Shareholder engagement

An alternative way to invest responsibly

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KEMPEN CAPITAL MANAGEMENT

Shareholder Engagement: An Alternative Way To Invest Responsibly

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Introduction

Responsible investing has shown a tremendous development during the last decade. Numerous asset owners and asset managers have developed an Environmental, Social, and Governance (ESG) policy to guide their investment process. Kempen Capital Management (KCM) has continued to develop an approach towards responsible responsible and long horizon investing. The core of that approach consisted – and still consists – of shareholder engagement. Even though we aim not to invest in companies or other investment entities that fundamentally violate our investment principles, we are an investment company. Not an exclusion company. It is our belief that we can contribute to the creation of added value by engaging with fund managers, corporations and other entities in which we invest.

In order to gain further insight on the developments in shareholder engagement we have asked Maastricht University's European Centre for Corporate Engagement (ECCE) to write a short paper infused with the latest academic studies. ECCE has been a valued partner since we started with our ESG-process and we welcome their views on engagement in this paper. We are happy to share their insights with you, our investors and our other stakeholders. We think the paper is relevant to us – and hopefully to you – since it takes on a broader view of shareholder engagement overall, rather than focus on ESG engagement exclusively. We can learn from the lessons numerous investors have learned in engaging with companies using a broad spectrum of instruments – ranging from casting votes at AGM's to individual and collective private discussions with corporate managers on how to create added value for shareholders, society and integrate our stewardship further.

With this paper and with our continued efforts to add value through our engagement process we hope to be able to serve your interests to the best of our abilities. Happy reading.

Yours Sincerely,

Erik Luttenberg
Chairman of the KCM ESG Council

What is shareholder engagement?

Shareholder engagement is the term used to describe all actions performed by shareholders to change corporate behaviour. An important feature of shareholder engagement is that it strives for changes in a corporation's governance policies and practices and is mostly financially driven. Recent research on shareholder engagement strategies shows that shareholder engagement with respect to the corporate environmental and social practices are on the rise, oftentimes outnumbering governance related engagements. Amongst the different shareholder groups, researchers consider institutional investors to be the most powerful group who can bring about changes to corporations (e.g. McCahery, Sautner, and Starks, 2010).

There is a broad range of strategies that investors employ to influence corporate behaviour and activity. A recent Eurosif study (2013) lists engagement as one of the more popular strategies as can be seen in the following table.

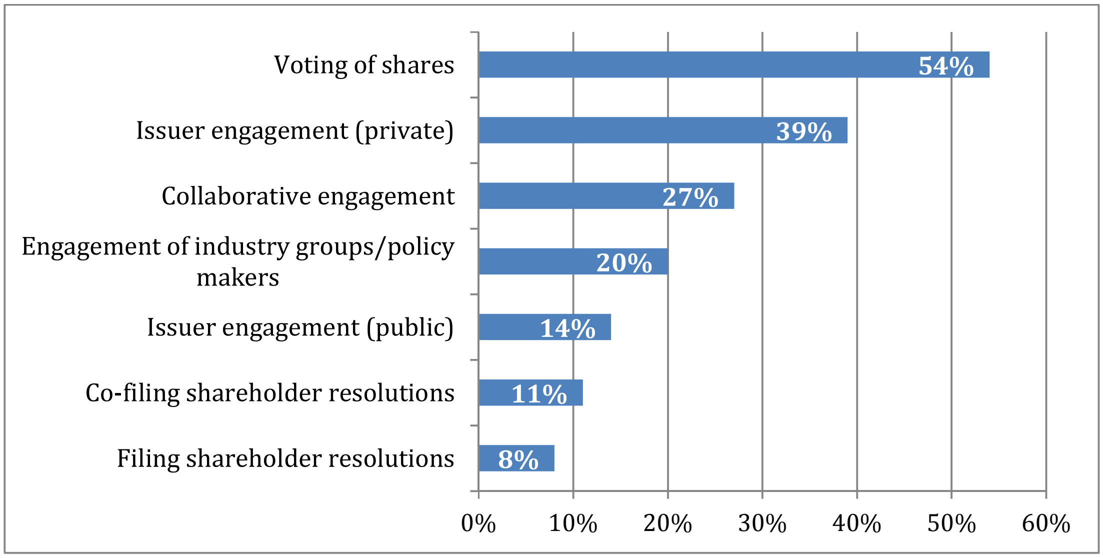

Figure 1: Primary engagement instruments used. Taken from Eurosif Study (2013)

