; Bennett, Sias, and Starks, 2003).²⁶

²⁶ While under SEC rules, institutional investors are required to disclose equity positions every quarter in 13-F filings, in other countries institutional ownership may be recorded almost in real time, such as in Finland (Grinblatt and Keloharju, 2000) and South Korea (Choe, Kho, and Stulz, 1999). To overcome the quarterly frequency limitation of US ownership disclosure, Sias, Starks, and Titman (2006) use monthly return data to make inferences about monthly changes in institutional ownership from quarterly institutional holdings. Campbell, Ramadorai, and Schwartz (2009) use intraday trading data to infer daily institutional trading and identify the best match to observed quarterly holdings data from 13-Fs.

Appendix D

Case Study D1 - Vodafone

Vodafone throughout the sample period was a member of the FTSE 100 index, and SLI had a holding of up to 2% in the company during the observation period, one of the largest positions by value in the portfolio. In 2007 the largest shareholder was Legal & General Investment Management, with a holding of 4.02% (Annual Report 2007, pg. 152). No other shareholder held a stake larger than 3%. In 2006 and 2007 the relationship between Vodafone and SLI was tense. On 30 June 2006 the G&S Group raised a governance health warning “on the ground of concerns re[garding] board balance and composition, strategic governance, inappropriate remuneration policies and lack of responsiveness to investor concerns.”²⁷ SLI was also dissatisfied with the performance of the CEO and voted against his reappointment at the 2006 AGM. SLI’s negative vote and the total opposition of 14% (9.5% against, 4.5% abstain) was widely reported in the press.²⁸ Despite some improvements in 2007, shareholder pressure forced the incumbent CEO to step down in 2008.²⁹ The board changed and the new CEO appointment induced the G&S Group to remove the Governance Health Warning on 13 July 2009. Remuneration engagements continued with negative votes in 2009 and 2012. There was relatively little net trading during the 2007-2009 period, the number of funds holding in Vodafone was largely unchanged and the SLI stake was nearly constant. The case illustrates the willingness of SLI to vote against management and their contribution to changes.

