SIFA
STRATEGY

CULTURE, BEHAVIOUR AND STAKEHOLDER ENGAGEMENT – MOVING UP THE INVESTOR AGENDA

Research on the views and intentions of investors on the increasing importance of governance issues in the investment decision-making process

June 2018

KEY FINDINGS

- **The importance to investors of understanding stakeholder engagement, corporate behaviour and culture is increasing significantly within the investment decision-making process.** These governance issues will be a growing part of investor engagement and stewardship in the future. They are seen as important indicators of the long-term quality and sustainability of a business, as transparency and stakeholder influence have a greater impact on performance.
- **Investors are fully supportive of the forthcoming changes to the UK Corporate Governance Code.** They believe it will encourage companies to reconsider their licence to operate and broader role in society, under Section 172, which will generate longer-term returns to shareholders.
- **Boards, in particular the Chairman and Non-Executive Directors (NEDs), will be considered ultimately responsible for these issues and the primary target for investor questioning.** Investors also prefer a unified Board approach, rather than individual NEDs or committees. They see the role of the executive management team as leaders of the process and delivery.
- **A standard "tick-box" approach will not be accepted.** Investors will expect each company to be able explain within their business model and strategy, supported by relevant evidence, how the company is treating stakeholder engagement, corporate behaviour and culture.
- **Investors see this as an opportunity for companies to take the lead in providing insight, clarity and differentiation on these key governance issues.** It should be a pro-active process rather than a reaction to a crisis or activist event. Investors see it as a competitive opportunity for a company to demonstrate that it is well led and managed.
- **Having, and explaining, a strong corporate culture is deemed as critical.** Investors recognise the challenge, but want companies to provide more, and different, information and insight on behaviour and culture and its interaction with different stakeholder groups.
- **The weight of capital moving towards this enhanced approach is significant and increasing.** The majority of investment institutions are growing their internal ESG resources and engagement practices with Boards and particularly NEDs. These demands from the investor community are only going to increase in influence in the years ahead.

WHAT DOES THIS MEAN FOR COMPANIES

- **Boards will need to better understand stakeholder engagement, corporate behaviour and culture – for simplicity 'corporate reputation' – and add it to the Board agenda.** The changes to the UK Corporate Governance Code will accelerate this trend.
- **Companies must identify and analyse the stakeholders which are material to their business and strategy.** They will need to articulate a clear plan for engagement and measurement for each stakeholder group.
- **The Board will require a new set of insight and data tailored to their business.** This will enable them to ask the right questions, make informed decisions and respond to investor questioning.
- **The Executive management team must lead on the action and insight.** They should nominate an individual or team to manage the data gathering process and provide recommendations. The individual or team should also have the responsibility to inform and educate the Board, especially NEDs, prior to any shareholder engagement.
- **This must be an ongoing long-term programme rather than a single reporting exercise.** As best practice develops, the successful adopters will fully integrate it into their business process and corporate narrative. They will be able to demonstrate a valuable return to the business and a quality share register.
- **The Board must not believe they are immune to these questions if they have not, as yet, been actively questioned on these areas.** Certain sectors and companies that have had a crisis or significant corporate event are currently at the forefront of investor interest. The increasing weight of capital, relevance of stakeholder influence and the UK Corporate Governance Code changes will expand the requirements to all companies and become a clear factor for corporate differentiation.

METHODOLOGY

SIFA Strategy conducted research amongst institutional investors with high exposure to UK equities as well as global companies, during the first quarter of 2018. The aim was to understanding investor attitudes to upcoming Corporate Governance changes, including the requirements around stakeholder engagement and culture, and harnessing views on how investment decision-making processes are and will continue to change.

In addition to in-depth interviews, conducted on a non-attributable basis with select professionals, public-facing commentary from individuals and the institutions that they represent were also reviewed and analysed. Due to the nature of the discussions and desktop research, we focused on Heads of Governance, ESG analysts, Responsible Investment professionals and those with 'Stewardship' or 'Engagement' titles.

Included in the analysis are the following notable institutions:

- Baillie Gifford
- BlackRock
- Close Brothers Asset Management
- Fidelity International Limited
- Hargreaves Lansdown
- Hermes Investment Management
- Invesco Perpetual
- Jupiter Asset Management
- Kames Capital
- Legal & General Investment Management
- M&G Investment Management
- Octopus Investments
- Polar Capital
- Royal London Asset Management
- Sarasin & Partners
- Standard Life Aberdeen
- Vanguard

Our thanks to those that participated in this research.

