Creative Tension? 25 years on

A collection of essays on the relationship between the management of public companies and institutional investors
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Foreword

In early 1990, the then National Association of Pension Funds published a collection of essays on “issues arising from the relationships between the management of public companies and institutional investors” under the title Creative Tension? I had asked a group of influential figures to write in their own way on the topic and the resultant booklet proved to be a landmark in the early evolution of the discussion of corporate governance.

Just over 25 years on, I thought it would be interesting to repeat the exercise and hence the present collection Creative Tension? 25 years on. As far as possible I have endeavoured to obtain contributions from those whose present positions mirror those of the original essayists. I am immensely grateful to all those who have contributed, each in a personal capacity, by writing their contribution.

Since the original publication, there have been many reports and committees, codes and rules and even legislation focussed on the issues involved. Reading the essays from 1990 again, it is striking both how much but also how little has changed. The core agency problems remain as before, perhaps exaggerated now by the fragmentation of types of intermediary asset managers and by globalisation.

It is also noticeable how questions of trust and corporate social responsibility feature more heavily today and there is less comparison with other economies, notably those of Germany and Japan. The concept of stewardship has been developed in more recent years, although I still find confusion between the stewardship of the directors on behalf of the shareholders and the stewardship of the asset managers on behalf of their customers.

The framework of communication with investors has developed considerably since the first booklet and the extent of the dialogue between companies and their shareholders (or their representatives) has grown substantially. And the responsibilities of UK directors have been widened at a time when there is a shifting boundary between the interests of shareholders and employees.
Common to both booklets, with varying degrees of emphasis, is an anxiety about the effects of short-termism by investors. Some writers have proposed avenues of remedy for what they see as the undesirable consequences. Despite some of the fears, it is nonetheless instructive to note that since the publication of the first collection GDP has grown in the UK by 2.2% pa whilst in Germany and Japan by only 1.5% pa and 1.0% pa respectively. Does this mean the anxieties were overdone or is it just a reflection that, although desirable, good governance is not a necessary condition of economic growth?

This is, by choice, a UK-centric view of corporate governance. I suspect Creative Tension? – 3 in 2040 will be dominated by discussion of global investors and international practices.

Some writers comment on the role of stock exchanges. In the past 10 years alone, £438.1bn has been raised by companies on London Stock Exchange across AIM and the Main Market. Despite some views, the role of London Stock Exchange in financing the growth of the corporate sector remains important.

Finally, I am struck by how little discussion there is in either collection of risk. At a time when the west is challenged by huge populations of risk takers in the east, the ability to take risk, with appropriate safeguards, has never been more important to our long-term economic prosperity. Regulation needs to be seen through a prism of growth as it lies at the heart of current work on the development of the European Capital Markets Union. We all need to be careful not to raise expectations of the performance of company boards or constrain them so much that boards’ default strategy is to minimise risk taking.

I very much hope that readers will find this volume provides a helpful foundation for further informed debate on the core relationship issues.

There are many calls on the time of the authors of this booklet. It is a tribute to such very busy people that they found time to write such thoughtful contributions. Again, I thank them. I would also like to thank the Pensions and Lifetime Savings Association for permission to reprint the original essays,
Joanne Segars OBE for providing a preface and my colleagues at London Stock Exchange for facilitating this publication.

**Donald Brydon CBE**
Chairman, London Stock Exchange Group
May 2016
Preface

Since the first edition of *Creative Tension?* was published over 20 years ago, the corporate governance landscape has changed beyond recognition. Indeed, it is thanks to people like Donald Brydon constantly highlighting the importance of this agenda that UK investors can now have recourse to – amongst other things – the guide to good corporate practice and reporting in the Corporate Governance Code; the clarification of company Directors’ duties in the 2006 Companies Act; a tri-annual binding vote on executive pay mandated in the 2013 Enterprise and Regulatory Reform Act; and the Investor Forum for co-ordinated stewardship activity established in the wake of the Kay Review. Policymakers in the European Union and Japan are busy replicating the UK’s Stewardship Code, established in 2011.

At the Pensions and Lifetime Savings Association, we are seeing an increased interest from our membership in governance and stewardship activity, with members increasingly assertive on issues such as executive pay, board appointments and pre-emption rights.

At the same time, however, there can be no debating the need for a second iteration of *Creative Tension?*. High-profile corporate governance failures continue to bedevil businesses to the detriment of shareholders, while public anger at executive pay levels and malpractice in the financial services sector remains a staple of the newspaper front pages.

As we wrestle with these enduring challenges, new ones are constantly emerging.

Stewardship is a far trickier task in a globalised economy where the ownership of a single company is increasingly fragmented and distributed across the globe. And just as UK companies are owned by investors from every continent, so our pension funds have investments around the world, rendering their interest in good corporate governance an international concern rather than a domestic one. Our research also leaves little doubt that the next generation of savers – one accustomed to far greater consumer choice and access to whatever information they need
at the click of a button – will have much higher expectations in terms of the environmental and social impact of their investments than those that came before.

Set down on paper, the task before us seems enormous. But I have little doubt that the insights within this book represent a clear, ambitious yet realistic way to overcome it.

**Joanne Segars OBE**  
Chief Executive, Pensions and Lifetime Savings Association  
May 2016
The penny and the bun

Dame Helen Alexander
Chairman, UBM Plc

Creative tension – is it a good thing?
Years ago, as a CEO I put to my board some long-term investment proposals. These would have depressed earnings in the short-term. The Chairman led the discussion that did not approve the proposals. “I want the penny and the bun,” he said – meaning “I want my cake and eat it”.

I should have foreseen this lesson in the need for trade-offs and balanced judgements. That need is everywhere. As Chairman of the Port of London Authority, a corporation by statute, not a public company, I regularly led discussions about how to accommodate competing uses of the River Thames. Container ships, commuter and tourist vessels, houseboats, rowers and paddle boarders can’t all use the same patch of river at the same time. But with discussion, and judgement, there are exciting ways forward.

