The AMBACHTSHEER Letter
Sustainable Pension Design • Effective Pension Management

January 2016

'ACTIVE INVESTING'…….THREE POSSIBLE PATHS

"We find that the Canadian Coalition for Good Governance's private engagements influence the adoption of shareholder democracy measures, say-on-pay advisory votes, and improve compensation structure and disclosure…"

"Can Institutional Investors Improve Corporate Governance through Collective Action?"
Doidge, Dyck, Mahmudi, and Virani (2015)

"We document outperformance following environmental, social, and governance (ESG) engagements by a UK institutional investor. After successful engagements, companies experience improvements in operating performance, profitability, efficiency, and governance."

"Active Ownership"
Dimson, Karakas, and Li (2012)

"Our strategy incorporates ESG factors holistically within a fundamental financial framework. Our high 'due diligence' focus, combined with the desire to maintain an active corporate oversight role with limited resources, leads to a concentrated portfolio…… but our 'active ownership' approach outweighs the risks embedded in this concentration…."

"Really Investing for the Long-Term: A Case Study"
van der Velden, van Buul (2012)

Rethinking 'Active Investing'

Our December *Letter* titled "Professor Fama's Folly: "Financial Markets Are Efficient" argued that while it may be impossible for 'beauty contest' investors to consistently outperform the market in the short-term, this is not the case for investors who focus on wealth-creation in the long-term. This *Letter* continues that theme by identifying concrete, practical pathways open to asset owners and institutional investors if they truly want to be wealth-creating long-term investors.

Specifically, we interpret the findings of published studies in three mutually-supportive contexts:

1. <u>A collective action approach with limited objectives</u>, supported by a large group of like-minded asset owners and institutional investors.
2. <u>An individual 'change agent' approach on specific issues</u>, with a single entity acting on behalf of a number of asset owners and institutional investors.
3. <u>An integrative investment approach</u>, with a single entity empowered to implement a comprehensive long-term investment program on behalf of one or more asset owners.

Why is identifying concrete, practical pathways to successful long-term investing so important? Because a survey of 81 institutional investor we conducted for the *Focusing Capital on the Long-Term* initiative in 2014 clearly showed a material aspiration gap: survey respondents said they understood the value of long-term investing, but offered a list of barriers that stood in the way of actually investing that way.[i] These barriers included a lack of resources qualified to operate actively in the long-term investing arena, dysfunction in how 'performance' is measured, perverse incentives, and ineffective collective action strategies.

A 'Large Group' Collective Action Approach

The 2015 study by Doidge et al. cited above sets out the accomplishments of the Canadian Coalition for Good Governance (CCGG) over the course of its first 11 years of existence (2002-2013). CCGG has been globally lauded as an effective initiative to raise the quality of corporate governance. The study lists four reasons for this:

- CCGG membership is restricted to Canadian asset owners and institutional investors, increasing the likelihood of positive responses to CCGG proposals. However, care was taken to ensure that the membership included different types of asset owners and institutional investors, eliminating the prospect for accusations of bias. CCGG members collectively hold material stakes in all major publicly-listed Canadian corporations. There were 50 members at the time the study was conducted.
- A collective choice was made to pursue activism through private CCGG persuasion rather than through more adversarial public shareholder proposals or proxy fights. This meant activism through targeting specific firms with letter writing campaigns, phone calls, and meetings with independent directors.
- CCGG would limit its activism to broad governance 'best practices' issues, rather than on issues such as business strategy, financial policy, or leadership at specific corporations.
- Corporate governance practices in Canada are largely guidelines- rather than rules-based, with a comply-or-explain requirement. There were no regulatory changes during the observation period.

A key success ingredient in the study itself was that CCGG made its private records available to the researchers, so that they could form a complete picture of its activism efforts. This in turn allowed them to construct tests that measure the impact of these efforts on corporate governance practices.

During the observation period, CCGG engaged firms on three major governance issues: 1. Majority Voting, 2. Say-on-Pay, and 3. Compensation Policies. Quoting from the study findings on the adoption of CCGG proposals in these three areas, the researchers found "in each case, we find that CCGG engagement is associated with a statistically significant and economically meaningful increase in the likelihood of adoption". The researchers conclude that 'large group' collective action strategies can be highly effective, if careful thought is given to organizational composition and structure, social context, and devising simple, well-understood implementation protocols.

An Individual 'Change Agent' Approach

The 2012 study by Dimson et al. cited above is also based on access to a unique proprietary database. The focus here is individual corporate engagements related to environmental, social, and governance (ESG) issues. The database was provided by a large UK-based institutional investor with a long history of actively engaging corporations in which it, and/ or its clients, are shareholders. It engages with over 3000 target companies around the world via letters, emails, telephone conversations, and direct dialogue with senior management. The focus for the study is 2152 engagement events at 613 U.S. public companies over the 1999-2009 period.

The study produced the following key findings:

- The engagement success rate was 18% attained over a median timeframe of one year.
- Successful engagements produced an average cumulative abnormal return of 4.4% in the year after success was achieved. There was no market reaction to unsuccessful engagements.
- Successful engagements related to governance and climate change issues were most successful, producing cumulative abnormal returns of 7.1% and 10.6% respectively.
- Successful engagements on non-governance themes generated 5.9% in cumulative abnormal returns.
- The return on assets, profit margin, asset turnover, and sales/employee ratios improve significantly one year after successful engagements, as compared to unsuccessful ones.

- Shareholdings by activist investors increase, and stock return volatility decreases one year after successful engagements.
- Corporate governance quality (as measured by the Gompers and Bebchuk indexes) improves in the targeted firms two years after successful engagements.

These findings lead Dimson et al. to conclude that this kind of activism lengthens the time horizon in which corporate managers frame strategic decisions, which in turn creates incremental value for all corporate stakeholders, including shareholders.