INTRODUCTION

Changes to the UK Corporate Governance Code are due to be published in July 2018 and enforced as of January 2019. Following the adoption of the EU's Market Abuse Regulations in 2016; the implementation of MiFID II in January 2018; and the ongoing development of the UK Stewardship Code, there are now fundamental shifts in the way that capital markets participants interact and the requirements on corporate transparency. There is also a clear ongoing and growing trend towards Environmental, Social and Governance ('ESG') factors being identified as important investment criteria by institutions.

Prompted by many well-publicised corporate scandals and collapses in recent times and a need to ensure that corporate Britain is well-placed for trade post Brexit, the UK Government is moving towards providing a framework which encourages organisations to adopt best practice in terms of their approach to multiple areas of governance.

It is clear that, regardless of formal guidelines and legislation, governance and taking into account the interests and perspectives of multiple stakeholders are areas which will continue to face increased scrutiny from the investor community and other influential stakeholders.

As BlackRock CEO, Larry Fink, noted in his January 2018 letter to the Senior Independent Directors or Board Chairs:

> **"Society is demanding that companies, both public and private, serve a social purpose. To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate....**

> **"The time has come for a new model of shareholder engagement – one that strengthens and deepens communication between shareholders and the companies that they own. I have written before that companies have been too focused on quarterly results; [---] – engagement needs to be a year-round conversation about improving long-term value."**

Evidence would suggest that this change in tone and approach by investors goes far deeper than a desire to stand out from the crowd – it is here to stay, with or without legislation. The reforms to the UK Corporate Governance code are actively encouraged as they are aligned with the investors' direction of travel. They are seen as part of an ongoing change in the investment decision-making process that is already well-entrenched.

Many are saying that they already take into account non-financial items, such as governance, corporate behaviour, stakeholder engagement and culture when considering an investment or engaging with their portfolio companies. This trend, and the Code's influence, is expected to grow as investors, irrespective of their investment approaches, consider their roles as engaged stewards of their beneficiaries' funds as increasingly important.

Institutional investors are already focusing more clearly on ESG issues when making and monitoring investments and, subsequently, exerting greater pressure on companies to perform and report their progress and provide more evidence behind their assertions.

This change is being driven by multiple factors: increasingly interconnected audiences that companies serve, which investors see as introducing new systemic risks; a growing body of evidence that suggest that Boards that treat ESG factors as key to their business outperform in the long term; and an expectation by asset owners and the general public that an ethical approach to investment is now the norm.

For the purposes of clarity, we believe it important to highlight how the Financial Reporting Council ('FRC') defines culture, because it correctly identifies that culture is not only an internal factor but also how a company interacts with all its stakeholders. The definition given in their 2016 report is:

> **"Culture in a corporate context can be defined as a combination of the values, attitudes and behaviours manifested by a company in its operations and relations with its stakeholders. These stakeholders include shareholders, employees, customers, suppliers and the wider community and environment which are affected by a company's conduct."**

GOVERNANCE FACTORS ALREADY CENTRAL TO INVESTMENT DECISIONS

The inclusion of ESG factors in investment decisions is changing the asset management industry at a rapid pace and will be accelerated by Government interventions.

According to a large international fund manager, "**the idea that considerations such as the environmental impact of a company, or its contribution to wider society, should supersede its ability to deliver profits and returns for shareholders has not been the historic starting point for hard-headed investors. That view is changing, however, in line with increased awareness of ethical issues and how they can affect the fortunes of companies. As the years go by, there is increasing pressure on governments to encourage good behaviour among companies.**"

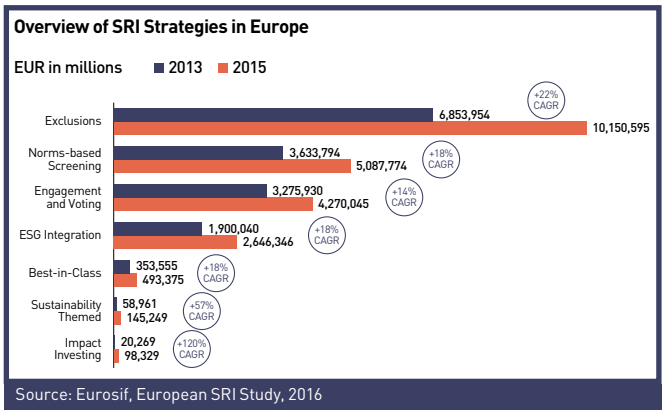
Institutional investors are responding to their clients' demands to not only deploy their capital for financial returns but also avoid systematic risk and deliver a positive impact for all stakeholders in the long term. As part of this, investors are universally concerned with governance.