Within the 'domain of engagement' a variety of engagement strategies can be distinguished to influence corporate and managerial behaviour. For example:

- Proxy voting at annual general meetings (AGMs)
- Exerting influence during AGMs
- Filing shareholder resolutions to corporations for a vote during the AGM
- Class-action lawsuits
- Launching media campaigns
- Aggressive stake acquisitions
- Just-vote-no campaigns
- Private dialogues and direct interventions
- Thematic engagements on a sector level

Over the years these strategies have been researched intensively with a particular focus on hedge fund activism, pension fund engagement and the filing of stakeholder resolutions in general. In the Appendix, we provide an overview of the most relevant academic articles that have been published on the subject of shareholder engagement.

This strand of research shows that institutional shareholders use many of the strategies simultaneously in order to change corporations and corporate behaviour (e.g. McCahery, Sautner, and Starks, 2010). It is important to realize that we discuss only those strategies in which no change of corporate control occurs. That is, we provide empirical evidence on those engagement tools that are used to change corporate behaviour without selling stakes or aggressively acquiring stakes in corporations. This is also how Gillan and Starks (2007) define shareholder activism in its most basic form. In this report, we explore two shareholder engagement strategies: shareholder resolutions and private dialogues between institutional investors and corporations. Both types are important shareholder engagement strategies in a global context.

Private engagements can take place between any shareholder and an investee firm irrespective of the jurisdiction. As documented by McCahery, Sautner, and Starks (2010), Eurosif (2013), and Bauer, Clark, and Viehs (2013), private engagements usually take place in the form of management meetings, letter writings, company visits, phone calls to executives and the like. The authors also show that this type of shareholder engagement takes place around the globe, be it in the United States of America, the Netherlands, the United Kingdom or any other country with major stock markets.

On the other hand, shareholder resolutions are generally considered to be an Anglo-Saxon phenomenon. According to a recent Eurosif study (2013) the fact that European investors made only limited use of filing shareholder resolutions is not a result of "technical barriers". The thresholds for filing resolutions in many EU member states are lower than in the US. An example is provided the Nordic countries where one share is sufficient. Rather, Eurosif argues, "the differences are mainly cultural and historical: European investors vote shares, but the main vehicle for change is private engagement rather than proposing a shareholder resolution on an ESG issue. In the US, the mere filing of a shareholder resolution can actually be a vehicle for successful engagement, as many proposals are withdrawn before the vote because companies respond to investor demands."

The evidence on shareholder resolutions provided in this paper emphasizes the importance of shareholder resolutions also for a European context. Specifically, as we argue later in this paper, large institutional investors can file shareholder resolutions also in Europe in order to promote change at investee firms. Looking at the efficacy of this specific engagement strategy one could even argue that it is surprising that the strategy has been rather unpopular so far. From the point of an investor's fiduciary responsibility filing shareholder resolutions can be instrumental in achieving the investors' objectives – both financial and extra-financial. This particularly applies to large investors that are unable to sell their assets without facing financial consequences. In those cases the old motto applies: 'if you cannot sell, you have to care' (cf. Monks, 2001, 2002).

How does shareholder engagement work in practice?

Proxy voting and shareholder resolutions

When institutional shareholders want to engage with their portfolio firms the two most obvious instruments available to them are proxy voting and the filing of shareholder resolutions. Of those, proxy voting at AGMs is considered to be shareholder engagement in its most basic form. This claim is also supported by the early academic evidence on shareholder engagement. Famous studies on the voting outcomes and subsequent wealth effects for shareholders are, for example, Gordon and Pound (1993), and Gillan and Starks (2000). Using voting rights, shareholders can – apart from engagement motivated by financial or governance issues – monitor and address corporate ESG and managerial behaviour. We argue that due to their fiduciary duties especially institutional investors should watch investee firms' ESG quality and behaviour.