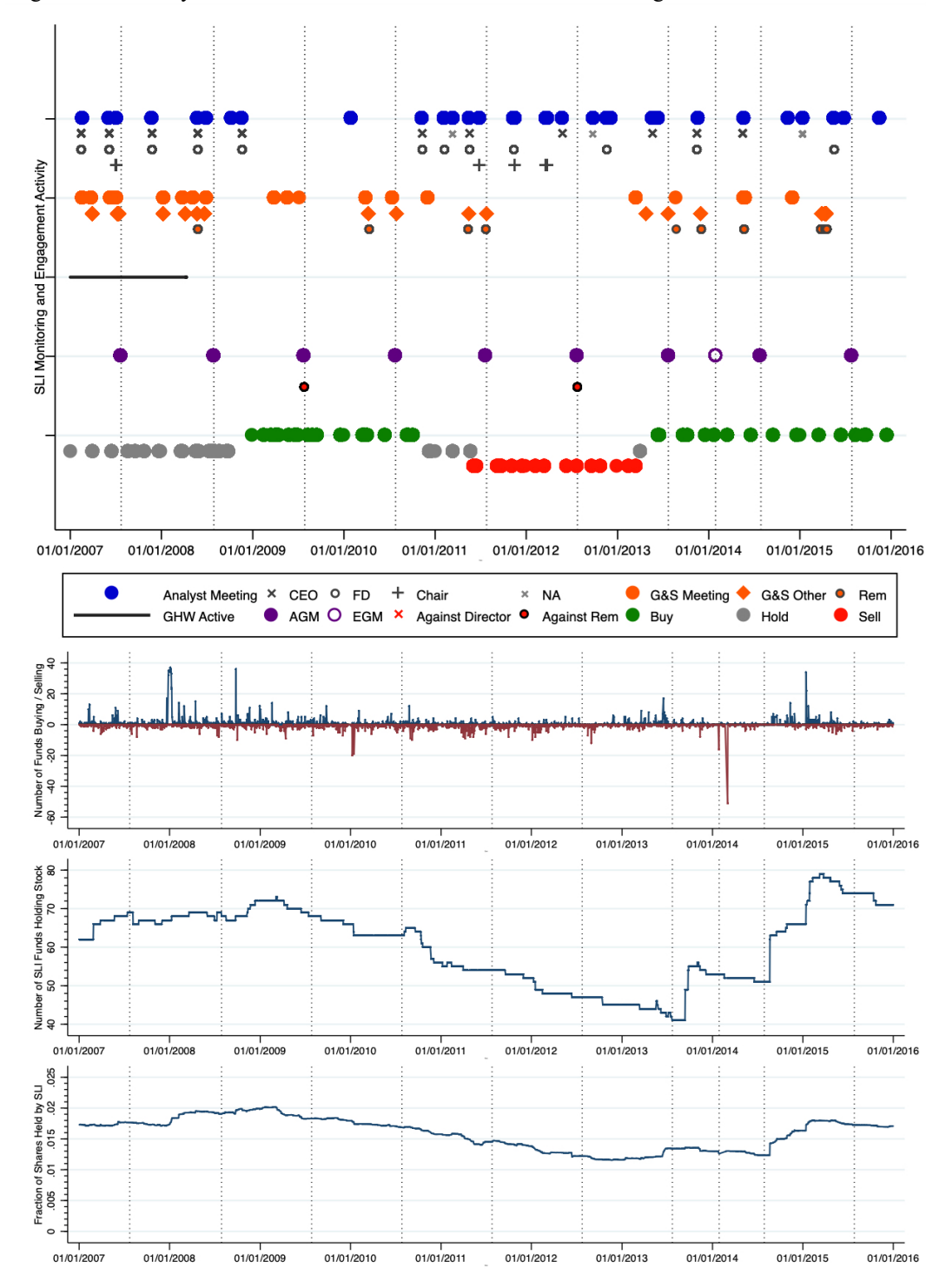
²⁷ SLI Q1 2007 Sector Analyst Report.

²⁸ Parker, Andrew (2006), StanLife opposes Sarin at Vodafone, 23 July, Financial Times.

²⁹ Parker, Andrew (2008), Sarin to step down from Vodafone helm, 27 May, Financial Times; Olson, Parmy (2008), Sarin The Survivor Steps Down, 27 May, Forbes.

Figure 9a - Vodafone

The figure shows interactions between the SLI UK Equities Team and Vodafone Plc, trading by fund managers, the number of SLI funds holding the stock at any one time and the evolution of the SLI stake during the observation window.



Case Study D2 - EasyJet

EasyJet, a low-cost airline founded in 1995, went public in November 2000 with the founder and his family retaining a substantial minority stake. In 2006, SLI was the largest independent shareholder with a year-end stake of 10.2%. In 2005 the company recruited a new outside CEO and CFO. The board was headed by a non-executive Chairman, while the founder served as a non-executive director.

In 2007 the SLI fund managers met with the company three times: once with the CEO and the CFO, once with the CFO and the Head of Investor Relations and once with the founder, at his request (Figure 9b). The meeting with the Chairman was attended by a member of the G&S Group. The analyst was positively impressed with the new CEO and CFO. The 2007 Q1 analyst report observed that the “appointments should ensure that EasyJet finally makes the transition from an entrepreneurial business into a plc.” The G&S Group had separate contacts with the company on remuneration, voting, SRI and governance (Figure 9b). The remuneration contacts were initiated by the company. The analyst recommendation was “buy” throughout the year. At the 2007 AGM, SLI voted in favor of all management proposals.

Towards the end of 2008 the EasyJet board entered into conflict with the founder over strategy and the company’s dividend policy. In 2009 the CEO, CFO, and Chairman resigned. A senior independent director was appointed Acting Chairman and the Deputy Chairman became Chairman Designate. In September 2009 the G&S Group raised a Governance Health Warning. In September SLI met the Deputy Chairman and conveyed the view that it would be “positive if they [easyJet] could reduce the perception of [the founder’s] influence on the board and the company”. In the Q4 report the analyst noted, “all very unhelpful and having material impact on share price.” The dispute continued in private during 2010 and a new CEO was appointed. In December 2010 there was a special meeting to approve a related party transaction. SLI voted in favor.