Related studies by Bauer, Clark, Moers, and Viehs extend the study by Dimson et al. to include public shareholder proposals as another form of activist engagement. They note that 20% of these public proposals are withdrawn before they come to a vote, and that these withdrawn proposals tend to be filed by large institutional investors. They point out that this effectively transforms public proposals into private corporation-investor negotiations, indicating that the public and private engagement routes are closely connected.

An Integrative Long-Term Investment Approach

The logical extension of the two activist approaches set out above is to empower a single entity to manage a comprehensive, integrated, long-term investment program on behalf of one or more asset owners. In the cited 2012 article, van der Velden and van Buul set out the key success drivers for the design and implementation of such a program. They had been managing such a program at a large Dutch fiduciary manager since 2008 at the time they wrote the article, and became principals of *Ownership Capital* (*OC*) at its founding in late 2012. *OC* has employed the same integrative long-term investment approach described in the article since its inception. Five key success drivers are:

- <u>Start with the fundamental belief that ‘sustainability pays’</u>: corporations which live by that belief will naturally frame their strategies in horizons that stretch beyond tomorrow into the ‘long-term’. This in turn will drive superior value-creation over time. For research backing, they reference the same Eccles et al. study we did in our February 2015 *Letter*. The study found that the return of a portfolio of high-sustainability firms was 4.8%/yr. higher than the return of a portfolio of low-sustainability firms over a 17-year period.
- <u>Integrate ESG factors holistically within a fundamental financial framework</u>: such integration recognizes that true corporate sustainability requires paying equal attention to the financial and non-financial drivers of corporate performance. ‘Due diligence’ doesn’t just involve thorough financial analysis and valuation, but also plant visits and conversations with management, customers, suppliers, competitors, unions, and NGOs.
- <u>Be able and willing to add ‘active ownership’ activities in the mix if needed</u>: such initiatives require in-depth knowledge of, and strong relationships with investee companies. This requires being a ‘top 20’ investor in investee companies with understandable business models and balance sheets. The average holding period for each investment is expected to be many years. Most engagements over time have been positive and constructive. However, sometimes an investee corporation will stray from its sustainability path, and if efforts to return it to that path fail, the exit option must be exercised.
- <u>Conviction investing means holding a concentrated portfolio</u>: this means holdings in the 20-25 range rather 200-250. However, such concentration does not necessarily mean greater risk exposure. Portfolio risk is controlled through deep fundamental and ESG analysis, combined with ‘active ownership’ activities. The resulting portfolio has a beta under 1.0, and the same level of absolute return volatility as a broadly-based index fund.
- <u>Align the ‘sustainability pays’ belief with manager compensation</u>: while incentive structures can be designed with different specifics, they must recognize the long-term nature of this approach to investing. Also, HR policies must do more than just recognize the need for financial skills on the investment team. Broader business strategy and applied ESG skills and experience are also needed.

Does this kind of integrative, long-term approach to investing work as well in practice as to does in theory?

The cited study by Eccles et al. suggested an affirmative answer: the high-sustainability portfolio outperformed the low-sustainability one by almost 5%/yr. over a 17-year period. Interestingly, stringing the actual portfolio performance of the approach described above together over its combined five years of operation has also produced an outperformance result in the 5%/yr. area.[ii]

The cited December 2015 *Letter* "Professor Fama's Folly" provided additional evidence for the 'outperformance' proposition, both theoretical and empirical. For example, John Maynard Keynes made a clear theoretical distinction between short-term 'beauty contest' and long-term wealth-creating investing way back in 1936. Empirically, using the latter style, he managed the University of Cambridge endowment fund from 1921 to 1946, producing an excess return, once again, in the 5%/yr. area. As another example, the CEM Benchmarking Inc. database contains pension funds with long-term outperformance results in the 2%/yr. area. Common characteristics of many of these high-performance funds are that they are large, and that they have insourced most of their private markets investment activities, leading to materially lower cost structures and higher net returns.

Three Pathways to Active Investing

The goal of this *Letter* was to examine three pathways to active investing in some detail. Why is this important? Because active investing, properly defined and implemented, is a 'win-win' proposition. It leads to a more functional, sustainable form of capitalism, and at the same time, it produces excess returns for the investors who practice it effectively. Importantly, the three pathways mutually support each other.

In closing, some thoughts on the practical 'takeaways' of the three pathways studies:

- The leaderships of other national and international governance coalitions (e.g., CII, ACSI, Eumedion, ICGN) should have a close look at the findings from the Doidge et al. study on the CCGG. What are the lessons to be learned? Can the effectiveness of these coalitions be improved?
- The 18% success rate for engagements in the Dimson et al. study seems disappointingly low, especially given the apparent financial benefits attached to engagement success. Why is the success rate so low? What can be done to improve it?
- The van der Velden-van Buul study helps explain why integrative, active long-term investment approaches are still such a rarity in the institutional investing world. Their adoption requires a genuine shift away from the still-dominant short-term 'beauty contest' paradigm. It is one thing to say such a shift is needed, it is quite another to actually achieve it.

Given these thoughts, it seems appropriate to let Keynes have the final word: *"Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally."*

Thus, we need to shift 'active investing' from an unconventional to a conventional strategy.

Endnotes:

i. *The study title is "How Effective Is Pension Fund Governance Today? and Do Pension Funds Invest for the Long-Term?" by Ambachtsheer and McLaughlin, January 2015. It can be accessed through the KPA Advisory Services website in Recent Publications.*

ii. *Based on information provided by Ownership Capital.*

Published by KPA Advisory Services Ltd., 1 Bedford Road, Suite 2802, Toronto ON Canada M5R 2B5
416.925.7525. www.kpa-advisory.com