Depending on the investor's ownership stake in corporations, the power of proxy voting might be limited. A related, but maybe more powerful engagement tool, is the filing of shareholder resolutions. In that case, institutional investors file their own resolutions in order to have a vote on a particular issue that they consider to be important. For example, Del Guercio and Hawkins (1999) as well as Smith (1996) and Wahal (1996) investigate the filed shareholder resolutions by pension funds. By filing such resolutions, a shareholder can set the AGM agenda and influence the outcomes of the AGM much more explicitly. Usually, filing shareholder proposals requires a time-consuming collective effort of a range of powerful investors although every qualified shareholder has the individual right to submit a shareholder resolution.

As an exemplary study on the effectiveness of shareholder resolutions as a shareholder engagement strategy, Bauer, Moers, and Viehs (2012) studied all shareholder resolutions filed to all S&P1500 corporations. As Figure 2 shows, the number of filed shareholder resolutions to S&P1500 firms is steadily increasing over time. Still, the number of total resolutions is relatively low – with just 300 resolutions in 2009 – given that the underlying sample comprises all of the S&P1500 constituents every year.

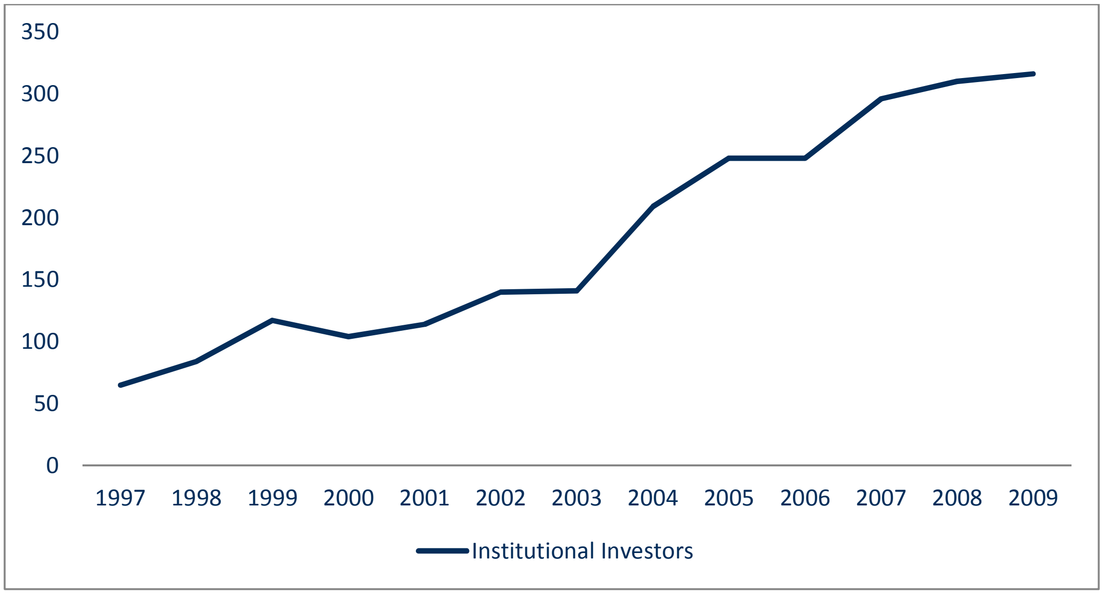

Figure 2: Filed shareholder resolutions by institutional investors to S&P1500 firms

It is important to note that filed shareholder proposals in the United States, which go to a vote during the AGM are non-binding for managers. That is, corporations are not obliged to implement the requests of the proposals even if they would receive more than 50% of the votes. However, the public power of voted proposals – even of those proposals receiving less than 50 % of the votes – should not be underestimated.

Filing a resolution does not imply that it will go to a vote during the AGM. Three distinctive outcomes can happen to the resolution. First, the filed shareholder resolution can be omitted from the voting agenda of the AGM. This can happen, for instance, if the resolution violates SEC regulations. That is, if the resolution is not concerned with policy issues but with the corporation's ordinary lines of business, management is allowed to omit the resolution. Second, the filing shareholder can withdraw the resolution before the AGM takes place, which will be discussed below. And third, the resolution can be put to a vote.

