ACTIVE OWNERSHIP: A CRUCIAL ROLE FOR INSTITUTIONAL INVESTORS

DISCUSSION PAPER

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Globally, institutional investors, such as pension funds, own the bulk of the shares in blue chip companies. Yet, historically they have been hesitant to convert that position into a role as active investors.

This relatively passive approach may hurt growth potential. There is strong empirical research that shows that firms without active owners underperform. Hence, if institutional investors collectively do not take up that challenge, there is a risk that no other have the capacity to undertake that role.

On a promising note, a number of large global investors – and alliances of investors – have recognised that they can play an important role as long-term investors in firms. They spend resources on participating in general meetings, preparing positions, and building alliances among like-minded investors to help the firms to take routes most likely to promote long-term growth.

The strength of that movement towards more engaged owners will not only be the result of the preferences of institutional investors; the regulatory environment also plays an important role. We discuss some of the important elements in this note.

Active ownership makes a difference

There is first of all solid evidence that companies without at least one large and active investor tend to underperform in a number of dimensions fx they[1]:

- Invest too little in R&D because incentive schemes fail to incentivise results that only materialise 5-10 years after spending,
- acquire other firms with limited synergy effects to existing activities and chose risky business strategies,
- have CEO compensation levels and structure which does not reflect actual value contribution,
- focus too much on quarterly returns because management lacks the backing of investors focused on longer term returns.

Basically, this is a reflection of an old challenge, namely the principle-agent problem. Managers may not necessarily and always act in the interests of the shareholders (or other stakeholders) owning the firm. This requires some efforts by the owners to protect their investments.

Institutional investors central to exercise of active ownership (also in Denmark)

Globally, institutional investors manage in excess of USD 80 trillion, with 38 percent (USD 32 trillion) in the form of public equity[2]. The largest institutional investors by a wide margin are investment funds, insurance companies, and pension funds: in 2011, they managed app. USD 73 trillion. The large investors primarily hold securities in public equity; however, they still invest approximately USD 29 trillion in assets such as private equity funds, venture capital, hedge funds, real estate, commercial assets, and financial derivatives.

The large investment capacity allows institutional investors as a whole to own the majority of publicly traded stocks. In the US, institutional investors makes up as much as 60 percent of the market. In important markets such as Japan and the UK, the share of direct shareholdings held by institutional investors is significantly higher.

Denmark has one of the largest shares of capital under management by institutional investors relative to GDP of the OECD (ranked 4th in 2011 among the OECD countries, only surpassed by Luxembourg, the Netherlands, and Switzerland)[3]. Over the course of the past 5 years, the foreign investments by Danish pension funds have remained stable at approximately 25 percent of total exposures[4].

Yet, with important exceptions, limited role historically as active owner

There are generally as many investment strategies and attitudes toward active ownership, as there are institutional investors. Exchange Traded Funds (ETFs) potentially have very limited engagement in active ownership, while VC and PE funds actively pick and nurse their investments fx by nominating board members etc. More recently, Sovereign Wealth Funds (SWF) have grown strongly and often build up a less diversified investment portfolio and a role as active owners.

However, the vast bulk of institutional investors have historically been hesitant in implementing strategies of active ownership. Indeed, they tend to hold diversified portfolios and are often only involved in reactive ownership e.g. following the policies put forward by smaller hedge funds or investment companies. This general tendency naturally neglects important nuances but the fact remains that the vast majority of global investment comes from mutual funds, pension funds, and insurance companies that generally, only to a limited extent, practice active ownership[5].

Economic barriers to active ownership

The market economy relies on shareholders, such as institutional investors, to allocate and price different business opportunities efficiently. This comes with a social benefit as shareholders continuously bring new information to the market, which in turn leads to an improved allocation of productive resources[6].

It is naturally in the self-interest of investors to keep track and monitor their investments, to ensure that the

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[1] See fx Belloc et al. (2016), Anderson, Duru, and Reeb (2012), Mezur and Wu (2016), Barton and Wiseman (2014), OECD (2011), Gruber and Kamin (2015), and Edmans and Gabaix (2016)

[2] OECD (2014)

[3] A key factor is the Danish pension system with very modest public pensions while essentially the entire labour market is de facto covered by obligatory pension schemes. This results in Denmark having the highest share of private pension assets under management in the OECD with more than DKK 4,000 bn in 2015, according to OECD (2015) and Forsikring og Pension (2016).

[4] PwC (2015). In an international comparison, Danish pension funds invest relatively modest amounts in foreign markets, especially compared to Finnish and Dutch pension funds that holds 74 and 76 percent in foreign assets, respectively. However, the exposure is still significant compared to Swedish pension funds that invest 17 percent in foreign assets

[5] OECD (2014)

[6] Dimson, Karakaş and Li (2015)

corporations are using the capital in a responsible manner.

However, gathering information and engaging in active ownership is costly. This present a free-riding incentive[7], where shareholders that do not find it worthwhile to engage in active ownership are benefitting from other market participants involved in improving businesses and capital allocation.

Market mechanisms will tend to correct some of the problem. If too many investors are free riding and the information available is not reflected in prices, hedge funds, as an example, can take advantage of the disparity and earn a profit by actively improving the business or make fundamental corporate analysis.