Irrespective of their investment approaches, assets under management and discretionary levels, investors all consider their roles as engaged stewards of their beneficiaries' funds as increasingly important.

As evidence, Eurosif notes in its 2016 study; "**the increasing relevance in stewardship and the ever more present debate around fiduciary duty, which continues at the European level, have given further impetus to Engagement and Voting, which grew by 30%. The UK continues to be the undisputed leader in this space with a growth rate of 50% (2013-2015) and over €2.5 trillion (GBP22 trillion) in total AuM.**"

Interestingly, however, the UK lags France and the Netherlands in assets directed by specific Sustainable and Responsible Investment[1] ('SRI') or Sustainability mandates, with less than half those countries' total amounts.

However, our research indicates that UK-based asset managers are adopting a more integrated approach, rather than segregating specific SRI funds in marked contrast to the common approach as recently as five years ago. This has significant ramifications for companies in terms of the way in which they engage with UK fund managers across the board.



By way of example, Natexis has a separate Responsible Investment subsidiary, Mirova. This is in stark contrast to many of the large UK investors included in our research. Invesco Perpetual, Invesco's European arm, says that a full 50% of its assets contain significant ESG inputs in investment decision-making but many of those funds are not deemed specifically as SRI-related.

> "Engagement with companies on ESG matters is a fundamental part of our business."
>
> **– Head of Equities, large UK-based asset manager**

> "ESG is more than risk management for us. Whilst traditionally it was always about financial performance, new issues such as corporate governance and sustainability are now a mainstream topic of discussion in many markets."
>
> **– Head of Risk and Compliance, small-cap focused UK asset manager**

> "Excitingly, we have the opportunity to be an industry leader in this field as we develop our ESG capabilities. This is a strategic commitment for us. Put simply, we believe integrating these factors adds value for our clients and this is reflected in increasing client demand for investment strategies in this sector."
>
> **– Chief Investment Officer, large UK-based asset manager**

1 "Sustainable and Responsible Investment is a long-term oriented investment approach, which integrates ESG factors in the research, analysis and selection process of securities within an investment portfolio. It combines fundamental analysis and engagement with an evaluation of ESG factors in order to better capture long term returns for investors, and to benefit society by influencing the behaviour of companies." **– Eurosif**

"While we do have ESG specialists, they sit with the investment teams and ESG metrics are considered alongside financial metrics in all investment decisions."

– Head of Corporate Stewardship, large Scottish asset manager

Most of the investors included in our research said that the way in which governance is discussed has changed out of all recognition. What was once seen as box ticking is now viewed as essential.

As a consequence, governance considerations are already embedded processes within their daily work and engagement with the companies they invest in. The level of engagement on non-financial items is increasing and is viewed as a key area of interest, and often a differentiator for both company and investor.

"You mentioned our active stance, so you understand that our proposition to clients centres on the active fund management philosophy and rests on the reputation of the fund manager. [---]. At [our investment house] it is quite sacrosanct that we would not take anything as important as Governance away from that equation. The fund manager has full accountability and responsibility for voting and engagement decisions. But our team [Corporate Governance] is embedded in the fund management department and I report into the CIO."

– Head of Responsibility, mid-sized UK asset manager

"The USP from the sustainable team's point of view is the integration of ESG issues into the investment process. Most fund managers just think about financial issues, but we will integrate ESG issues as well. We think the two become one – ESG issues become financial issues. We do financial, corporate governance and environmental and social analysis."

– Head of Sustainable Investments, large UK-based pension fund

According to the 2017 IRRI Extel survey, a majority (82%) of asset owners require managers to report on SRI & Corporate Governance activity. This has resulted in 58% of asset managers showing a 'strong or sustained interest in SRI' and 65% saying the same of 'Corporate Governance'.

Looking forward this is only set to continue with asset owners placing further scrutiny on managers to differentiate between those with real focus on sustainability as opposed to those that are greenwashing.