Is there tension in arriving at solutions? Yes. Is it creative? Mostly. Creative tension exists in the discussions about whether there is too much short-termism these days, about the role of shareholders in relation to other stakeholders and about the role of the board in relation to shareholders.

Long-term and short-term
This is a well-rehearsed tension. It certainly creates tension when different shareholders in the same company have different time horizons. Management and boards have to assess the best route to achieve value over time, taking into account shareholders’ views. That is often easier said than done, because share registers include such different categories of investors – with different investment horizons – long-term/short-term – yield or growth and their various combinations. Investors who pick and hold a smaller number of stocks can often spend more
time with each firm in their portfolio. These concentrated funds can be more vocal and enjoy a disproportionate share of voice. It’s not likely that all can be satisfied.

Meanwhile, we have to wonder whether the fund managers who manage long-term funds are entirely long-term in their thinking. The incentive structure for funds is pretty opaque and likely, to some extent, to be based on short-term performance, particularly since funds have to attract their own capital.

Managements often see themselves as stewards of companies, so even long-term shareholders can be perceived by management to be more short-term by comparison. This is not necessarily a bad thing. It builds in creative tension, forces boards and management to be crystal clear about the longer-term value of their plans, and forces a discussion, to get both the penny and the bun.

**Shareholders and other stakeholders**
It took a while for the new(ish) Companies Act to be absorbed by boards, who now have to take into account stakeholders other than shareholders. In the early 21st century, businesses are beginning to realise that they have a part to play in the wider world, with responsibilities to employees, the environment and to communities where they operate. To leave an enterprise in better shape than when you found it is a good aim for management – and now that shape will no longer be measured exclusively by financial returns, which, though critical, are not the only metric.

Employees are an important stakeholder group. The need for jobs is clear, and many companies after the effects of the 2009 recession decided to protect their workforce, by enforcing unpaid leave, closing factories temporarily and cutting hourly rates to
minimise the need for job losses. This played havoc with productivity figures, but was an example of the needs of this wider stakeholder universe being taken into account.

When senior employees are incentivised in a way that is described as “aligned” with shareholders, they are often paid in relation to total shareholder return. Many such employees might see this as outside their control, and therefore not an incentive. The debate about how much management should be rewarded on a metric like this is serious. The roles are complex, and cannot be judged exclusively on one measure – hence creative tension between the penny and the bun again.

Much research has demonstrated that companies with strong sustainability credentials perform better. But are better managed companies more likely to have spare capital to spend on the “softer” activities, or does a strong sustainability agenda attract better talent? Does it matter if this creative tension creates the right behaviour, leading to better relationships and lower costs as a result? The rise of ethical investing and focus by shareholders on elements other than purely financial show this is being recognised, and that if needs of all stakeholders are balanced then it should be possible to have the penny and the bun.

The Board and the shareholder?
Companies have to develop as their markets change, and this transformation can take time. The media sector is a prime example of that transformation in the last couple of decades. Companies have had to evolve and be nimble and invest to survive – transformation is often a journey. At such times, the equity story has to be told, clearly and convincingly, to shareholders.

Today, companies are encouraged to be more shareholder-friendly to reduce the chance of unproductive – uncreative – tension. There is a more proactive approach to shareholder relationships, usually with more engagement, including by the Board, and with a more constructive tone. There can be dialogue, but to work well, both sides have to want it.

The tone of engagement is absolutely critical. The Chairman or CEO who disregards the shareholders is dead. The old picture of
someone referring to ‘teenage scribblers’ is, happily, a thing of the past. Seeking views from shareholders is often useful, though sometimes constrained by regulation, but always instructive. Whatever the tone of the engagement – tense or easy, it always tells us something about the shareholders’ views of the company and the market.

A good board will take regular reports of shareholder views, from management, from brokers and from independent sources. It will take these views into account, but not follow them slavishly, recognising a responsibility to all stakeholders.

Companies don’t have to be run by shareholders to get the best of their views. Execution is the job of management and the Board is in charge. Lack of clarity of roles can lead to plain tension, with no creativity. When everyone understands those roles, then the dialogue can be constructive, the tension creative and the penny and the bun delivered.

**Does any of this matter?**
If we want a thriving economy, with jobs and good public services, business needs to play its part in that ecosystem with full vigour. That is only possible if the role is understood and those who engage with it are prepared to trust the players. The players include shareholders, boards and management and they must earn, and keep earning, that trust. Engagement between them in a tone which is respectful and intelligent is a good place to start. Then we have a chance of having the penny and the bun, or having the cake and eating it.

May 2016
When the first *Creative Tension?* collection of essays were penned back in 1990, our firm Makinson Cowell had been trading for less than 12 months. Since then, we have been helping listed companies understand the perceptions of their institutional shareholders around the world and sharing these in the Boardroom. This gives us a unique and privileged perspective on the relationships between companies on the one hand and those that control most of their issued share capital on the other. I am delighted to have this opportunity to share some personal observations.

Before doing that, a few postscripts from the original collection of essays. There was much bemoaning of the UK system, which has indeed subsequently changed for the better in several important respects. Germany and Japan tended to be held up as exemplars of how things could work better, but we note that over the intervening period, the UK has delivered superior GDP growth and the London stock market has outperformed its rivals.

There was also much talk about takeovers and the then fashionable management buyouts. The former have continued apace, of which more later, and the latter have all but disappeared. In passing, we note that four of the nine corporate representatives contributing essays back in 1990 subsequently saw their companies agree to be taken over while, today, London Stock Exchange itself is engaged in merger talks with Deutsche Börse.

The UK system has worked well over the past 25 years, and I would contend that it is working better than ever today. The major problem for UK companies and their shareholders currently is not the relationship between them or a shortage of risk capital, but a lack of revenue and profit growth, given low GDP expansion, low inflation, increased pricing transparency on
the back of the dramatic expansion in digital commerce and the ever-increasing burden of regulation.