In February 2011 the annual meeting re-elected the Chairman. The number of SLI funds with a holding in EasyJet stock dropped from 60 towards the end of 2010 to 40 at the beginning of 2012.

The confrontation escalated at the February 2012 annual meeting when the founder’s family voted against the election of directors proposed by management. The management proposals passed with a narrow majority. The escalation continued when the family called an extraordinary shareholder for 13 August to remove the Chairman

of the Board. The proposal narrowly failed due to the support of independent shareholders, including SLI, for the incumbent. The family continued to vote against the director candidates of management in 2013 and 2014, without success.³⁰

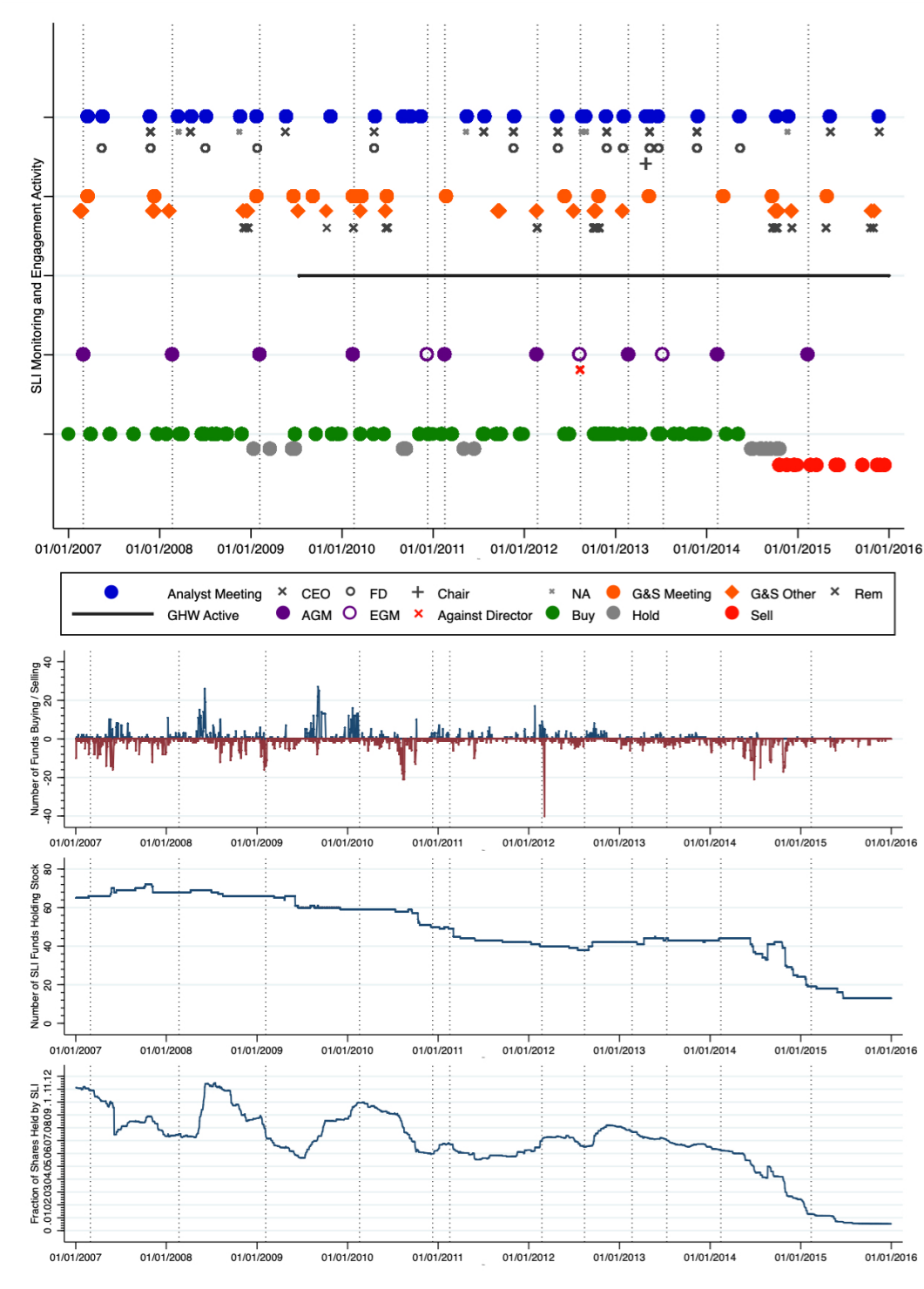
In Q4 of 2014 the analyst recommendations turn persistently negative and SLI sold down its stake of over 5% to almost zero across funds at the end of 2015. The switch in analyst opinion was motivated by overly aggressive growth in a competitive industry with deep pocketed rivals that were also seeking to expand.