Withdrawn shareholder resolutions

As research shows (e.g. Chidambaran and Woidtke, 1999, Landier and Nair, 2009), the withdrawal of shareholder resolutions by the filing shareholder is a rather interesting phenomenon. Why would anyone submit a proposal in the form of a resolution and afterwards take it off the table again? Bauer, Moers, and Viehs (2012) document that institutional investors often withdraw their shareholder resolutions before the AGM actually takes place. Consequently, the withdrawn resolutions do not appear on the voting agenda and no vote is held on the particular resolution. Withdrawals of resolutions usually occur after the management team invited the sponsoring institutional shareholders into private negotiations on a withdrawal. The authors argue that corporate managers negotiate with shareholders on a withdrawal, when the resolutions contain issues that could harm managers' reputation, or have other adverse effects for them or their compensation packages. Whether or not the negotiations are successful is entirely up to the shareholder to decide. It usually happens when managers offer the sponsoring shareholder a compromise in the sense that the resolution is partially implemented. The authors, therefore, argue that withdrawn resolutions signify successful engagements by shareholders. Figure 3 presents the evolutions of the number of filed and withdrawn shareholder resolutions over time.

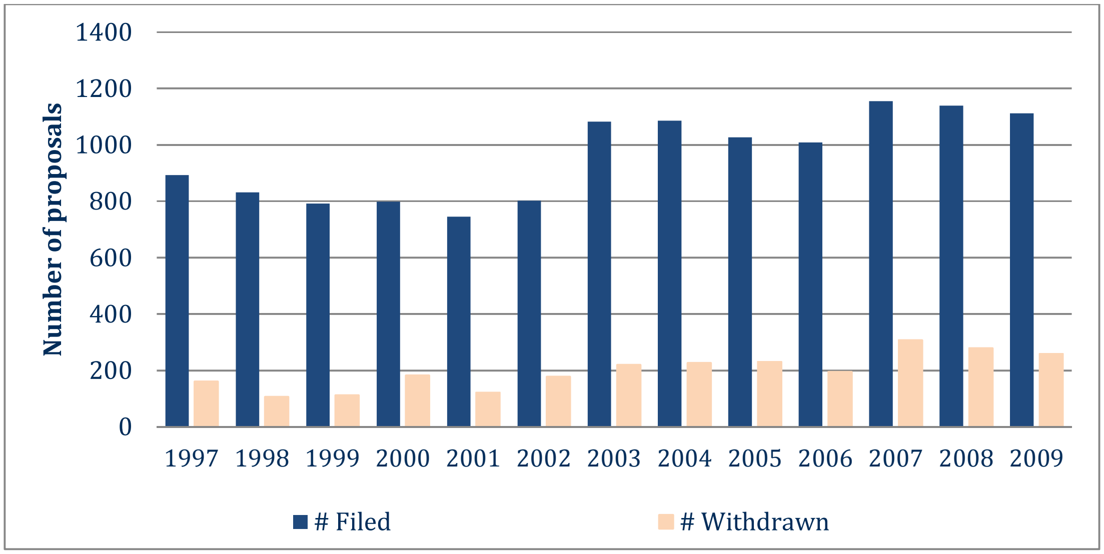

Figure 3: Filed and withdrawn shareholder resolutions (Bauer, Moers, and Viehs, 2012)

The above figure shows that almost 20% of all filed shareholder resolutions – by both institutional and non-institutional investors – are withdrawn every year. In addition, the authors investigated whether the withdrawal rates vary by shareholder type (institutional, individual, union, or collective) and resolution topics (Governance, Corporate Social Responsibility (CSR) or other). The appendix (Table A2) shows that shareholders not only engage on corporate governance issues. They are also concerned about CSR, which is reflected by the high number of CSR proposals filed every year. On average CSR resolutions are more often withdrawn than corporate governance resolutions. This has important implications for institutional investors who want to engage on both, CSR and corporate governance issues.

The second noteworthy result is the high degree of withdrawn resolutions by institutional investors. Almost 34% of all resolutions filed by these investors are withdrawn. With respect to CSR the percentage is even higher: 42.4% of all filed resolutions were taken off the table before the AGM. The question is: how should this result of the interaction between corporate managers and institutional investors be interpreted? Bauer, Moers and Viehs (2012) argue that a resolution withdrawal is likely to represent a successful engagement and a sign of the bargaining power of the investors. They claim that if corporate managers and the sponsoring shareholder reach a satisfactory compromise the shareholder will withdraw the resolution. This is of course only the case if the compromise involves at least a partial or full implementation of the shareholder's resolution. Landier and Nair (2009) argue, based on the same reasoning, that withdrawn shareholder resolutions can be seen as a successful engagement.