In four of the past five years, aggregate earnings for the London market have gone backwards. Over the full five years while earnings are 16%, dividends have been increased by 35% and this means that the dividend pay-out ratio has increased from sub-40% five years ago to around 65% last year. Furthermore, the top six dividend payers by value listed on the London market will have distributed all their underlying earnings in 2015, and that is earnings before the ‘bad stuff’. We see this trend in the pay-out ratio as unsustainable.

For equity investors, where growth is the holy grail and the main driver of share prices over time, this is a difficult environment. It also helps to explain why any company that is capable of delivering sustainable growth finds its shares trading at a significant premium to the London market today.

So why do I say the UK market model is working well?

— In a primary sense, I cannot recall any respectable UK listed company that has failed to get the support of most of its shareholders when asking them for new equity capital, provided the company concerned has respected pre-emption rights. Indeed, I would go so far as to suggest that institutional investors have not been discerning enough when allocating their clients’ monies to new equity issues, perhaps because they have been coerced by deeply discounted rights issues.

— In a secondary sense, it has never been cheaper for investors to buy and sell UK equities. Meanwhile, share registers are remarkably stable. Over any 12-month period, more than 20 of
the top 25 shareholders in the typical FTSE 100 company will be unchanged. Contrary to popular belief, major institutions rarely deal meaningfully on the day a company produces its results. There is, of course, a small portion of the share register that is being churned at high frequency, which for liquidity purposes is no bad thing. This trading activity has little impact on the stewardship of listed companies which have no need to even know who these traders are.

— The UK corporate sector has the best governance regime among the geographies with major equity markets. Our research among global institutional investors shows a clear preference for splitting the role of Chairman and CEO rather than combining them, and for unitary boards with a majority of independent non-executive directors serving maximum nine-year terms, over supervisory boards.

— Companies have invested significantly in building their in-house investor relations capability in order to communicate directly with institutional investors rather than rely on the dwindling band of quality sell-side analysts to do that for them. Today, most major companies have comprehensive investor relations programmes in place and we estimate that, at the core of the typical programme, the CEO and CFO of a FTSE 100 company will averagely attend between 80 and 120 one-to-one institutional meetings between them in a 12-month period, with the investor relations team typically hosting as many one-to-one meetings again. At the same time, most FTSE 100 companies have meeting programmes for the Chairman and the Chairman of the Remuneration Committee as and when required.

— While the UK share registration system is increasingly remote from underlying beneficiaries and hardly fit for purpose, we do have registered stock so that shareholders can be accurately identified in contrast to the bearer shares system that prevails in most of continental Europe and the US. Additional UK disclosure rules, including short positions of 0.5% or more, have proven a significant force for good.

— Finally, voting levels at General Meetings have been increasing since the systems for doing so have been improved and the Stewardship Code was introduced. For a typical FTSE 100 company, we estimate that 90% of the shares controlled by UK and North American institutions are voted, while the percentages for institutions in continental Europe and the Rest of World are
lower at 50% and 25% respectively. The worst voting offenders are private shareholders who on average only vote 20% of their collective shareholdings which are increasingly tied up in nominee names linked to popular dealing platforms.

While relationships between UK companies and their shareholders have been working increasingly well over the past 25 years, there has at the same time been massive change in both the institutional and corporate order.

Starting with institutions where we take the top 25 global investors in UK equities as our benchmark:

— First, only seven of these 25 institutions have remained on the list in anything like their original form over the 25 years.
— Second, the top 25 control an estimated average 37% of the market today compared with 40% at the outset.
— Third, there has been the rise and rise of index funds: back in 1990, there were only two indexed investors in the top 25 and they controlled less than 4% of the market; today that number is 5½ institutions and they control more than 14% of the market. The weighting of active managers is down significantly from 36% back in 1990 to 21% at present.
— Fourth, there were no overseas institutions among the top 25 at the outset, whereas today there are four in the top 10 and seven in the top 25, including two sovereign wealth funds: Norges Bank Investment Management in third position and People’s Bank of China in 14th.
— Finally, we estimate that more than 38% of the equity of the FTSE 100 is now controlled by overseas institutions compared with the 46% in the hands of UK institutions.

Next, changes in the corporate order where we take the FTSE 100 as our benchmark:

— Only 37 of the companies in the index back in 1990 are still there today in one form or another. Of the 63 that have gone missing, 45 were taken over, around half by foreign bidders. Nearly all of these deals will have been on an agreed basis and, in most cases, the lion’s share of the value will have accrued to the acquired company’s shareholders.
— While talking corporate activity, it is important to remember that in many cases the strong market positions enjoyed by UK listed companies overseas were founded on earlier acquisitions in those countries.

— Among the names that have disappeared, we note that conglomerates feature prominently with the likes of BET, BTR, GEC, GUS, Hanson and Trafalgar House among them because they have been either successfully or unsuccessfully broken up.

— In terms of sub-sectors, the most dramatic shift has been the demise of Industrials from a 15% capitalisation weighting down to 7%, and now almost entirely represented by Aerospace & Defence and Support Services.

Finally, no system will ever be perfect and so we close by highlighting three areas where we think relationships between institutional investors and the companies could be made more effective. First, greater use of technology in terms of facilitating meetings, disseminating information, collating consensus forecasts and providing business model frameworks for the buy-side. Second, detuning the role of proxy voting agencies to whom some institutions blindly delegate their governance responsibilities, and whose business models require high-profile intervention from time to time to justify their fees. Third, finding a more effective means of getting institutional support for, and risk capital into, start-ups and private and smaller listed companies to facilitate growth in this key sector of the economy.

If people look back at this this set of essays in 25 years’ time, things will naturally look very different. There will be new technologies as yet unimagined to invest in, and new investment instruments alongside equities, but for the early years the direction of travel is clear. Digital technology will continue to drive massive change and facilitate disruption across many industries and sectors. Some of these new companies will burst their way into the FTSE 100 and naturally demote declining businesses. One thing is for sure, the changing composition of the index will continue to reflect that in the wider economy and active institutions will need to continue to reposition their portfolios and allocate new capital wisely if they are to outperform and attract new funds to manage.
We suspect that the relationships between listed companies and their institutional investors are set to become even more important as the pace of change continues to accelerate.