But it is fair to say that the merits of an active versus a more passive approach fx index tracking, is very much up to debate in the investment community.

The regulatory environment

In addition to market barriers such as free riding, there can also be regulatory barriers. In the US, legislation introduced in the 1930 limited exposures to individual companies and hence also restraining the role fx pension funds can have as owners in industries[8]. In Denmark, there is a general rule that pension funds cannot have a share of stocks that makes them so-called dominating investors in individual firms[9].

More generally, corporate and security law regulates the rights of shareholders vis-à-vis the board and the management in ways that can either promote or discourage active ownership. Some of the most important rights are:

- Transferability of shares
- Access to information
- Participation in key decisions affecting the business
- Voting rights in the election of the board

However, these rights are not (always) a legal responsibility to exercise. This has spiralled into a discussion about differentiating dividends between active owners that provide both capital, information, and monitors, and passive owners that only provide capital.

Legal requirements both support and oppose active ownership. In the US, institutions subject to the ERISA act are generally assumed to have a de facto obligation to vote. Similarly, in the UK the Stewardship Code encourages institution to vote their shares. On the contrary, the Swedish pension fund AP7 is explicitly prohibited by law from exercising their voting rights for their Swedish shares.

In Denmark, voting caps are allowed but they tend to be restricted to the financial sector. This generally prevents institutional investors from exercising their proportional voting rights.

The Danish committee on corporate governance has recently presented new recommendations for active and responsible ownership[10]. The recommendations are so-called soft law principles, not to be confused with actual legislation (hard law), to allow for extended flexibility. Institutional investors are to monitor and engage in an active dialogue with companies in which they have invested. Furthermore, institutional investors should have a clear policy for how to escalate their active ownership activities, or stated differently, how their exercise their rights.

Stepped up focus on active ownership

More recently, some of the largest global institutional investors have been stepping up their corporate governance activities.

The Norwegian Oil Fund, the world's largest SWF with more than NOK 7 trillion under management, has implemented a number of measures:

- Revealing their voting intensions at annual meetings
- Doubling the number of companies it analyses in depth
- Issuing "position papers" setting out its corporate governance principles
- Signing up for the nomination committees that decides who the board members will be

Another example is Blackrock that is increasing the number of company engagements, with a focus on corporate strategy, board composition and skills, executive compensation, bylaw amendments, issues related to

[7] McCahery, Sautner, and Starks (2015)

[8] Finansministeriet (1999).

[9] Financial firms, e.g. pension funds, under supervision are not allowed to have dominating voting rights in other companies in Denmark cf. Finansministeriet (1999).

[10] Komitéen for god selskabsledelse (2016)

capital structure and executive succession planning, and sustainability reporting, among other matters[11].

We also see global alliances of large international investors building networks focused on long-term ownership ("stewardship") of the companies they invest in[12].

A similar pattern of increased focus on responsible ownership is seen in Denmark where 66 percent of the institutional investors had policies for active ownership in 2015 compared to only 56 percent the year before[13].

Key focus areas going forward

The instruments to be used in exercising active ownership are indicated above: use voting rights, seek alliances and work with like-minded investor, ensure that the competent and independent board members are selected etc.

The result of that increased engagement could be to achieve four key results:

One: A shift from a focus on quarterly returns to the long term and future business opportunities. If attention is shifted more towards the long term, active ownership can play a key role in unlocking the long-term value of investments. This is driven by the fact that active ownership is costly in the short-run but profitable in the long-run.

Two: Better alignment between shareholders and management. The lack of alignment of incentives between shareholders and management is often attributed to asymmetric information or costly monitoring. The problem have received renewed attention in the aftermath of the financial crisis. Holding management accountable by active ownership could improve the alignment between shareholders and management. If institutional investors take an active stance on business models and actively ensure that the management is complying with the wishes of investors, the problem might evaporate.

Three: Executive remuneration is a critical area also for wider social reasons. Particularly in the US but also the UK, executive pay has risen dramatically relative to median earnings[14]. There is increasing evidence that this relative increase has no equivalent counterpart in improved company performance, it might even be detrimental to growth[15]. To successfully mitigate this problem, executive remuneration should be tied to long-term performance, from which institutional investors will likely benefit[16]. Active ownership through say-on-pay/vote-on-pay has been shown to reduce the level of pay and therefore mitigates the problem[17].

Four: Transforming record low financing costs into investments. While the corporate world is awash with cash, global investment remains at historical low levels. Excess capital is either saved, part of massive equity buy-backs, or paid out as dividends[18]. This trend started even before the financial crisis in most G7 countries and have speeded up significantly in the aftermath[19]. In the US, gross (non-financial) corporate savings have outpaced gross investment persistently by more than 2 percent of GDP from 2009 to 2013. A similar pattern can be seen in Japan, Canada, the U.K. and Germany.

The low investments happen in an environment of highly attractive conditions for financing. The QE programmes pursued by central banks combined with unprecedented low policy rates have shifted the whole term structure down significantly, which makes the low investment levels even more puzzling.

So the question that institutional investors could ask themselves: should the companies they (part)own invest more at the margin even if that lowers rates of return given the expected very real low returns on fixed income securities over the coming decades?

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