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The Case for Active Ownership

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Investor engagement with companies is reported as being on the rise,[1] with clear evidence demonstrating the ability of investors to successfully promote change at investee companies. There are a number of academic and industry studies which, looking at different aspects of active ownership, consider its impact on corporate social and financial performance. These studies paint a compelling picture showing that investors could at the same time improve the potential social impact of their shareholdings through stewardship as well as improving companies' financial performance.

The following document reviews the academic and industry evidence for the impacts of shareholder engagement. It groups the papers discussed in four key themes which examine:
1. the increase in active ownership and the growing role of institutional investors as activists;
2. the link between corporate social responsibility, shareholder activism and corporate financial performance;
3. the market reactions following shareholder campaigns;
4. the effects of active ownership on companies' social and environmental performance.

The Rise of Active Ownership and The Role of Institutional Investors

Activist Insight (2015) An Annual Review of Trends in Shareholder Activism
http://www.shareholderforum.com/access/Library/20150130_ActivistInsight-SRZ.pdf

> The latest "Annual Review of Trends in Shareholder Activism" published by Activist Insight (2015) argues that corporate governance is now more shareholder-centric as a result of the activist movement, with far less passivity from shareholders and proxy voting advisors, even in areas traditionally within the exclusive remit of the board of directors. The report indicates that a total of 344 companies worldwide were subjected to activist demands in 2014, up 18% from the 291 recorded in 2013. In 2014, 75% of demands were at least partially satisfied, up from 67% in 2013.

OECD (2014) Institutional Investors and Ownership Engagement
http://www.oecd.org/corporate/Institutional-investors-ownership-engagement.pdf

> This recent OECD (2014) report provides evidence of the rise of public equity held by institutional investors across the world. In the last 50 years in the UK, the portion of public equity held by individual investors, as opposed to institutions, has decreased from 54% to only 11%. Similar trends are observable elsewhere in the world as well. In the mid-1960s, individuals held 84% of all publicly listed stocks in the United States, whereas today they hold around 40%. In Japan the proportion of direct shareholdings is even smaller – in 2011 only 18% of all public equity was held by individuals.

Deutsche Bank Group (2012) Corporate Engagement by Institutional Shareholders
https://www.db.com/cr/en/docs/DBAdvisors_CorpEngagement_090113.pdf

> The paper cited above argues that: "Corporations increasingly face a new type of shareholder: the shareholder activist. The rise of shareholder activism suggests that engagement with companies can be an effective approach to socially responsible investing." Institutional investors can successfully promote change at investee companies because they are the most powerful shareholder group and can put pressure on the board of directors.
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> This report by the Deutsche Bank group is based on research produced by the European Centre for Corporate Engagement. It assesses the importance of withdrawn shareholder resolutions as a governance mechanism and analyses a sample of proposals at S&P1500 companies from 1997 – 2009. The results indicate that a significant number of proposals are withdrawn (approximately 20% each year). Institutional investors filed 2,392 proposals over the period, of which 810 or 33.9% were withdrawn before the AGM, indicating the reaching of an agreement with management. The paper argues that institutional investors appear able to promote changes in corporate behaviour pertaining to ESG issues.

1 | Goldstein, M. 2014. Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives. Institutional Shareholder Services, http://irrcinstitute.org/wp-content/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf

The latest Eurosif SRI study (2014), covering institutional and retail assets in 13 European markets, reveals that SRI strategies have continued to grow at double-digit rates since 2011. The growth rates of responsible investment strategies range from 22.6% (sustainability themed) to 91% (exclusions) between 2011 and 2013. Engagement and voting exhibits impressive adoption rates of 86%. For more information see: http://www.eurosif.org/wp-content/uploads/2014/09/Eurosif-SRI-Study-20142.pdf

Burkhart, M., Gromb, D., and Panunzi, F. (1997). Large shareholders, monitoring, and the value of the firm. *The Quarterly Journal of Economics*, 112(3), pp. 693-728

Shleifer, A. and Vishny, R. (1986) Large Shareholders and Corporate Control. *Journal of Political Economy* 94(3), pp. 461-488.94(3).