The withdrawal rate indeed serves as a good proxy for successful shareholder engagements because shareholder proposals (1) arise from the entire institutional shareholder base and (2) are also likely to be supported by other institutional investors as well. This increases the pressure on the managers of target firms. One should note that labour unions and coordinated activist groups (like interest groups such as Greenpeace and the like) are on average also quite successful in negotiating compromises with the corporate managers. However, given that institutional investors more carefully select target firms and file fewer proposals than labour unions and coordinated activist, one can conclude that institutional investors are the most powerful shareholder engagement group.

As mentioned before, shareholder engagement through proxy proposals is often, but not exclusively, used in the United States. There, ownership structures are much more dispersed than, for example, in Continental Europe. Hence, in the United States, not only institutional shareholders use these engagement means to strive for changes in corporate behaviour, but also foundations, networks (like the Interfaith Center on Corporate Responsibility) and small retail investors who just hold couple of shares. Whereas proxy voting occurs on a quite regular basis for most institutional investors nowadays, it is important to realize that the filing of shareholder resolutions is not a common engagement device yet. What do institutional investors generally do before they file their own shareholder resolutions? Private dialogues. This engagement strategy is discussed in the next section of this report.

Private dialogues with investee firms: active ownership[2]

Private dialogues (or private engagements; direct interventions) at investee corporations are an important foundation for any institutional investor's responsible investment program. This engagement strategy is implemented through telephone calls, letters, emails or corporate visits. That is, the institutional investor becomes an active owner at portfolio firms and exerts monitoring power. Active ownership should therefore be the all-embracing engagement tool for institutional investors to ensure that investee firms are sustainable and have proper financial and non-financial standards in place, including ESG standards. Again, just like in the case of filing shareholder resolutions a collaborative effort by a number of large institutional investors is reinforcing the efficacy of the engagement. It is not uncommon therefore, that institutional investors coordinate their behaviour within the limits of the law to exert as much influence as possible. That coordination is usually sought after via networks like the Principles for Responsible Investing (PRI), International Corporate Governance Network (ICGN) or Eumedion in the Netherlands.

Recently, this topic has been researched extensively in the academic domain. The objective was to find out whether private engagements pay off in terms of improved stock price performance of targeted firms. In addition, the research focused on which firms became an engagement target and how successful – in terms of measurable and structural changes of firms – private engagements actually were.

[2] By "active ownership" we mean the active participation in corporate governance. We do not refer to "activist" engagement approaches, which involve, for example, aggressive stake acquisitions to exert influence over managers.

To start with, Dimson, Karakas and Li (2012) studied the private engagements of an UK-based institutional investor who engages with portfolio firms on particular ESG topics on behalf of its institutional clients. In particular, they investigate how successful these engagements actually are. The authors find that firms that were the object of successful private engagements on average deliver an abnormal stock price performance of 4.4% against firms at which private engagements were not successful. Hence, the conclusion can be drawn that private engagements are successful, also in terms of stock price performance of target firms.

In a related study, Bauer, Clark, and Viehs (2013) examine the engagement activities of the same UK-based asset manager with respect to the geographical focus of its engagement activities. Specifically, the authors hypothesize that because the asset manager is domiciled in the UK, it is more likely that the private engagement activities also focus on UK-based corporations. To study this research hypothesis, the authors collected the information on all private engagements at 397 so-called “priority firms” over the time period from 2006-2011. Table 1 below provides some of the relevant statistics on the underlying sample.

Sample overview

Number of unique firms	397
Number of objectives raised	6,837
Total number of milestones reported	592
Success ratio	8.7%

Table 1: Investigated statistics Bauer, Clark, and Viehs (2013)

The authors show that the UK-based asset manager engaged with 397 companies between 2006 and 2011. These firms display in total 6,837 engagements (objectives raised). Out of those, 2,159 objectives were raised at UK firms, 1,783 at US firms and 1,650 at European firms, signalling a significant tilt towards UK companies. The engagement efforts resulted in 592 so-called milestones. Milestones are the successful engagements that lead to structural changes at target firms. Putting the number of engagements in relation to the number of milestones, the study finds that the success ratio of private engagements is, on average, 8.7%. This success ratio is relatively high, given the fact that the engagement activities come from just one single UK-based asset manager taking governance, environmental and social objectives equally into account. To investigate whether the success of private shareholder engagements differs across geographical regions, the study investigated the success ratios more closely. The results of this analysis of the asset manager’s database are displayed in Table 2 below.