EasyJet is a case where governance problems, in this case tensions between the company's founder, an independent Chairman and the executive team, were perceived to threaten value. The issues were interpreted consistently across the whole UK Equities Team and resulted in a reduction in the number of SLI funds holding the stock and a smaller aggregate holding. The permanent switch in analyst opinion from buy to sell and exiting the company almost completely was triggered by concerns about strategy and governance.

³⁰ We exclude shareholder proposals from the statistical analysis because a negative vote can be a vote supporting management, like in this case.

Figure 9b - EasyJet

The figure shows interactions between the SLI UK Equities Team and EasyJet Plc, trading by fund managers, the number of SLI funds holding the stock at any one time and the evolution of the SLI stake during the observation window.



Case Study D3 – Sports Direct

Sport Direct was a sports retailing company that went public in 2007, grew rapidly, and the founder retained majority control throughout the sample period.³¹ To comply with the London listing rules a relationship agreement was put in place ensure that the company would be run independently from its controlling shareholders. The G&S Group placed Sports Direct on a GHW shortly after the IPO; it was never lifted (Figure 9c).

Sports Direct was included in the FTSE250 after the IPO and advanced to inclusion in the FTSE100 in September 2013, dropping out in March 2016, after a substantial fall in its stock price. SLI had a 1% holding after the IPO and the holding remained quite small until the beginning of 2013. The analysts' recommendations started out as "hold" and switched to "buy" after the FTSE100 index inclusion. At the beginning of 2017 SLI had become one of the largest independent shareholders with a 2.5% stake, approximately 5% of the free float.

SLI had regular voting engagements with Sports Direct. In 2010 Sports Direct put forward an Executive Bonus Share Plan that was opposed by 60% of the independent shareholders, although it passed with the votes of the founder. In 2011 two further management resolutions were passed that were opposed by the independent shareholders, including SLI.³² In 2012 Sports Direct proposed a Super Stretch Share Scheme that required 75% shareholder approval. This time the resolution failed.³³

In 2015 in a private meeting with the Chairman SLI repeated its concerns about corporate governance. In September 2015 SLI was asked again, in separate resolutions, to approve an amended remuneration policy, and to re-appoint the members of the remuneration committee. This time independent shareholder approval was required for director appointments. SLI voted against but a majority of the minority approved the motions.

The standoff over remuneration intensified when the Guardian newspaper revealed that Sports Direct paid its workers below minimum wages and compared the company's main UK facility to a "gulag". An editorial

³¹ The controlling stake was 71% after the IPO and was reduced to 58% in 2017.

³² The 2011 AGM Resolution 17 "Approval of amendments to the Sports Direct Bonus Share Scheme 2011" was opposed by 79% and Resolution 18 "Approval of amendments to the Sports Direct Executive Bonus Share Scheme 2011" by 80% of the independent shareholders.