> According to Burkhart, Gromb and Panunzi (1997), as well as Scheifer and Vishny (1986), large shareholders are important and powerful corporate monitors because they have more influence and incentives to incite change in corporate behaviour due to their large stake in targeted firms. However, investment portfolios tend to be greatly diversified as shareholders seek to mitigate risk by spreading their shares across a variety of different companies. As the recent Kay Review of UK Equity Markets and Long-Term Decision Making (2012 – published by BIS)[2] revealed, the price of this diversification is a loss of information and control. Investors are less familiar with the activities and performance of any one individual company in their portfolio.

Bauer, R., Clark, G. and Viehs, M. (2013) The Geography of Shareholder Engagement: Evidence from a Large British Institutional Investor. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2261649

McCahery, J. A. and Sautner, Z. and Starks, L. T. (2011) Behind the Scenes: The Corporate Governance Preferences of Institutional Investors (June 2015). *Journal of Finance*, Forthcoming. Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1571046

Goldstein, M. (2014) Defining Engagement: An Update on the Evolving Relationship Between Shareholders, Directors and Executives. *Institutional Shareholder Services*, http://irrcinstitute.org/wp-content/uploads/2015/09/engagement-between-corporations-and-investors-at-all-time-high1.pdf

Skancke, M., Dimson, E., Hoel, M., Kettis, M., Nystuen, G. and Starks, L. (2014) Fossil-Fuel Investments in the Norwegian Government Pension Fund Global: Addressing Climate Issues Through Exclusion and Active Ownership. *Report by the Expert Group appointed by the Norwegian Ministry of Finance.* Oslo, https://www.regjeringen.no/contentassets/d1d5b995b88e4b3281b4cc027b80f64b/expertgroup_report.pdf

> All four references cited above, which are representative of the recent corporate governance literature, discuss the growing importance of corporate engagement by institutional investors (see McCahery, Sautner, and Starks, 2011; Skancke et al., 2014; Bauer, Clark, and Viehs, 2013). According to Goldstein (2014) the extent of engagement between corporations and investors is now at an all-time high.

Sparkes R. and Cowton C. J. (2004) The Maturing of Socially Responsible Investment: A Review of the Developing Link with Corporate Social Responsibility. *Journal of Business Ethics* 52(1), pp. 45–57.

> Sparkes and Cowton (2004) argue that, compared to other more passive SRI strategies, shareholder activism is a more powerful tool for influencing companies. The impact of investors is likely to remain marginal at best if they continue adopting a passive policy focused on avoiding investment in companies disapproved of. Large institutional investors have the ability to express meaningful dissent, and influence company policy, rather than just divest from companies.

2 | Kay, J. 2012. *The Kay review of UK Equity Markets and Long-Term Decision Making*, https://www.gov.uk/government/publications/kay-review-of-uk-equity-markets-and-long-term-decision-making-implementation-progress-report

Arabesque Partners and University of Oxford (2015) From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance,
http://www.arabesque.com/index.php?tt_down=51e2de00a30f88872897824d3e211b11

This 2015 report published by Arabesque Partners, an asset manager, in association with Oxford University, assesses over 200 of the highest quality academic studies to provide a broad perspective on the economic evidence for sustainability. The results suggest that 90% of studies on the cost of capital reveal that sound sustainability practices lower the cost of capital for firms and 88% of the research suggests that solid ESG practices lead to better operational performance of companies. Similarly, 80% of studies show that stock price performance is positively influenced by good sustainability practices. The report argues that strategies incorporating ESG issues outperform similar non-ESG strategies.