"Companies are waking up to the fact that investors do care about these things. But a lot of it is lip-stick. You really need to dig deeper if you want to really understand these things."

– Head of Corporate Finance and Stewardship, large UK asset manager

For UK companies it may be difficult to understand exactly how much focus to place on ESG metrics and engagement; however, what is clear is that the answer is 'more'.

This is where there is a clear opportunity for Boards to differentiate and provide a clear indication that they are taking governance seriously within their strategy and decision-making. At the moment, investors admit to struggling to find adequate metrics, often from external sources, that they know do not provide a full or clear picture on their investment.

"We have an ESG tool that we use. But a lot of it is estimated – where there is an assumption that one company in a sector will have the same issues as another. We put the data in front of companies and ask them to comment or correct it – it may not be the best, but it is a starting point."

– Head of Corporate Finance and Stewardship, large UK asset manager

INVESTORS SUPPORTIVE OF CORPORATE GOVERNANCE REFORM

With governance already being a key consideration for investors when they review portfolio companies and consider new investments, the additional information which UK plc will be expected to provide as part of the proposed Corporate Governance reforms will only solidify an existing trend.

> "We are supportive of the new regulations to make companies consider their benefits to other stakeholders, as well as shareholders. We think that shareholders will ultimately benefit as well if companies consider broader society benefits – and I think the evidence points in that direction as well."
>
> **– Head of Responsibility, UK mid-sized fund manager**

Investors expressed that the changes to the Corporate Governance Code will enhance their ability to understand companies.

> "Corporate Governance is one part of their investment process. The new regulations won't change that. The content from companies will change and hopefully improve in the same way that Chairmen have for a while now come to us and talked about pay. The same will happen for other Governance and stakeholder items."
>
> **– Head of Responsible Investment, UK asset manager**

The integrated approach means that Executives will face increased questioning from active and passive fund managers and expectations for engagement with Non-Executive Directors is also rising.

BOARD AND NEDS CONSIDERED ULTIMATELY RESPONSIBLE FOR STAKEHOLDER ENGAGEMENT AND TO LEAD ON REPORTING

The relationship between the Board and investors, and the responsibilities attributed to the Board is changing in line with the new guidelines and behaviours which govern 'best practice'.

As investor accountability and interest grows, and as they continue to consider new and important variables in their investment decisions, Boards are challenged to provide appropriate levels of transparency and clear, concise reporting on the information which is material to them and their business.

> "In our view, companies that report only to meet the regulatory disclosure requirements are missing a prime opportunity to more comprehensively engage new and existing investors about how effectively a business is led and managed."
>
> **– Managing Director, Large global asset manager**

> "Enhanced reporting would be welcome. Enhanced regular and detailed reporting."
>
> **– Head of Corporate Governance, large passive fund manager**

Topics such as the workforce, corporate behaviour, environmental impact and culture and the health of the license to operate from consumers or affected communities are becoming increasingly important parts of the dialogue and reporting requirements.

Investors acknowledge that the benefits of a company's activities in these areas are more difficult to articulate than the well-honed narrative of financial results.

Most encourage Boards to decide how they will present evidence of their company's value to the stakeholders and society for the long term. Equally, they do not want to be prescriptive about how Board oversight of these strategic issues is conducted, just that it is, and they can explain the process.

> "Section 172 is not new. The point here is how companies bring it to life. We expect better behaviour from companies and deeper engagement from investors. Companies compete on multiple levels and I think their articulation of stakeholder relationships will be no different. The investment industry is changing at the same time to act more

as responsible stewards. Companies are in the best position to take the lead in telling us which relationships amongst their stakeholder groups are important and why. Investors need to get much better at using that information."

– Head of Responsibility, mid-sized UK asset manager and pension fund

"Companies must lead the way in explaining what specific stakeholder groups are important to them, why and what they are doing to deliver sustainable value to each of those, often overlapping, groups. What we are looking for is companies that we invest in to demonstrate a clear purpose and to articulate how they will achieve that purpose through meeting the needs of all their stakeholders."

– Head of Responsibility, mid-sized UK asset manager

While it is clear there is no 'one size fits all' approach, investors universally believe the Board has the ultimate responsibility for governance and relevant stakeholder relations and reporting, with the unity of the Board preferred over the appointment of separate committees or a single NED fulfilling these functions.