May 2016
There can be little argument that capitalism has proved to be the only system capable of providing sustained (albeit not continuous) long-term economic growth. For all its imperfections, no other system comes close. The modern principle that shareholders are liable to the corporation was introduced by the Joint Stock Companies Act 1844, and the subsequent 1856 Act provided a simple administrative procedure for any group of individuals to register a limited liability company. This laid the foundation for modern capitalism in the UK, enabling anyone to establish or put funds into a company, thereby becoming a joint-owner and sharing in its profits and growth, whilst limiting the individual liability to an acceptable and appropriate level. The shareholders elected the board of directors to run the company on their behalf, while they acted as the stewards of the business, its long-term custodians.

The principles were sound and the establishment of London Stock Exchange enabled these to be translated into efficient practice. However, the whole system is now failing in one very important aspect of its originally intended role: it is no longer funding or driving long-term company development, and hence no longer being the vital engine of the nation’s economic growth. This is crucial at a time when the UK’s future economic prosperity depends heavily on the creation and growth of new companies, indeed whole new industries. In a world full of opportunity – new markets, new products, new services and new ways of doing business, much of it created by fast-evolving technologies – the UK simply isn’t growing a sufficient number of companies able to exploit such opportunity and compete in today’s global markets.

The underlying problem is that all the pressure on publicly traded companies is to deliver short-term results. This stifles the

Don’t criticise the players, change the rules of the game

Sir George Cox
Pro-Chancellor & Chair of Council, University of Warwick
pursuit of strategic vision. Too few entrepreneurs look to the market as the next step in growing their business, and of those that do, too many tend to see an IPO as an exit rather than the first step on an escalator. Of even more concern, established companies increasingly concentrate on ways of maximising the return on today’s assets rather than investing for tomorrow.

It is not a question of anyone behaving irrationally or improperly. Quite the reverse; within the rules of the game, investors and corporate management are behaving completely appropriately. Nor does the fault lie with the markets themselves; the world’s leading stock markets are incredibly well-ordered and efficient.

The problem is systemic. Over the years, the nature of share trading has changed. The volume of transactions on a major market such as London Stock Exchange is huge – over a million on a typical day, equating to a financial value of over £5 billion – but in the main these transactions have nothing to do with money being invested in companies. It is simply a matter of shares continuously changing hands. Moreover, the vast bulk of these transactions are made not on the basis of any careful assessment of the company’s potential but on the prospect for short-term share price movement. Indeed, an increasing amount of the trading is carried out without any human intervention at all; it is executed automatically on the basis of algorithms tracking market movements by the microsecond.

This has led progressively to a change in the nature of shareholders, who on the whole no longer see themselves in their traditional role as the ‘owners’ or long-term custodians of the business. This in turn has resulted in a change in the relationship between company management and shareholders, with
‘engagement’ by the latter progressively taking the form of increasing or decreasing their holdings rather than getting involved in dialogue with the company’s management.

This is hugely important because the whole basis for UK corporate governance rests on the concept of ‘stewardship’, which makes assumptions of shareholders’ perception of – and willingness to fulfil – the role of stewards.

As a consequence, codes of conduct defining best practice in corporate governance – no matter how well drafted – fail to have their intended effect.

The traditional long-term shareholders such as insurance companies and pension funds represent a declining force in today’s markets which are dominated by fast-trading funds. The investors in these funds are usually funds themselves, thus setting up a complex chain of intermediaries between the quoted company and the eventual beneficiary, namely the individual with their savings or pension. As Professor John Kay pointed out in his recent Review, neither the companies nor the end-of-the-line investors have done very well out of the system in recent years, whereas the intermediaries have flourished.

The problem that this gives is that there is unrelenting pressure on publicly quoted companies to deliver short-term results – for the year, even for the quarter – much like a football manager being judged on the outcome of the most recent string of matches. The aim, therefore, within the company is not just to keep growing profits quarter-on-quarter but to stay in line with market expectation. When company boards sit down to review results or outlook, they compare the figures not against budget or plan, but against ‘consensus’: the prevailing view of what the market expects. It becomes a matter of expectation management as much as delivering business performance. If the results are likely to fall short, the company will inevitably be obliged to issue a profit warning. This is not necessarily an indication that the company is in trouble or making losses; it is simply an indication that the company does not believe it will meet the market’s current expectations for the immediate reporting period. Nonetheless, the result is almost invariably an immediate drop in share price.
Given such pressures, it is not surprising that corporate management responds accordingly. The short-term becomes the overriding focus of company performance, which is then reinforced by financial incentive schemes to reward the achievement of short-term goals. This played a big part in the 2008 financial crash, when companies like Northern Rock delivered exactly what was being asked of them – to the delight and applause of investors, market analysts and financial journalists – right up to the point where the shaky platform underpinning their continuous high growth collapsed.

Given any market turndown, the immediate pressure is to cut costs – rein in investment, cut capacity and reduce staff – even where this impairs long-term potential.

Indeed, if a company has strong long-term potential but indifferent short-term prospects, then it is likely to come under pressure to sell the business. Once a bid is made, either welcome or not, new investors move in buying out the existing shareholder base. Thus the whole future of the company rests for a short but critical period in the hands of investors who have no interest in the business beyond a few weeks.

The problem that this overall emphasis on the short-term gives the nation is that it impedes genuine wealth creation. Wealth is created (as opposed to being just moved around) by the long-term development of solid businesses: companies which invest in skills, research, product design and development. There has to be more incentive to invest in such companies. There is nothing wrong with speculation, indeed it is essential for market liquidity, but it cannot be allowed to be the dominant force driving corporate behaviour. Speculation has to be recognised, and treated, as something different from investment.

Given the nature and extent of the problem, one might think that it is insoluble. But that’s not the case. Indeed, most corporate executives and many investors would love to be allowed the scope to take a longer-term view.