Friede, G., Busch, T. and Bassen, A. (2015) ESG and Financial Performance: Aggregated Evidence from More than 2000 Empirical Studies *Journal of Sustainable Finance and Investment* 5(4), pp. 210-233

Deutsche Asset Management and the University of Hamburg recently conducted an exhaustive overview of academic literature on the link between ESG criteria and corporate financial performance (CFP, hereafter). The results of this meta-analysis of more than 2200 empirical studies published since 1970 reveal that roughly 90% of papers find a non-negative ESG-CFP relation, with the majority (62.6%) reporting that ESG issues have a positive impact on corporate financial performance. The study also explores whether any of the three factors – social, environmental and governance – has a dominating effect on CFP and concludes that environmental studies offer the most favourable relation (58.7% positive findings compared to 4.3.% negative).

Margolis, J. D., and Walsh, J. P. (2003) Misery Loves Companies: Rethinking Social Initiatives by Business. *Administrative Science Quarterly,* (48)2, pp. 268-305.

Margolis and Walsh (2003) review 127 empirical papers examining the relationship between companies' socially responsible conduct and their financial position and conclude that the majority of results point to a positive relationship between social and financial performance.

Dimson. E., Karakas, O. and Li, X. (2015) Active Ownership. *Review of Financial Studies*, Forthcoming,
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724

Dimson, Karakas and Li (2015) examine the highly intensive environmental, social and governance corporate engagement activities at 613 US firms between 1999 and 2009 (the sample consists of a total of 2,152 engagement sequences). The findings reveal that ESG engagements generate a cumulative size-adjusted abnormal return of 2.3% over the year following initial engagement. Successful engagements, where the institutional investor achieved change, generate much higher cumulative abnormal returns of +7.1%. The research provides evidence that ESG engagement activities can be value enhancing for shareholders as the targeted firms' operating performance, profitability, efficiency and governance indices improve as a result of successful engagements.

Alliance Trust Investments (2015) Sustainable Investing: Separating Fact from Fiction, Institutional Investor Attitudes to the Role of Sustainable and ESG-based Investing, http://www.alliancetrustinvestments.com/global/documents/6076/2015/October/Sustainable-investing-Separating-fact-from-fiction

Recent research by Alliance Trust Investments (2015) compared a set of companies over time – one set with a strong ESG programme, and another similar set with no emphasis on ESG or sustainability. The findings show that the group of companies with a strong sustainability focus outperform their peers both in terms of stock market value and financial returns. Such evidence suggests that investor engagement with investee companies with the goal of improving their sustainability performance results in clear benefits for shareholders.

Becht, M., Franks, J., Mayer, C. and Rossi, S. (2010) Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund. *Review of Financial Studies*, 23(3), pp. 3093-3129.

> Similarly, Becht et al. (2010) studied the private engagement activities of the Hermes UK Focus Fund and concluded that they create shareholder value, which also translates into superior performance of the entire fund. The fund substantially outperforms benchmarks and the authors estimate that returns are largely associated with engagements rather than stock picking.

Positive Market Reactions to Shareholder Activism

Cunat, V., Gine, M., and Guadalupe, M. (2012) The Vote is Cast: The Effect of Corporate Governance on Shareholder Value. *Journal of Finance*, 67(5), pp. 1943-1977.

> This study investigates the market reaction to shareholder-filed governance proposals that pass or fail by a small margin of votes at AGMs. The findings reveal that passing a proposal leads to significant positive abnormal returns. Adopting one proposal increases shareholder value by 2.8%.

Klein, A., and Zur, E. (2009) Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors. *Journal of Finance*, 64(1), pp.187-229.

> The authors examine shareholder activism campaigns by hedge funds and other private investors. The main similarities between the groups are a significantly positive market reaction for the target firm around the initial Schedule 13D filing date, a further significant increase in share price for the subsequent year, and the activist's high success rate in gaining its original objective.