"We are not in favour of an individual Board member being in charge of stakeholder relations as we think that should be the responsibility of the whole Board. It may be preferable for an employee to have the responsibilities of a Board Director or for the Board to review stakeholder relationships on a regular basis, taking in qualitative information as well as metrics."

– Head of Responsibility, mid-sized UK asset manager and pension fund

"It is the whole Board's responsibility. We are believers in the unitary Board principle. It's up to them to organise themselves and explain why they are doing what they are doing to us as shareholders. Especially when it comes to engagement with the workforce – there is a range of options there. But the Board is responsible for how they do it. They are the stewards of the company's assets. So, they should decide what the best approach is and then tell us as shareholders why they have taken that path. We don't have a prescriptive approach. But we are certainly asking more of these questions of the Board when we meet them. On culture, diversity, health and safety, on the non-financial issues."

– Head of Corporate Governance, UK mid-sized asset manager and pension fund

Boards will be encouraged to be clear and bold in how they articulate their strategy and approach to stakeholder engagement and how their interests have been taken into account at a strategic level.

It is viewed as an opportunity to set out their strategic intent and provide regular updates through proactive engagement.

"We are not in favour of a box-ticking approach to say that the Board has considered its stakeholder relationships. These should be seen as a source of competitive or strategic advantage."

– Head of Responsibility, mid-sized UK asset manager and pension fund

"Companies compete on many different levels and stakeholder engagement should be no different."

– Head of Corporate Governance, large passive fund manager

"This is about good old strategic stuff – about how companies explain their purpose as a business; how they plan to outperform in the long term; how they will deliver sustainable returns and how stakeholders fit into that plan. It may be that a competitive advantage will be the main factor, like price advantage due to supply chain arrangements or a better customer experience due to staff training, but the bottom line is that companies need to tell us their story."

– Head of Corporate Governance, UK mid-sized asset manager and pension fund

Chairs and NEDs are expected to lead this process, especially as the core Governance elements (Audit, Remuneration and Nomination) are core NED responsibilities, while Environmental and Social reporting tends to fall under risk management and strategic direction which are also within the Boards purview.

The challenge will be that many if not most of the underlying issues which investors will expect a discussion about at Board level, have blurred responsibilities with the executive leadership, across HR, IR, Health & Safety, Supply Chain, Communications, Ethics and Compliance, Sustainability and more.

This will require more co-ordination and information exchange between the company, its stakeholders and the Board, and consequently between the Board and the investors.

THE CHALLENGE OF UNDERSTANDING AND REPORTING ON CULTURE

Respondents in our research agreed that a strong corporate culture is a critical factor in the sustainable success of a business and is led from the top of an organisation.

However, they expressed frustration about how to understand this intangible item.

> "[On culture] It is the hardest thing to measure. It is also the most important factor for us. You try to talk to a number of different people. Top execs, site visits, capital markets days, any opportunity to meet as many people as possible.

> "More people talking to more people is the first thing. Engagement is our key tool before selling out or voting down. You will see more of our 'activeness', talking to companies more and more about these issues. We have to prove to clients that we are a better option than a cheap passive solution. We have started to talk about these things, but we are under increased pressure to demonstrate what we are doing to hold companies to account."

– Head of Corporate Finance and Stewardship, large UK asset manager

> "There are clear examples of where culture has not been sustainable. There are short term incentives that encourage bad behaviour. We are now looking much harder at what makes companies sustainable in the long term. We are long term investors, especially in the UK. So, we are looking for the characteristics that make a company successful in the long term.

> "If companies pay lip service to these issues it won't necessarily be successful in the long-term, but we think that companies that really think about these things will succeed over time. We think there is a correlation between companies that are focussed on creating a good corporate culture and long-term success. We are looking for those signs as well as looking at the warning signs as well. UK companies – they talk very well about Governance and there is good access. Especially on Governance. The 'E' and 'S' side is more mixed."

– Head of Corporate Finance and Stewardship, large UK asset manager

Investors recognise that the Board and its NEDs may need more, and different information to answer questions on culture across the different stakeholder groups.

Respondents also talked about placing relevance on the skills and experience of individuals at Board, Executive and Exco levels, especially when defining or articulating corporate culture.