³³ The Non-Executive Chairman of the Remuneration Committee was unrepentant and commented: "As a Board, we are very disappointed that this resolution was not passed, however we respect shareholders' views. We will, however, continue to look at innovative incentive programmes for all of our people to help drive growth and in turn, increase shareholder value. As such, a new Super Stretch Share Scheme with further performance criteria will be proposed to shareholders at a future meeting." (Results of Annual General Meeting, 5 September 2012, RNS Document 5967L).

published in September had the subtitle: “For its workers, Sports Direct offers zero-hours contracts; its bosses get mega-bonuses.”³⁴ The newspaper report triggered a parliamentary inquiry.

Subsequently, the re-election of the Chairman was successfully opposed by a majority of the free float.³⁵ In accordance with the listing rules the motion to re-elect the Chair was tabled again at an EGM in January 2017 and passed only with the votes of the founder.³⁶

In 2017 SLI divested completely from Sports Direct International, and the sale was widely reported.³⁷ The decision to divest across all funds was deliberate and motivated by the realisation that engagement through voice would not lead to success.

³⁴ “The Guardian view on Sports Direct: big British capitalism at its grubbier”, 8 September 2015

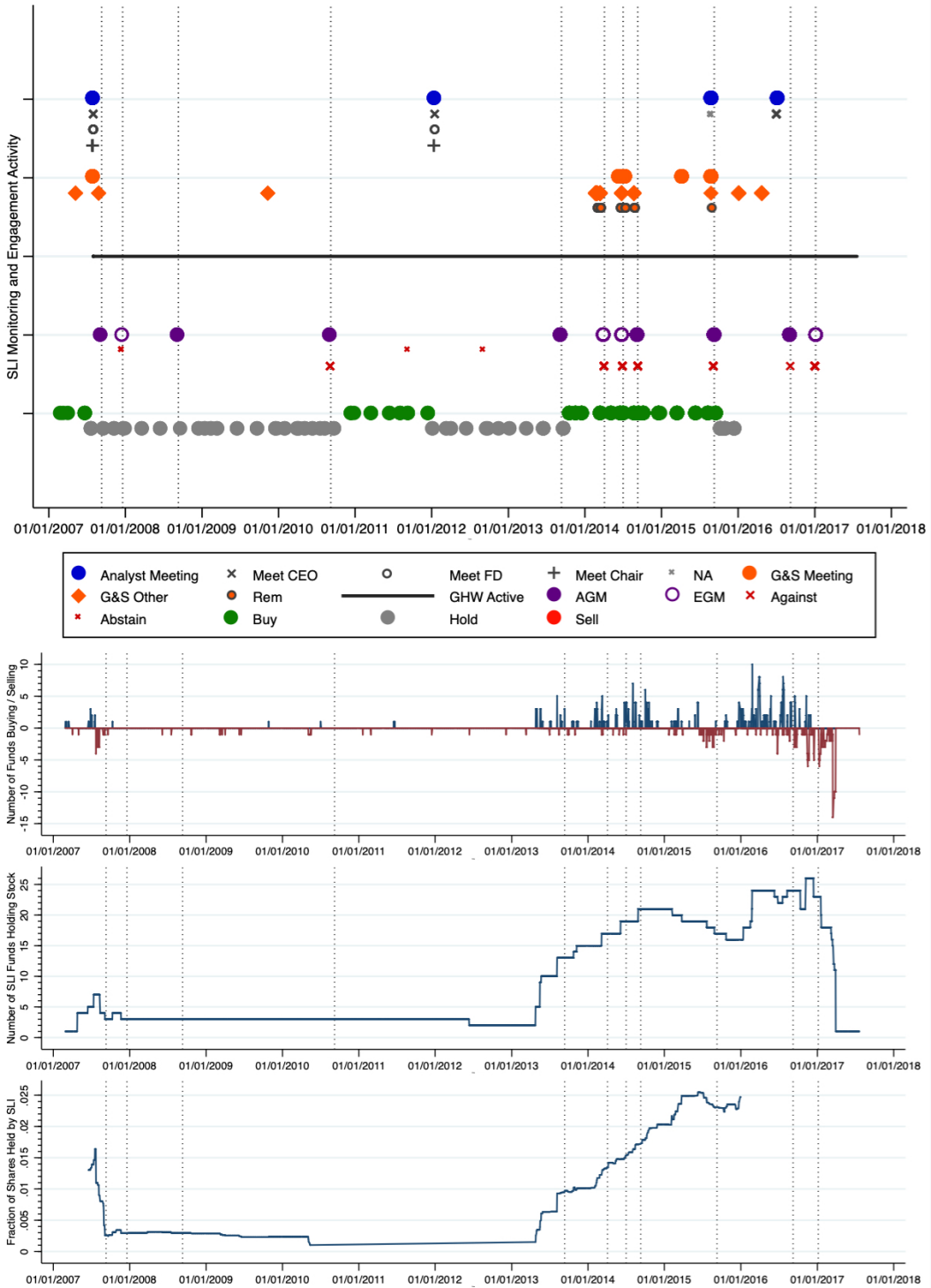
³⁵ The reappointment was opposed by 56% of the independent shareholders, including SLI. In 2014 the London Stock Exchange strengthened its rules on controlling shareholders’ independence requirement (Listing Rule 6.1.4D). For director elections the new listing rules stipulated that “the election or re-election of any independent director by shareholders must be approved” by all shareholders and by the independent shareholders separately. If the independent shareholders fail to approve the election a second meeting could be called between 90 and 120 days from the original vote.