Geographical dispersion of engagements and milestones

Region	# Firm-years	# Objectives	Per firm-year	# Milestones	per firm-year	Milestones-per-objective
United States	211	1,783	8.45	172	0.82	9.6%
United Kingdom	240	2,159	9.00	191	0.80	8.8%
Cont. Europe	285	1,650	5.79	154	0.54	9.3%
Japan	39	129	3.31	17	0.44	13.2%
Other Countries	218	1,116	5.12	58	0.27	5.2%
Total	*993*	*6,837*	*6.89*	*592*	*0.60*	*8.7%*

Table 2: Engagements and success across regions (from Bauer, Clark, and Viehs, 2013)

Based on this overview one can conclude that engagement success varies across regions. On a firm-year basis, engagements at US corporations are most successful (0.82 milestones per firm-year), followed by UK and Continental European firms (0.80 and 0.54 respectively). The authors point out that governance-related engagements have the highest success rate: 10.7 percent in the UK, 14.3 percent in the US and even 15.8 percent in Japan. Overall, the success ratios demonstrate the importance of governance topics like the corporate board structure or compensation practices. According to the authors changes in corporate governance structures are much more explicit and thus better measurable than changes in corporate social and environmental policies.

Sample by engagement topic

	# objectives	# milestones	success ratio
Governance	2,771	307	11.1%
Social	2,162	121	5.6%
Environment	1,902	164	8.6%

Table 3: Engagements by ESG topics (Bauer, Clark, and Viehs, 2013)

The results in Table 3, however, also emphasize the importance of social and environmental topics – relative to corporate governance. The investor is not only engaging on popular topics like executive compensation, but also on social topics, like human rights standards, worker safety standards, and environmental topics like climate change. Their research points out that Japanese companies are, relatively speaking, more sensitive to social issues, while Continental European companies are most receptive to environmental engagement objectives. The relative importance of social and environmental engagements has also been growing over the last couple of years, as shown in Figure 4 below for the years 2006 - 2010.

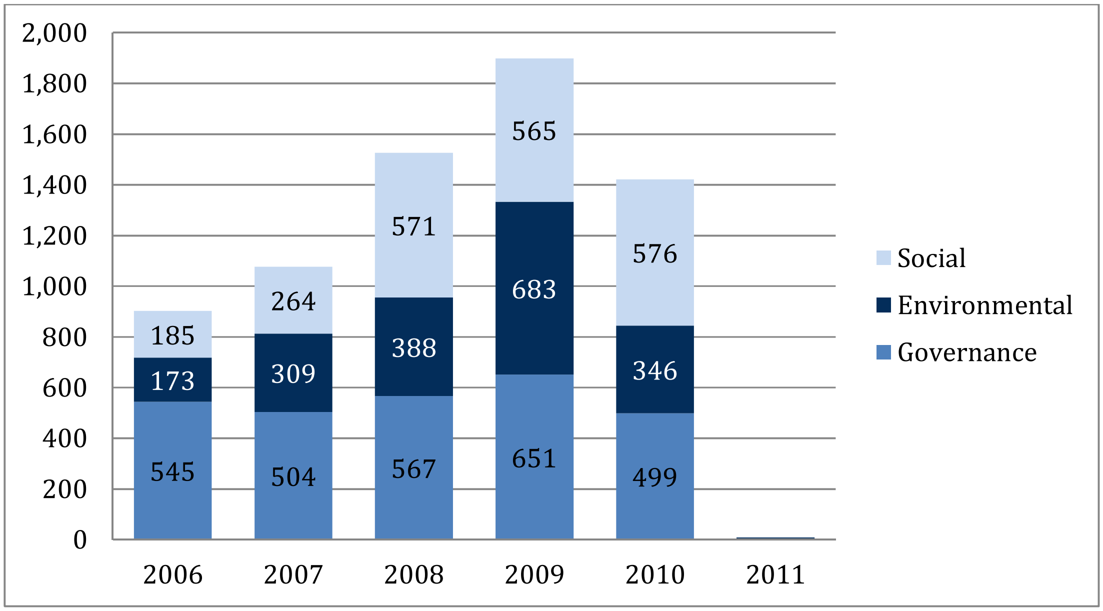

Figure 4: Evolution of engagements over time by Bauer, Clark, and Viehs (2013)