> "What we think should happen is that the Non-Exec and Chairman should be able to talk about the top tier of management i.e. the CEO, CFO and the [members of] ExCo and talk about how they operate. Essentially, it's these characters that define or at least help to define the culture of an organisation, depending on what kind of company you are talking to."

– Head of Corporate Finance and Stewardship, large UK asset manager

Investors acknowledge that they need to improve the way that they access and digest information on the non-financial metrics.

This should be welcome news to senior management teams who have considered the values and culture of their businesses as competitive advantages for a while but who have typically struggled to get investors interested in those dynamics.

BOARD RESPONSIBILITIES AND INVESTOR ACCESS REQUIREMENTS TO INCREASE

As the focus on ESG factors continue to increase, many active managers see their levels of engagement on non-financial items within their portfolio companies as a key differentiator to clients, as they face increased competition from passive funds and ETFs.

For their part, passive managers are positioning themselves as drivers of the engagement agenda. It is clear that the volume of engagement, activity and commentary on ESG factors is at an all-time-high for the UK investor.

Whether they have Governance, Stewardship or Engagement job titles, the appropriate teams within institutions expect and receive good access to Chairs and NEDs of UK corporates, usually meeting without IR or senior management representation.

> "The best Chairmen come through on their own to meet us. We are looking to be a trusted partner for the Board. We don't want to only go through Governance topics. We want the conversation to be a strategic one."
>
> **– Head of Responsibility, UK mid-sized fund manager**

The timing of engagement with NEDs may now be concentrated around the AGM due to the implementation of the Market Abuse Regulations, but investors insist that meetings should not just focus on specific resolutions but instead try to advance investors' understanding of Board practices and long-term strategic initiatives that improve sustainability, with relationships with employees and suppliers seen as good examples. The key point is that Boards identity and explain the materiality of their stakeholder universe.

Other triggers that investors would like to see as prompting engagement with their portfolio companies are strategic change, changes in management and M&A.

> "MAR may impact our engagement this year. We would engage throughout the year but now our fund managers don't want to meet during the close period. So, it's going to refocus around the AGM – preferably before the vote."
>
> **– Head of Research and Portfolio Manager, large retail investor focused fund manager**

> "So, these Non-Exec or Chairman relationships are not just centred around one AGM vote or one remuneration vote, they are legacy relationships. We could be meeting with the same Chairman year-on-year for 3 or 4 years and that builds a familiarity, with the business story but also familiarity with the personnel involved. It is the strategic intent of the meetings and disclosure that's important. If the company has had a strategic review – it would be a good time for the Chairman to do the rounds. Or a significant management change. M&A is also a good opportunity for the Chairman to see shareholders. How do non-execs provide oversight on the decisions for M&A? That's a very important issue for shareholders."
>
> **– Head of Corporate Governance, mid-sized UK asset manager**

Overall, it is clear that investors expect companies to proactively manage their stakeholder engagement, behaviour and culture, supported by relevant evidence and data. While investors will question companies in far more detail after a corporate event such as a crisis, merger and acquisition or senior management change, they do not want companies to wait for such a trigger event, or the intervention of an activist shareholder, and to be on the defensive.

> "It doesn't make sense for companies to put themselves on the defensive. Companies are expected to do their own continuous self-examination and monitoring of business strategy, performance goals, governance and risk factors. Strategic questions are basic to managing a business. If these issues are addressed only in response to an activist, investors are likely to conclude that the business isn't being run effectively."
>
> **– Managing Director, Large global asset manager**

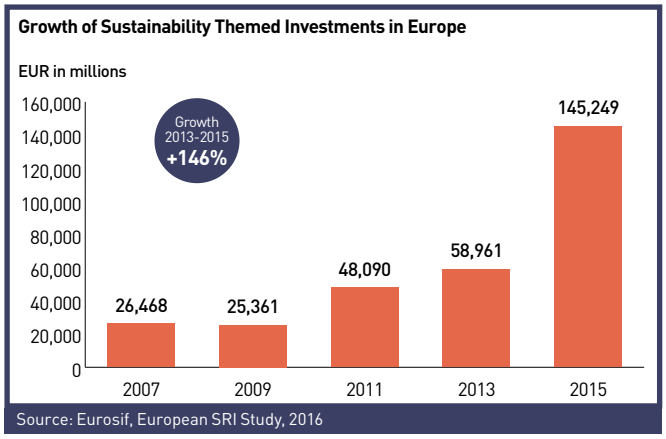
Investors are looking to cement closer participation and working relationships with Boards, Chairs and NEDs going forward. The dialogue is expected to be honest, strategic and insightful, with tick-box and boiler-plate approaches seen as unacceptable.