Exhortation, which has been the approach to date, will do nothing to change the system. Further revision of an already excellent code of governance will have no effect either. You
cannot expect people to act contrary to what the system in practice demands of them. Someone managing my savings or pension fund is currently acting entirely in my interest by getting in and out of shares at the right time. The rules have to be changed. There has to be greater incentive for long-term investment. This can only be brought about by changes in regulation and taxation. These words inevitably have a negative connotation, but financial markets only exist because of regulation. Indeed, London’s reputation as a global financial centre is heavily dependent on the confidence in the way it is regulated and operated. And changing the rules of taxation doesn’t mean extracting more money from society but providing incentive to grow the economy, which in the long-term means generating money for society.

Possible courses of action include such things as tax incentives which promote long-term shareholding; reviewing accounting standards and statutory liquidity requirements (which in recent times have obliged pension funds to reduce the proportion of their assets invested in the stock market); requiring executive pay to be biased more towards long-term results; and tying shareholder rights to long-term holding.

Any such changes would require careful thought to avoid infringing the law of unforeseen consequences. For example, the greater emphasis on seeking an increased proportion of long-term shareholders has to be balanced against allowing the protection of entrenched poor management. It is important that underperforming companies, which fail to make the most of their assets or potential, should remain prey to intervention.

Also, many will recoil at any thought of changing any aspect of a long-established system, with its underlying principles of treating all shareholders and all transactions equally, but without these types of changes the UK will remain overly dependent on financial services and will never invest in the kind of companies on which its future economic prosperity needs to be built. We will never ‘re-balance the economy’ as everyone seems to be parroting.

We have a powerful engine for growth in the stock market, but we are not using it for the purpose for which it was originally
created. And, in doing so, we are not requiring, or indeed allowing, shareholders to play the role which good governance expects of them.

May 2016
“Progress is impossible without change, and those who cannot change their minds cannot change anything.” So said George Bernard Shaw.

The collection of essays, first published in 1990 under the title *Creative Tension?*, considered the relationship between companies and institutional shareholders. What is striking reading those essays today is the similarity between the arguments used then and now: concerns about company short-termism, board effectiveness and the influence of institutional investors, to name three. It would be tempting to conclude that nothing much about the debate on corporate governance has changed over the past quarter-century.

Yet in one crucial respect, there has been real change. Over the past 25 years, the evidence base on these issues has lengthened – and strengthened. In this short essay, we set out some of this evidence on corporate and investor behaviour, and in particular on short-termism. To paraphrase Keynes, while our minds may not have changed, the facts have. That being the case, the time may be ripe for a change of mind – and perhaps public policy approach – towards corporate governance.

**Evidence on short-termism**

There has been a range of studies, both quantitative and qualitative, over the past two decades assessing the relationship between companies and their shareholders and the way this has
affected the behaviour of both. We consider the evidence, first, on the behaviour of companies and then their shareholders. In practice, of course, those behaviours are often closely intertwined.

(a) Company behaviour
One set of studies has used survey techniques to understand company decision-making, asking executives to evaluate the constraints facing them. For example, a survey of over 400 US executives in 2005 found over three-quarters would sacrifice a net present value positive project to smooth their earnings. More recently in the UK, the Cox Review in 2013 found that 60% of business leaders, 92% of Institute of Directors members, 86% of trade union representatives and 67% of Intellect members thought short-termism was a significant impediment to the growth of British business.

An alternative lens on company behaviour comes from assessing what they are doing, rather than what they say they are doing. One interesting metric on behaviour comes from looking at the amount companies choose to distribute to shareholders, whether in the form of dividends or share buy-backs, by comparison with the past.

When the public limited company was in its infancy during the mid-19th century, the pattern of dividend pay-outs was broadly symmetric. That is to say, companies were as likely to cut as raise dividends. Today, the situation could not be more different. The likelihood of a company cutting dividends has fallen from 50% to below 10%. Rather than being a source of financial flexibility, dividend pay-outs have become a source of financial rigidity.
And it is not just the rigidity of pay-outs which has increased, but also their scale. Back in the early 1970s, the average US public company paid out around 10 cents for every $1 in profits, as dividends or share buy-backs. The remainder was ploughed back. By the 1990s, that pay-out ratio had risen to 20–30 cents in the dollar. Today, it is closer to 50–60 cents in the dollar, with close to half now taking the form of buy-backs rather than dividends.

This pay-out behaviour has two, potentially adverse, knock-on consequences. First, it means that sizable chunks of financing are being taken out of the public equity market. In fact, buy-backs of stock have comfortably exceeded new issuance of shares by UK companies over the past 20 years or so. A similar pattern is evident in the United States. Rather strikingly, public equity markets are no longer a net new source of company financing, at least among the largest UK and US firms.

That trend is mirrored in the pattern of listings by large firms on the world’s major stock markets. These have been in retreat over a number of years, particularly so in the UK and US. In the UK, the number of firms listed has halved since 2000. The number of IPOs and newly listed companies has more than halved over the same period. The message is clear: public equity markets appear no longer to be large firms’ preferred means of mobilising financing.

Second, every dollar paid to shareholders is a dollar not reinvested in that company. Of course, that money may be recycled into other companies with better prospects. But given the shrinking scale of public markets in aggregate, that recycling appears not to be happening among publicly listed companies. To that extent, shareholder pay-outs are prospectively acting as a drag on longer-term investment by public companies.

There is some evidence, looking across both companies and across time, of that being the case. Business investment across the major advanced economies, relative to GDP, has been falling for several decades, both before and after the crisis. That is one reason why global real rates of interest are so low at present, reflecting the imbalance between world desired savings and planned investment.

Looking more specifically at R&D investment tells an even less encouraging story, at least for the UK. Business spending on R&D
in the UK, relative to GDP, has been gently declining for a decade. The UK is rooted at the bottom of the G7 R&D league table. In 2014, there were only 80 patents per million inhabitants among UK companies, well below the EU average of 109. Only three UK companies lodged more than 100 patents in 2014.