The above figure illustrates that the relative importance of social and environmental topics increased over the last couple of years. In 2009, for example, the institutional investor engaged more on environmental issues than governance issues. Similarly, in 2008 and 2010, the investor was more engaging on social issues than on governance and environmental issues. The results, therefore, emphasize the importance of all three dimensions of responsible investments to the UK-based asset manager: E, S, and G.

Among other things, these results emphasize the fact that an institutional investor who outsources its engagement efforts has to carefully select an engagement agent in order to avoid "geographical biases" in the engagement decisions. Of course, the empirical results of the academic research discussed here are based on one single asset manager, but are corroborated by US-based research (Dimson, Karakas and Li, 2012). We believe that the general trend in engagement scope is mirroring what is going on in the shareholder engagement domain for other conventional asset managers as well.

Private shareholder engagements in Europe

The previous paragraph on the private engagements activities of one institutional investor provides for the first time evidence on private engagements in Europe. Most of the existing empirical evidence on engagement by shareholders focuses on the Anglo-Saxon markets, mainly because of data scarcity in Europe, Japan and the Pacific. However, there is some anecdotal evidence on European private shareholder engagements. For example, there are a few "engagement service providers" in Europe providing private engagement services to institutional clients. Often, these service providers are conventional asset manages with specialized ESG teams who conduct shareholder engagement in-house and on behalf of other institutional investors. Many institutional investors in Europe, like pension funds, banks, and asset managers are using these specialized engagement providers.

Two prominent UK providers are Hermes Equity Ownership Services (Hermes EOS) and F&C Asset Management (F&C). Together, they represent a portfolio of more than $US200 billion. Another example is Governance for Owners (GO) contracted by SNS Asset Management in the Netherlands. GO is an engagement boutique focusing on governance engagements with corporations in order to ensure proper management practices and sustainable value creation. Kempen Capital Management works together with Global Engagement Services (GES), which acts as an “owner advocate” in promoting sustainable ESG practices at investee firms.

A second relevant development points to mastodon institutional investors conducting their shareholder engagements in-house rather than outsourcing them to external service providers. One example represents Allianz Global Investors (AGI). AGI mentions that it has an own ESG team, which is responsible for the entire responsible investment program of AGI, which includes also engagement. According to the company, it has been developing a company-wide engagement policy to be implemented in 2013. AGI views engagement with investee firms as important which is implemented to “seeking change” at corporations (Allianz Global Investors, 2013). The same type of thinking is displayed by large pension providers like APG and PGGM, or by large asset managers like Robeco. This scanty evidence of a rising number of engagements does not conceal that there is no evidence for the efficacy of this emerging practice. Overall, there is lack of research on European, Japanese and Pacific shareholder engagement.

Implications for institutional investors

This report discussed two important engagement strategies for institutional investors: shareholder resolutions and private engagements. These are just two examples of many different engagement strategies available to institutional investors. Which tools an institutional investor in the end selects to exert influence over an investee firm is up to the investor – or the collective of investors. But what this paper shows is the fact that shareholder engagement can – and we think should – be a key building block for every institutional investor’s responsible investment domain. This report argues for an **active ownership** role of institutional investors to promote sustainable business practices and responsible governance, environmental, and social structures at corporations. Specifically, institutional investors can use their economic power and speak up to change corporations for the better.

Key findings for developing a mature engagement

Some key lessons can be taken away from this summary report of academic research on shareholder engagement:

- Institutional investors – both asset owners and asset managers – can and are expected to become active owners and engage with portfolio firms on ESG topics
- To do so, they can choose from a wide range of possible engagement strategies:
    - Shareholder resolutions (especially suitable for the US market);
    - Private engagements through dialogues;
    - Ex-post: Class-action lawsuits;
    - Media campaigns;
    - Collaboration with other institutional investors through networks like the ICGN, the PRI and the like.
    - Thematic engagements addressing issues, which apply throughout a sector.