³⁶ SLI had voted (again) against the re-election. Its voting database cited an analyst: “We voted against the Chairman’s re-election at the AGM and, while we have had subsequent engagement with him, our views on his position remain unchanged. We were disappointed by the letter (attached) received from the [the Chairman] yesterday in response to our concerns [..].”

³⁷ Rupert Steiner, “Sports Direct loses biggest independent investor”, The Guardian, 2 August 2007

Figure 9c - Sports Direct

The figure shows interactions between the SLI UK Equities Team and Sports Direct Plc, trading by fund managers, the number of SLI funds holding the stock at any one time and the evolution of the SLI stake during the observation window.



Appendix E – Voting Decisions³⁸

Corporate voting is central to the SLI engagement process. Voting decisions are taken centrally across all funds by the analyst, the voting manager or another relevant member of the G&S Group. The majority of UK holdings are reviewed by the voting manager; however other members of the G&S Group may undertake the voting analysis for specific companies. The same voting manager has been in charge since the creation of the governance group in 1998, providing continuity and consistency. The analyst has the lead on all voting decision that are directly related to the financial analysis of a company, like capital issuance, takeovers, divestitures, acquisitions or voluntary delisting. The voting manager has the lead on governance and stewardship issues, like the appointment of non-executive directors, E&S and remuneration. The voting managers will also advise on the governance aspects of M&A decisions. Final voting decisions will be agreed by the voting manager and the analyst. Should they fail to be able to agree the decision can be escalated to senior management.

Voting is seasonal and largely concentrated in the annual meetings season. Extraordinary general meetings receive special treatment and attention. Hedge fund activist proposals also get special treatment that would involve the Head of UK Equities. SLI are generally skeptical towards hedge fund activists.

To prepare voting decisions SLI subscribes to external research from Institutional Shareholder Services (ISS) and the Institutional Voting Information Service (IVIS), run by the Investment Association.³⁹ SLI also has a custom voting policy on which ISS bases its voting recommendations. IVIS applies the policies defined by the Investment Association (IA) in agreement with its members. SLI is a member of the IA. An internal watch list is maintained of companies that require additional focus in the voting analysis process. Reasons for this could be previous voting issues or governance concerns. Negative voting outcomes flagged by ISS or IVIS are also assessed and discussed. In addition, fund managers or the G&S Group might bring additional cases of concern to the attention of the vote manager throughout the process.

³⁸ This section is based on an interview with the vote manager, other ASI staff and the content of the voting database.

³⁹ In the past this service was provided by the Association of British Insurers (ABI). SLI was a member of the ABI by virtue of its parent company being an insurance company.