Of course, there are many reasons for this poor investment performance, many unrelated to corporate governance. Nonetheless, studies which have compared broadly equivalent companies, public versus private, suggest there is some causal link. Privately owned US companies invest more, and are more responsive to investment opportunities, than equivalent public companies. And when firms switch from private to public, they tend on average to reduce their number of patent citations and their investment.

This pattern is replicated among UK firms. The capital stock of private companies, relative to their turnover, is consistently higher than for equivalent public companies. On average, UK private firms plough back between four and eight times more of their profits than equivalent publicly held firms. The rising tide of investor pay-outs has had real consequences for business investment.

(b) Investor behaviour
Company short-termism may itself be no more than a mirror image of behaviour by shareholders. And here, too, the evidence has moved on over the past decade or so. Some studies have surveyed investors to understand their behaviour. For example, a 2004 study of members of the Investment Managers Association (IMA) and the National Association of Pension Funds (NAPF) found between a third and two-thirds of members respectively believed their mandates encouraged short-termism.

Perhaps the simplest metric on the changing nature of share ownership is found by looking at average shareholding periods. In 1950, the average share was held by the average investor for around six years. By 1990, that holding period had fallen to around three years. Today, it is around six months. This pattern appears to be mimicked internationally.

Of course, there are a number of factors responsible for these short-termist trends. One is the rise in the importance of
so-called high frequency trading, where holding periods can often be fractions of seconds. This would tend to distort downwards the average shareholding period. But it is not the whole explanation. Among other cohorts of investors, there have been important changes in shareholder ownership and structure over recent years, which may have blunted incentives to engage in active stewardship of companies and encouraged short-termist behaviour.

Comparing patterns of share ownership today with those 20 years ago, the picture this paints is of an increasingly splintered and distant investor base. Underlying this have been two structural trends. First, ownership of shares by institutional investors (insurance companies and pension funds) has fallen dramatically, from more than half the market in 1990 to less than 15% today. To the extent these institutions are more likely to pursue longer-term investment strategies, this may have had an important effect in lowering average investor time horizons.

Second, there has also been a significant fall in individuals’ direct equity holdings. Many more equity assets these days are held indirectly, through collective investment funds, often invested on an indexed or passive basis. That trend has put greater distance between the ultimate beneficiary of an investment and the company in which they are invested. It may also have increased the degree of herding behaviour in the market.

A different way of assessing the behaviour of investors is to look at the way they price companies in financial markets. For example, is there evidence of investors discounting too heavily the longer-term cash-flows companies generate, thereby making less attractive – perhaps un-investable – long-lived investment projects? This is something recent studies have sought to assess.

The bottom line from these studies appears to be that, yes, there is evidence of such “excess discounting” of longer-term cash-flows. Moreover, this short-termism appears to have risen over time. There is little evidence of excess discounting prior to the 1990s. But in the period since, short-termism has been present on a material scale: hurdle rates for investment have been 5–10% per year “too high”. This is sufficient to have had a dramatic impact on the viability of longer-lived projects.
This under-valuation problem appears, moreover, to be particularly acute among certain types of asset. Intangibles – such as goodwill, human capital, patents, intellectual property etc – appear to suffer particularly acutely from this under-valuation problem, perhaps because they are more difficult to value by investors and are only sporadically reported. Since many of the newer and more innovative companies these days are likely to have a high ratio of intangible to tangible assets on their balance sheets, this myopia could have significant implications for R&D investment.

This, of course, is just analysis. Yet it is striking that this analysis is increasingly finding voice among a wide cohort of stakeholders, from academics, to investors, industrialists and politicians. Take these four recent quotes, which are striking in the commonality of their message:

“(the public company) has created more prosperity and misery than could have ever been imagined. As time goes by, the balance is moving increasingly in the latter direction – the corporation is becoming a creature that threatens to consume us in its own avaricious ambitions.”

“More and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buy-backs or dividend increases, while under-investing in innovation, skilled workforces or essential capital expenditures to sustain long-term growth.”

“(public companies are) the dumbest idea in the world.”

“Too many pressures in our economy today are pushing businesses towards short-termism – a focus on the next earnings report or the short-term share price, rather than the sources of long-term growth and lasting value.”

The quotes are from, respectively, Colin Mayer (Professor of Economics at Oxford University), Larry Fink (CEO of BlackRock, the world’s largest asset manager), Jack Welch (former CEO of General Electric, the world’s largest company at the time) and Hillary Clinton (US presidential candidate). This is a broad church, if not a universally accepted religion.
What is to be done?
If there is now a stronger evidence base, and a wider and deeper body of opinion, on the potential corporate governance problems associated with public companies, the next question is what, if anything, could be done to improve matters?

The first thing to recognise here is that progress has already been made over the past few years across a number of fronts. In the UK, this has come partly in response to the review of short-termism conducted by John Kay in 2013. For example, since that review the first steps have been taken to put in place an Investor Forum – a mechanism for co-ordinating the actions of institutional investors so as to enable them to better exercise stewardship over the companies in which they are invested. The Investor Forum is still in its infancy and its success is, thus far, untested.

A second area of progress is in moving away from requirements to report quarterly results, again as recommended by Kay. The EU Transparency Directive Amending Directive removed the requirement for interim management statements (“quarterly reporting”). For UK firms, this took effect in November 2014. While a number of firms have exercised their option to stop quarterly reporting, a large number have continued to do so, in part it seems due to pressures from investors.

It is important to recognise that there is unlikely to be any single, silver bullet solution to these complex corporate governance issues. That is because they have no single source, reflecting multiple incentive problems among multiple stakeholders: shareholders, creditors, managers, end-investors, asset managers, investment consultants etc. Indeed, these incentive problems have probably grown with the lengthening of the intermediation chain over the past few decades.

This also means that solutions aimed at correcting one set of problems could potentially exacerbate problems elsewhere. One prominent example of this is remuneration. During the 1980s, there was a big push for equity-based remuneration packages for executives. This had a straightforward and sensible rationale: it aligned the incentives of executives and their shareholders. What followed was dramatic. Among US CEOs, stock and stock-based
compensation packages rose from around 10% of total compensation in the 1980s to more than half today.