Some of these instruments appear to be more suitable for ESG-engagement then others. Due to the fact that the materiality of ESG-considerations is very often difficult to prove, an ESG-related class-action suit is not the first instrument an investor will think of. On the other hand, in Europe the instrument of shareholder resolutions has not been tested as much as in the US. As we have shown, filing – and withdrawing – proposals can sometimes be an effective approach in exerting influence. This instrument is likely to be even more effective if it will be used in a collaborative effort by a manifold of investors. Supporting a proxy voting and private engagement process with a concerted media campaign – for instance endorsed by influential civil society organizations – can be an important addition to tip the balance in the right direction.

In conclusion, the findings presented in this paper point to some steps that a mature institutional investor's responsible investment (or active ownership) program includes. We recommend to integrate at least the following layers in an engagement policy:

- The introduction of consistent ***proxy voting guidelines*** communicated to beneficiaries and to clients.
- The formulation of ***proxy filing guidelines*** that specify under which circumstances a filing can be considered.
- The introduction of a ***private engagement policy***, which is communicated to clients, (potential) investees and other relevant stakeholders. In order to be effective – as has been shown in the case of the UK asset manager engaging companies on behalf of a substantial number of institutional investors – the bundling of shareholder power and the familiarity with the country or region is important to guarantee a successful engagement. Understanding the rules of the game and the culture in which the engagement takes place are important factors in creating a successful engagement.

<u>Appendix</u>

Table A1: Overview of studies on different engagement means

Authors, publication year and journal	**Engagement means investigated**
Bauer and Braun (2010, Financial Analysts Journal)	Class action lawsuits
Bauer, Braun and Viehs (2012, ECCE Working Paper)	Shareholder resolutions (filed and voted)
Bauer, Clark and Viehs (2013, ECCE Working Paper)	Global private engagement acitivi-ties of one institutional investor
Bauer, Moers and Viehs (2013, ECCE Working Paper)	Withdrawn shareholder resolutions
Brav, Jiang and Kim (2013, NBER Working Paper)	Hedge fund activism
Brav, Jiang, Partnoy and Thomas (2008, Journal of Finance)	Hedge fund activism
Core, Guay and Larcker (2008, Journal of Financial Economics)	Media's monitoring role
Del Guercio and Hawkins (1999, Journal of Financial Economics)	Pension fund activism
Del Guercio, Seery and Woidtke (2008, Journal of Financial Economcis)	"Just vote no" campaigns by institutional investors
Dimson, Karakas and Li (2013, Working Paper)	Private engagements of one institutional investor
Ertimur, Ferri and Muslu (2011, Review of Financial Studies)	Compensation-related shareholder resolutions
Ertimur, Ferri and Stubben (2010, Journal of Corporate Finance)	Shareholder resolutions
Gillan and Starks (2000, Journal of Financial Economics)	Shareholder resolutions (with a focus on governance)
Gillan and Starks (2007, Journal of Applied Corporate Finance)	Shareholder resolutions
Klein and Zur (2009, Journal of Finance)	Hedge fund activism
Smith (1996, Journal of Finance)	Engagement by CalPers
Wahal (1996, Journal of Financial and Quantitative Analysis)	Pension fund activism

Table A2: Withdrawn proposals by sponsorship and coarse sub-categories

Table A2: Withdrawn proposals by sponsorship and coarse sub-categories

	Institutional Investors			Individual Investors			Coordinated Activism			Unions		
	Filed	Withdrawn	%	Filed	Withdrawn	%	Filed	Withdrawn	%	Filed	Withdrawn	%
Corporate Governance	1,115	277	24.8%	4,189	166	4.0%	555	102	18.4%	2,588	904	34.9%
Corporate Social Responsibility	1,244	527	42.4%	473	21	4.4%	1,684	522	31.0%	97	32	33.0%
Other	33	6	18.2%	162	6	3.7%	36	6	16.7%	41	8	19.5%
Total	2,392	810	33.9%	4,824	193	4.0%	2,275	630	27.7%	2,726	944	34.6%

Taken and adapted from Bauer, Moers, and Viehs (2012)

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