In the case of a negative decision or an abstention the Head of UK Equities is informed by email. The text of the email is recorded in the voting database. The vote manager will usually inform the company of the negative vote or an abstention before the meeting. This might be done in writing or via a phone call. The company might respond by email or by phone. Responses vary in tone. The response is usually recorded in the voting database. It is also possible that the company will contact the vote manager. These approaches are recorded as “consultations” in the voting and the G&S Group’s engagement database. Consultations are often linked to votes on remuneration. The involvement of the internal analyst implies and ensures that voting decisions are incorporated in internal analyst recommendations and reports.

Appendix F – Governance Health Warnings

GHWs were a central task for SLI's UK G&S Group. The GHW methodology is set out in a series of internal notes that have the character of a “how to” manual for G&S Group members. The notes describe the general philosophy and the mechanics of the HW process. We had access to the 2010, 2011, 2012 and 2013 copies of the manual. We also conducted interviews with former and current G&S Group members. The procedure was stable from 2010 to 2015 for UK equities.⁴⁰

The G&S Group at SLI came into existence around 1992/93 (Table A1) and had the role to engage in conversations with companies and to vote the shares in the SLI portfolio. Internally the Team kept a list of corporate governance “saints and sinners”. The criteria that defined a “sinner” were subjective and the actuarial tradition of Standard Life, an insurance company, suggested a quantitative measure to communicate the “sinner” status more effectively to fund managers. The response was a binary “Health Warning” flag that was raised when the Team had fundamental concerns. First health warnings were raised around 1997, for example for the Royal Bank of Scotland (RBS) around board and remuneration issues.

The GHW process is part of the corporate governance and stewardship mission of SLI. A GHW is first raised during a regular contact with a company. The raising of a new GHW is a significant event. The decision had to be approved by the head of the G&S Group. The information was then sent by email to the entire SLI hierarchy, including the head of UK and global equities, the head of fixed income and the chief executive officer.

The internal notes recommend that the GHWs were reviewed annually for all UK companies and discussed quarterly at G&S Group meetings. The review took the form of a 1-1 meeting for holdings of 5% or more of a company's stock. In other cases, there should be at least a desktop review. Primarily the review uses records stored in the internal G&S Group's engagement database, but also information from other sources.

The G&S Group member responsible for the review would form an opinion based on several areas that might give rise to concerns. These might include issues like lack of independent directors, lack of integrity, inappropriate remuneration policies, poor environmental and regulatory record, resistance to suggested governance

⁴⁰ In 2016, the last year of our study period, a significant revision occurred.

improvements, external criticism (regulators, press, others) and related party transactions. The presence of significant family or other controlling shareholder was a specific area of concern.

The outcome of the review was recorded in four databases: (i) the SLI G&S Group's engagement database used extensively throughout the study, including a review note, when warranted; (ii) health warning summary spreadsheets; (iii) a Central Information System (CIS) accessible across all SLI teams via a Bloomberg terminal, including fixed income; (iv) a "Black Book" summary sheet linking health warnings to stock performance. Fund managers had access to (iii) and (iv) but not to the G&S Group's engagement database, since it might contain information that is privileged under the UK's insider trading rules. This basic GHW information was further communicated by analysts in company and industry reports and also appeared in the voting database that was maintained by the vote manager. In the analyst reports GHWs had a separate box that appeared at the top of the first page of the report. The report always displayed in bold letters if the GHW was "on" or "off". In addition the box might contain notes on specific corporate governance issues, but not always.

A subsequent review of a GHW was scheduled automatically once the data entry was complete. The procedure ensured that all members of the UK equities, fixed income and G&S Group had complete and up-to-date access to the HW status information.