In practice, while better aligning the incentives of shareholders and managers, equity-based compensation packages may have worsened other sets of stakeholder relationship. For example, they appear to have encouraged management to undertake share buy-backs, at the expense of reinvestment, to raise earnings-per-share and boost executive compensation. And there is evidence that bank CEOs with large equity stakes in their firms engaged in “gambles for resurrection” during the financial crisis, effectively shifting risk toward other stakeholders, such as creditors and governments.

With this cautionary tale in mind, what other initiatives might be worth considering to tackle the short-termism problems outlined earlier? Let me mention four.

First, remuneration. There is some good progress to report here, at least among banks. For example, new regulatory requirements have lengthened the period over which discretionary payments to executives can be deferred or clawed back, to seven years or more. This will tend to reduce managerial short-termism. Those requirements do not, however, apply to non-banks. Moreover, levels of equity-based compensation among executives in both financial and non-financial firms remain high. A remuneration structure which paid less in equity and cash, and more in debt, might be preferable from a risk-taking perspective.

Second, transparency. Reporting is not an unalloyed good, as experience with quarterly reporting may have demonstrated. What matters is the nature and quality of reporting, rather than its quantum. For example, despite the relentless rise in the length of company annual reports, there still appears to be a gap when it comes to reporting of intangible assets. As these are a high and rising share of total company assets, this problem is a potentially serious one. Take intellectual property. Unlike physical property, there are no valuation conventions which enable it to be recorded, accurately and consistently, on the balance sheet. This is a reporting problem that can, and probably should, be fixed over time.
Third, control rights. Here we have seen, in a number of countries over the past few years, attempts made to rebalance the scales towards longer-term investors. For example, in the US we have seen the emergence of so-called “proxy access”, which gives longer-term shareholders the right to appoint directors on their behalf. This has been a market-led initiative, rather than a legal or regulatory initiative. In France and Italy, laws have been passed which confer extra voting rights on investors who hold shares for longer periods. And a number of high-profile companies, such as Facebook and Google, have gone one step further and issued dual-class shares, where one class of shareholders effectively sacrifices their voting rights. These initiatives, while fledgling, no longer look as radical as they would have done a few years ago.

Fourth and finally, company law. The “shareholder primacy” model has served the world well. But there is a legitimate question about whether it achieves a sufficient degree of balance among the various stakeholders in a firm – employees, customers and clients, wider society etc. The UK and US are towards one end of the spectrum in their degree of emphasis on the shareholder. The “enlightened shareholder interest” objective embedded in the UK’s 2006 Companies Act has not always been as enlightened as some might wish. It may be time to reconsider the statutory objectives of companies, in light of the experience over the subsequent decade.

These are, at this stage, no more than speculative ideas. Whether any of them could be put into practice will have to await the third instalment of this publication, perhaps a quarter-century hence. But there are grounds for optimism. Over the longer run evidence and analysis tends to weigh, whether in the functioning of financial markets or in the design of public policy. Benjamin Graham, the original value investor and long-termist, said “in the short run the market is a voting machine, but in the long run it is a weighing machine”. Public policy is much the same.

May 2016
Modern business, modern markets

Professor John Kay CBE
Economist and author, Other People’s Money

Stock markets of the kind we recognise today owe their existence to the development of railways in the 19th century. Railways were large, capital intensive businesses, and their physical assets were specific to their particular purpose. There is little you can do with a railway except run trains on it. The funds required were raised from a wide group of relatively affluent private individuals. The stock market both provided a focus for the raising of funds for railway construction and allowed secondary trading so that savers could realise their investment without disturbing the train timetable.

This model was successfully extended to the large manufacturing corporations which were at the centre of the industrial landscape for much of the 20th century – breweries, automobile plants, petrochemical installations. The shareholders provided the plant, the workers operated it, the managers oversaw the process.

But this does not describe the typical corporation of the developed economy of the 21st century. Business is no longer capital intensive. Apple is today the largest corporation in the world with market capitalisation approaching $600bn, but owns operating assets valued at less than $20bn, and is typical of the ‘new’ companies that have come to dominate the global economy in the last two decades. Such capital as these businesses do use is largely fungible – it need not be owned by the business which operates from it, and typically is not. Apple’s flagship store in Regent Street is jointly owned by the Queen and Norway’s sovereign wealth fund: on behalf of the citizens of the UK and Norway respectively (the profits of the Crown Estate are ceded to the Treasury). Such is the nature of capital, and capital ownership, in the modern economy.
Modern businesses are typically cash generative at a much earlier stage of their lifetime. When they come to market – and some are querying the need to do so – it is to provide a liquidity event for early stage investors and for employees rather than to raise funds for new investment. And established companies, too, are increasingly “capital light”. Even large oil companies, with large exploration and development programmes, earn more than sufficient from their operations for their needs: the value of repurchased shares in ExxonMobil’s treasury exceeds the value of its operating assets. In both Britain and the United States, amounts taken out of the market through share buy-backs and acquisitions for cash have exceeded the amounts raised through new issues over the last two decades. The stock market is no longer a means of putting money into companies, but a means of taking it out. This is not an unworthy or economically undesirable function, but it is different from the market’s traditional role.

At the same time as business has changed, so has the nature of savings and the channels through which these funds are directed. Outside the United States (and to an increasing extent even in that country) household savings are institutionalised. Two decades ago, UK equity markets had become dominated by large insurance companies and pension funds. But events have moved on further. Insurance and pension funds have outsourced or divested much of their asset management, while equity investors worldwide have begun to discard their ‘home country bias’, a preference for securities registered in the investor’s domestic market. More British savings are invested outside British markets, and sovereign wealth funds and other foreign investors now account for a large share of UK companies. The dominant player in UK equity markets today is the large asset manager. Many of these are American headquartered firms – BlackRock, Fidelity, Capital, Vanguard – but all maintain substantial operations in London.