The Effectiveness of Active Ownership In Changing Company Behaviour

Reid, E. M. and Toffel, M. W. (2009) Responding to Public and Private Politics: Corporate Disclosure of Climate Change Strategies. *Strategic Management Journal* 30(11), pp. 1157 – 1178.
http://onlinelibrary.wiley.com/doi/10.1002/smj.796/abstract

> Reid and Toffel (2009) hypothesise that shareholder actions and regulatory threats are likely to prime firms to adopt practices consistent with the aims of a broader social movement. They find empirical evidence of direct and spill over effects. In the domain of the company's internal operations, shareholder resolutions filed against a firm and others in its industry increase a firm's propensity to engage in practices consistent with the aims of the related social movement. Similarly, in the realm of public politics, threats of state regulations targeted at a firm's industry as well as regulations targeted at other industries increase the likelihood that the firm will engage in such practices. These findings show that both activist groups and government actors can spur changes in organizational practices, and that challenges mounted against a single firm or a single industry can inspire both firm and field-level changes.

Lee, M. P. and Lounsbury, M. (2011) Domesticating Radical Rant and Rage: An Exploration of the Consequences of Environmental Shareholder Resolutions on Corporate Environmental Performance. *Business & Society* 50(1), pp.155-188.

> With a geographical focus on the US, the authors examine the effect of environmental shareholder resolutions on chemical and petroleum firms' environmental performance. They track thirty eight public corporations for thirteen years, using data from the Toxic Release Inventory, and conclude that the resolutions have a significant and positive effect on the targeted firms' environmental performance.

Telman, J. A. (2011) Is the Quest for Corporate Responsibility A Wild Goose Chase? The Story of Lovenheim V. Iroquois Brands, Ltd. *Akron Law Review* 44(2), pp. 479-528.

> In a study which discusses socio-ethical shareholder proposals from a legal perspective, Telman (2011) explores in detail the legal case of Lovenheim v. Iroquois Brands (1985). The article's main argument is that filing shareholder proposals facilitates open, clear and specific communication between firms' management and shareholders, and has the potential to influence corporate decision making. Moreover, the implementation of activists' ideas advanced by the proposal can be of benefit to the corporation.

Del Guercio, D., Cole, L. S. and Woidtke, T. (2008) Do Boards Pay Attention When Institutional Investor Activists 'Just Vote No'? *Journal of Financial Economics*, 90, pp. 84 – 103. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=575242

The authors examine 'Just Vote No' campaigns whereby activists encourage their fellow shareholders to withhold votes towards a director's election in order to express dissatisfaction with performance or the firm's corporate governance structure. The results suggest that such campaigns are effective and lead to companies taking actions as operating performance improvements and abnormally high CEO turnover are observable following such interventions. A recent example of this happening in practice is Aviva's 2012 AGM held during what became known as the 'Shareholder Spring' where almost 60% of all votes (against and withheld) did not support the company's executive pay proposal and, as a result, Aviva's CEO Andrew Moss stepped down.[3]

Ertimur, Y., Ferri, F. and Muslu, V. (2010) Shareholder Activism and CEO Pay. *Review of Financial Studies,* 24(2), pp. 535 – 592. http://rfs.oxfordjournals.org/content/early/2010/11/18/rfs.hhq113

In another study that explores vote-no campaigns, Ertimur, Ferri and Muslu (2010) analyse 134 vote-no interventions and 1,198 shareholder proposals related to executive pay between 1997 and 2007. Mostly sponsored by union pension funds, the majority of proposals relate to the pay-setting process (e.g., proposals to subject severance pay to shareholder approval). The results reveal that firms with excess CEO pay targeted by vote-no campaigns experience a significant reduction in CEO pay ($7.3 million).

Stevens, J., Steensma, H., Harrison, D., and Cochran, P. (2005) Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives' Decisions. *Strategic Management Journal*, 26(2), pp.181-195.

This study is based on a survey of 302 senior financial executives and the aim is to test the extent to which ethics codes are actually used by executives when making strategic choices as opposed to being merely symbolic. The authors find that financial executives are more likely to integrate their company's ethics code into their strategic decision processes if they perceive pressure from market stakeholders to do so (suppliers, customers, shareholders). Shareholder activism is related to the adoption and internalisation of ethics codes by financial executives.

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About ShareAction

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3 | See: http://www.bbc.co.uk/news/business-17938865