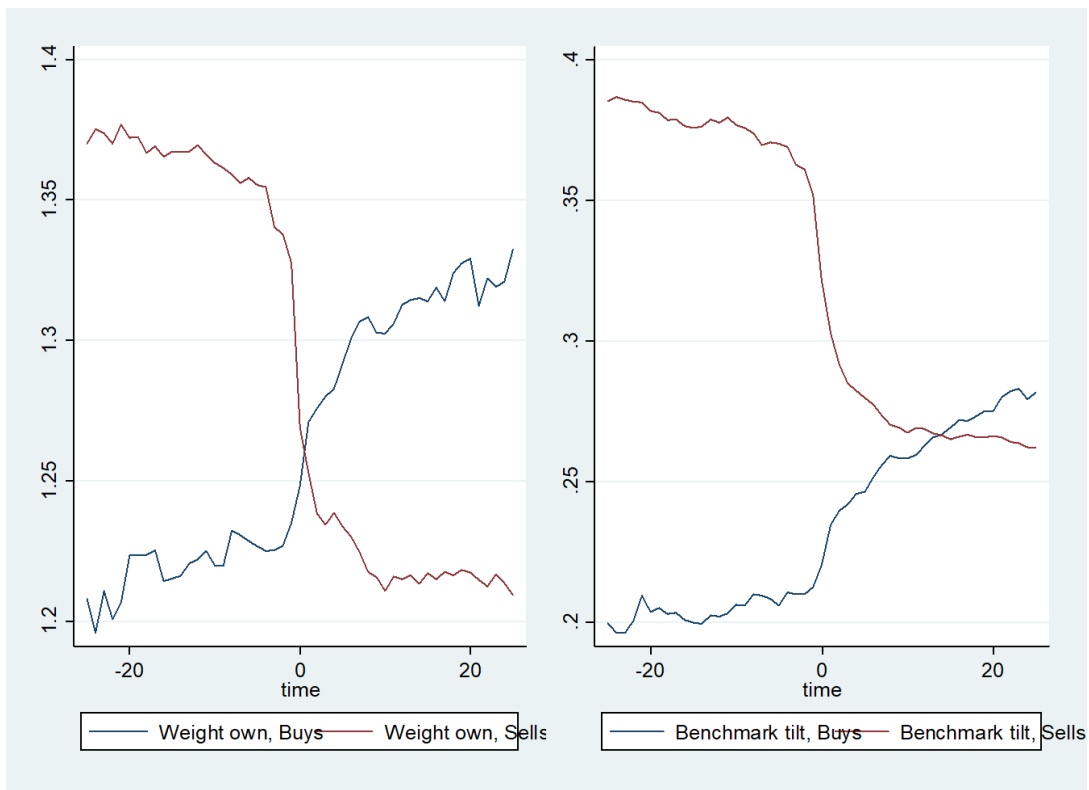
The quantitative information on health warnings we obtained comes from the G&S Group's engagement database, the "Black Books" and occasional copies of the summary spreadsheets. The "Black Book" was started in 2007, fully implemented in 2008 and updated unchanged until the end of 2014. The 2008 sheets, for example, lists all portfolio companies that had a health warning during the year. If a health warning was added or removed this is recorded in a note with the date. If the company was acquired or trading was cancelled this is recorded as well. Using this information, we were able to construct a list of health warnings containing the name of the stock, the ticker (EPIC) symbol, the date we first observed the health warning and we last observed the health warning. We were particularly interested in health warning activation events. These events were observable to SLI fund managers through the information channels and "push" action described above, but not to the company or other investors.

Appendix G – Additional Results

Figure G1

Fund Manager Portfolio Weights and Benchmark Tilts

The figure shows relative benchmark weights of stocks subject to analyst recommendation changes, for [-25, 25] day windows around analyst recommendation changes of new Buy and new Sell signals. Sell Signal indicates any switch of Buy to Hold, Buy to Sell, Hold to Sell; Buy Signal indicates any switch of Sell to Hold, Sell to Buy, Hold to Buy. The left figure shows average portfolio weights of stocks within funds' own portfolios, where the own weight is calculated as the portfolio weight in stock i of fund j . The right figure shows average portfolio tilts of stocks within portfolios, where the portfolio tilt of a stock is calculated as the portfolio weight in stock i of fund j minus the value weight of that stock in the benchmark.



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