IN-HOUSE INVESTOR TEAMS GROWING TO REFLECT ESG TRENDS

The weight of capital moving towards this enhanced approach is vast, with the majority of investment institutions growing their internal ESG resources and engagement practices with Boards and particularly NEDs. These demands from the investor community are only going to continue to increase in influence in the years ahead.

ESG and SRI have been gaining international prominence in recent years. According to the Global Sustainable Investment Alliance (GSIA), assets invested in funds integrating ESG factors and applying SRI screens rose to $22.89trillion globally at the beginning of 2016, up 25% from the start of 2014.

Growth in Sustainability themed investments in Europe has increased by 146% (CAGR) since 2013, and by 28% (CAGR) in the UK alone.



Equally, Extel, the foremost independent evaluation of quality across the European equities investment industry, has for the first time incorporated ESG/SRI rankings in their influential annual ranking as opposed to the previous approach of having free text submissions should respondents want to include them. Beyond this, asset owners, i.e. institutional investors' clients, are increasingly demanding that their chosen managers have robust processes to include ESG considerations in deploying their funds.

As the focus intensifies on ESG investment, more internal resources are being dedicated to ESG research by asset managers. According to the 2017 IRRI Extel survey, 82% of asset owners require that their allocated asset managers report on ESG and corporate governance activities. This information can be sourced either from portfolio companies or from third party providers.

Coupled with this, 85% expect to see some growth in resources dedicated to SRI/ESG research at their firms over the next 3 years with the vast majority of those saying the investment will be in their in-house teams of ESG analysts – with the sell-side demonstrating the weakest historical and forecast growth due to the difficulty in monetising research post MiFID II.

To offer a high-profile example of this growth in in-house resources Vanguard recently announced (Feb 2018) the formation of a new European stewardship team, based in London. The world's 2nd largest asset manager is responding to the growth of its exposure to European issuers as well as criticisms over its voting practices which have seen it support 90% of votes in favour of management teams over the last 3 years.

Concurrently Bill McNabb, Vanguard's Chairman, wrote a letter encouraging Board and senior executives to discuss long term sustainability and risks with investors:

> **"Vanguard-sponsored mutual funds and other investment portfolios we manage own a significant number of your company's outstanding shares. We depend on you and your fellow directors to serve as the ultimate stewards of our significant investment. We look to your leadership in matters of governance, compensation, succession planning, and oversight of strategy and risk. Thank you for taking on these critical and weighty responsibilities on behalf of investors."**

CONCLUSIONS

Our research demonstrates the buy-side is increasingly building areas such as stakeholder engagement, corporate behaviour and culture into its investment decision making models – either through an integrated decision-making process or stand-alone specialist investment funds. The relevance of these new criteria will continue to grow as asset managers see the importance they play in investment returns and also in the demands placed on themselves to demonstrate stewardship.

As a result, investors welcome the expected changes in the Corporate Governance Code in this area. However, they do not see it as a watershed moment. They see it as regulation matching and supporting an already ongoing change in the variables they take into account in their investment decision-making.

This is going to create a significant new demand on Boards in the future for both new types of information and a new dialogue as part of the engagement with shareholders. A key challenge is that much of this engagement will be through the Chairman and Non-Executive Directors, who historically have not had the necessary insight or responsibility to be custodians of some of these intangible assets, such as culture and corporate behaviour.

The challenge for every Board is that this demand will not be satisfied by a uniform standard response written in the annual report or a simple set of data – for example such as the gender pay ratio. It is far more complicated and will require more in-depth dialogue and evidence.

Investors want Boards and management teams at their portfolio companies to be specific about their long-term strategy and narrative, how they analyse and manage behaviour and culture within their management process and how engagement with various stakeholder groups influences their strategic decision making. Each Board will have to create its own unique response, own data and explain its relevance within its overall business model and direction.

This is a major opportunity for UK-listed companies to demonstrate leadership and importantly – differentiation. Those that embrace this change will benefit in two significant ways. Firstly, investors have already clearly identified that those companies that build engagement and governance into their business model, with bespoke metrics and a suitable strategic narrative, demonstrate improved commercial performance and long-term sustainable returns. Secondly, companies that communicate and engage openly will gain an investor base that is aligned with their long-term plans.

