Pension Funds: on Track for an Efficient Engagement Strategy

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As long-term investors, pension funds are increasingly under pressure to become active shareowners. To this effect, it is particularly important that they engage in discreet dialogue with investee companies.

Over the past several years, the financial community has become aware of a profound change in the share ownership structure of listed companies - namely, the gradual shift in predominance of institutional investors. Among the latter, pension funds are increasingly playing an important and interesting role.

By their nature, pension funds are bound to adopt a long-term investment strategy so as to ensure that their investments and return are congruent with their actuarial liabilities. They are thus prompted to invest a substantial part of their assets in domestic and international shares. In order to limit the risk of deviation from relevant benchmarks, an important part of share portfolios is index tracking, especially for domestic shares. As a result, pension funds have become captive shareowners of many companies.

From captive to active shareowning

Pension funds are becoming increasingly aware of the importance of making use of their shareholder rights.

This involves taking three steps. First, shareowners can exercise their right to vote at the annual shareholder meeting. This is a fundamental right because, in most countries, it is the shareholder general meeting that has the inalienable right to make various major decisions, such as to elect members of the board and to approve the articles of incorporation.

Most subjects, however, cannot be discussed in detail during shareholder general meetings. Indeed, matters as delicate and complex as executive pay or corporate environmental strategy require a tailored, in-depth approach. In a second step, therefore, shareowners can engage in dialogue with management throughout the year. Shareholder engagement of this kind can be much more effective than exercising the right to vote at the meeting of shareowners, if it is discreet, coherent and coordinated, and if it is conducted from a long-term investment perspective.

Lastly, should the dialogue conducted as part of a shareholder engagement strategy bear no fruit, shareowners have one more card to play: they can table a resolution on the agenda of the general meeting of shareowners. In taking this third step they must be aware that it usually leads to a conflictual relationship with the management of the companies concerned. It also involves a public campaign in order to garner maximum support for the resolution from other shareowners.

The right to vote, the right to engage in dialogue and the right to submit a shareholder resolution all have an economic value. Institutional shareowners therefore have a duty to exercise those rights as part of their fiduciary duty towards their many beneficiaries. Pension funds, for their part, should clearly and actively exercise their shareholder rights with a view to enhancing the long-term value of the investee companies.

The long view

The most successful of active exercise shareholder rights is probably discreet engagement with corporate management over the course of the year. Paradoxically, such engagement is rarely brought to light by investors, perhaps because, in order to get results, the dialogue must initially be confidential. In addition, there is also free riding in terms of engagement, as many investors prefer to leave the task to a few active investors who bear the costs, while the investor community at large benefits from it.

Although the objective is to enhance the long - term value of companies, shareholder engagement can concern widely varying subjects. The point is not for the shareholder to interfere in the day-to-day running of the company, but rather to raise concerns of strategic interest to the investor, in terms of return, risk, corporate governance or corporate social responsibility. As long-term oriented captive shareowners, pension funds have a special interest in engaging in dialogue so as to guarantee the strategic long-term orientation, the application of the rules of good governance and the implementation of corporate environmental and social responsibility.

Given the cost of any engagement initiative, some activist investors have a tendency to focus on a relatively limited group of companies where the potential to make progress is high. They hope thereby to obtain rapid significant results with a positive effect on the price of the shares concerned.

It would nevertheless seem that thus limiting the circle of companies targeted is not really the best way forward. Pension funds are captive investors in a relatively large number of companies. No company is perfect in every area, and so there is always room for improvement. Pension funds can therefore legitimately engage and maintain a dialogue with management in the widest possible circle of companies. In addition, the dialogue should cover a relatively broad spectrum of topics.

Conducting a multifaceted dialogue with a large number of companies may at first seem costly for several reasons. However, this is not the case if the outcome is gauged against a timeframe spanning several years. First, every topic has to be thoroughly prepared in advance. It therefore becomes advantageous to engage with many companies on each issue. Secondly, when engaging with a company, several topics can be dealt with in the course of a single contact, which is cost-effective. Thirdly, the fact of engaging on a specific topic with a large number of companies will produce constructive results from one company to another. It is often relatively easy to convince one firm to move ahead on an issue by benchmarking it against its competitors whom have already made important steps in the right direction!

Strength in numbers

The greater the shareowners' collective weight, the more effective the dialogue. Interestingly, pension funds are influential not only because of the size of their investments but also because of the large number of beneficiaries they represent. Those beneficiaries are also consumers and citizens, and may even be company employees or suppliers, a fact to which management is not indifferent.

In view of the effort required to carry out an effective, broad-range strategy of dialogue, it is particularly important to be able to muster strength by bringing together investors sharing the same interests to conduct a grouped dialogue. In this spirit, it is to the benefit of pension funds to group at regional level in order to give priority to dialogue with companies within the same country. Doing so has several advantages.

First, the geographical proximity between the investor and the target company improves the chances for successful engagement. Indeed, the company is generally particularly sensitive to domestic shareowners that represent a large number of local beneficiaries. Various examples have shown that such a strategy is far from being utopian and that it can have very positive results: the United Kingdom's Local Authority Pension Fund Forum *(www.lapfforum.org)*, the New York State Common Retirement Fund *(www.osc.state.ny.us)*, the Australian Council of Superannuation Investors *(www.acsi.org.au)* or the Ethos Foundation in Switzerland *(www.ethosfund.ch)*.

The second advantage lies in the possibility of sharing the cost of the dialogue between several investors with the same objectives. This is particularly important when engagement activities are planned for the long term, and for a relatively broad range of companies. Lastly, the fact that the dialogue has been organised by local investors in no way precludes the organisation, when needed, cooperating with other regional or international groups, especially on important topics relating to large corporations with worldwide operations.

The past few years have seen the emergence of a new form of investment group – international associations grouped around a specific topic such as access to medicines, climate change or freedom of expression on the internet. Ties of this kind have been forged essentially in the fields of environmental and social responsibility. In terms of corporate governance, the specific nature of each country's legislation often obliges the stakeholders to deal with the topics separately in each country, making global campaigns a lesser priority. The existence of international investor networks or forums such as the ICGN or Eumedion, is however fundamental in setting the principles of best practice that all listed companies, regardless of their location, should eventually adopt.

The future of engagement lies in more efficient organisation of dialogue activities. This will entail the long-term organisation of an engagement procedure bearing on several subjects and a broad range of companies. In addition, the dialogue should be conducted by groups of investors sharing the same long-term expectations in terms of corporate governance and social responsibility.