WHAT DOES THIS MEAN FOR BOARDS AND THE MANAGEMENT PROCESS

1. Boards will need to better understand stakeholder engagement, corporate behaviour and culture – for simplicity 'corporate reputation' – and add it to the Board agenda. The changes to the UK Corporate Governance Code will accelerate this trend.

2. Companies must identify and analyse the stakeholders which are material to their business and strategy. They will need to articulate a clear plan for engagement and measurement for each stakeholder group.

3. The Board will require a new set of insight and data tailored to their business so that it can ask the right questions, make informed decisions and respond to investor questioning.

4. The Executive management team must lead on the action and insight. They should nominate an individual or team to manage the data gathering process and provide recommendations. The individual or team should also have the responsibility to inform and educate the Board, especially NEDs, prior to any shareholder engagement.

5. This must be an ongoing long-term programme rather than a single reporting exercise. As best practice develops, the successful adopters will fully integrate it into their business process and corporate narrative. They will be able to demonstrate a valuable return to the business and a quality share register.

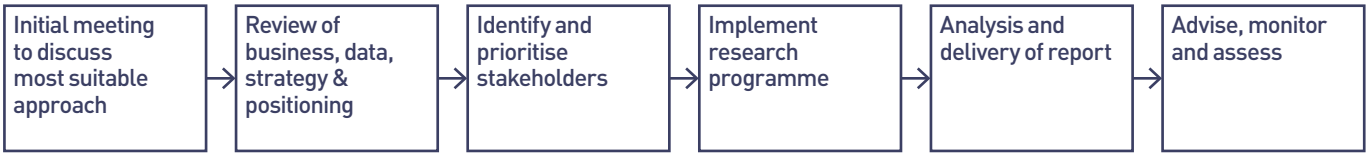
6. The Board must not believe they are immune to these questions if they have not, as yet, been actively questioned on these areas. Certain sectors and companies that have had a crisis or significant corporate event are currently at the forefront of investor interest. The increasing weight of capital, relevance of stakeholder influence and the UK Corporate Governance Code changes will expand the requirements to all companies and become a clear factor for corporate differentiation.

OUR APPROACH

SIFA Strategy works with organisations to enable them to measure and embed stakeholder measurement and engagement programmes to assist decision-making, support corporate governance and inform reporting responsibilities.

Underpinned by bespoke research and insight programmes, organisations can obtain intelligent insight and recommendations providing detail on how they are perceived amongst stakeholders, areas of risk and strength, and how and in what areas they can improve their engagement, culture, and reputation.

HOW WE WORK WITH YOU



For advice and guidance on building and implementing a stakeholder research and insight programme, visit www.sifastrategy.com or contact the SIFA Strategy team.

OUR PRODUCTS

REPUTATION REPORT	STAKEHOLDER SCORECARD+	STAKEHOLDER SCORECARD
■ Integrated approach, unifying all stakeholders	■ Tailored and bespoke scorecard measuring reputation and stakeholder support	■ Analysis of predetermined reputation drivers and criteria
■ Bespoke & in-depth research and insights programme	■ Uniform insight across key stakeholders	■ Uniform insight across key stakeholders
■ Analysis & presentation of quantitative and qualitative results and recommendations	■ Quantitative results and analysis only	■ Quantitative results and analysis only
■ 8-12 week timeline	■ 3-6 week timeline	■ 2-4 week timeline
Input: Stakeholder lists & management workshops	**Input:** Stakeholder lists & management workshops	**Input:** Stakeholder lists

ABOUT SIFA STRATEGY

We work with senior management teams to enable them to measure and embed stakeholder measurement and engagement programmes to assist decision-making and support corporate governance.

Underpinned by our bespoke research and insight programmes, we analyse the current level of support for an organisation across multiple stakeholders. By identifying potential areas of reputation risk and strength, we enable organisations to protect and enhance their stakeholder relationships and treat corporate behaviour, culture and reputation as strategic and measurable tangible assets.

With a 25-year track record of advising organisations, across different industries and geographies, we work with clients to enhance and manage strategic communications programmes, improve their corporate narrative across different stakeholders and develop best practice Corporate Affairs functions.

To learn more about our work please visit sifastrategy.com.

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