The simple, but not inaccurate, historical caricature of the large listed corporation – the shareholders finance and own the plant in which the workers are employed – no longer describes business. What the shareholders of Apple own is a claim against the future earnings of the company. These earnings will be the product of the company’s brand, the creative energy of the
team’s work there, its iconic designs. The loyalty of Apple customers, on which these earnings depend, is in part the result of spontaneous affection for the product, in part enforced by Apple’s proprietary operating systems.

And so the boundary between the property of the stockholders and the property of the employees, once relatively clear, is blurred. It is a corporate cliché that ‘our people are our most valuable assets’, and, like many clichés, it is often true. But if your most valuable asset goes home every evening, and can terminate his or her contract with you at short notice, your claim to ownership of such assets is tenuous.

This change in the nature of the corporation necessitates a change in the relationship between the company and its shareholders. If I acquire a share of your future earnings, I cannot be an arm’s-length owner of the asset I have purchased. A people business is intrinsically a partnership between its employees and its investors. The alignment of interests that follows from employees maintaining a substantial equity stake is an essential part of such a structure. Indeed, the transaction could only sensibly occur in the first instance on the basis of a relationship of mutual trust and confidence. (Importantly, there is no equivalent necessity in the traditional corporation: in these the commitment to the company of a particular management team is typically a rather modest part of the overall value of the business.)

In some instances, partnership may be the appropriate organisational form: in retrospect, the easy presumption of the last two decades of the 20th century that the listed company should not only be the dominant form of economic organisation of medium and large enterprises but the only form of economic organisation appropriate for such enterprises was a mistake. Too often conversion to a listed public company was the result of a greedy generation’s anxiety to realise the goodwill created over a long history for the benefit of those who had the good fortune to be around at the time. Shareholders in financial businesses which became limited liability companies and floated on public markets did not do well: neither former building societies nor investment banks proved rewarding for their shareholders. They fell victim to two problems: the asymmetry of risk allocation, in
which employees shared the profits but not the losses from highly leveraged equity: and a clash of organisational culture within the firms which was incapable of maintaining a relationship of trust and confidence with outside investors.

External ownership of people and knowledge businesses demands an understanding of the business, and a familiarity with the people and knowledge substantially greater than that required when the assets of the business take the form of tangible assets you can see and touch. That has implications for the portfolios of those who invest in them, inviting greater engagement of a substantive kind, not simply the box-ticking of proxy services and some corporate governance departments. For such companies, governance and investment management are, or should be, inseparable.

It may be time to rethink the general hostility to multiple share classes which is visceral in Britain. Historically, these structures were typically used to maintain family control of a business in which the primary economic interest had passed to outsiders. But for Sergey Brin, Larry Page, and Mark Zuckerberg and their senior colleagues, the businesses they control are in a real sense still their businesses even after a majority of the shares are held by others; they are dependent on the founders not just for the realisation of their ideas, but for the development of their long-term value. In a world of algorithmic trades and ‘activist’ investors, there is nothing improper – or against the properly understood interests of long-term investors – in entrenching the role of charismatic founders and their management teams: and doing so may be a necessary condition if these charismatic founders are to allow such companies to be brought to market at all when there is no need of external capital.

Our markets need to adapt to the changed nature of 21st century business if they are to remain relevant in a world in which capitalism has little need of capital.

May 2016
A moving landscape
Since the financial crisis, the roles of both investors and boards have been thrown into the spotlight. The last few years have seen the rapid development of corporate governance codes for firms and stewardship codes for investors. Expectations on both sides have been ratcheted up.

The operating context is also changing. Waves of mergers, consolidation and expansion have created companies that are large, multifaceted and global. The shifting macro environment has also brought cyber risk, disruptive technologies and economic challenges.

Against this fluid background, five factors stand out as central to helping boards of companies to navigate change and to create the framework to reassure investors and provide a long-term competitive advantage.

1. Evolving boards
A starting point is to recognise that effective boards have to be organic, changing over time as the companies they govern change and the external environment alters. A board that recognises long-term trends and is diverse, transparent and open to change will be better placed to create sustainable growth and meet modern governance requirements.

The composition of the board should encourage diversity of thought (which is helped by different backgrounds) and reflect experience in the markets in which the business operates. Regular evaluation of the board’s structure and effectiveness is important.

To aid increased diversity, the pool of potential candidates considered for board seats should be wide, including candidates...
from different nationalities and industries. There should ideally be a balance between generalist experience and expert knowledge.

Boards should also be prepared to look beyond traditional quoted company experience to sectors such as charities and the public sector, and should spend time to provide the appropriate skills to new non-executive directors.

2. The challenge role of non-executive directors
NEDs play a range of roles as constructive and independent challengers. Their contributions cannot be underestimated. Crucially, they bring the helicopter view to the boardroom table, ensuring a broad perspective that balances management focus and detail. So how can NEDs best contribute?

Effective boards will enable non-executive directors to offer their input based on individual and collective experience, drawn from other boards and organisations. Their help will be sought in developing and challenging proposals on company strategy and they will scrutinise the performance of management in meeting its objectives. Having agreed strategy, a Board’s duty is to ensure it has the best team available to implement.

NEDs need to be kept up to speed in developing areas such as regulation or technology so that they are in a position to seriously challenge executives about strategy and risk. They also need to be close enough to the company and sectoral realities to ask the right questions, but detached enough to avoid cosiness and groupthink.

In undertaking their tasks, NEDs often take on a heavy workload as members of the Board’s committees. They need to be available to meet with regulators, suppliers of services and even shareholders when required, although the main engagement channels should be via the Chairman (or SID) on governance matters and the CEO or CFO on investment and operational matters.

More and more is being demanded of NEDs, particularly in the financial sector, and it will be important to ensure that they receive the appropriate support to deliver any significant increase in duties or expectations. Many Boards underestimate
the time they require of NEDs and this is particularly true of the Chairmen and Committee Chairs. Despite this the debate on appropriate remuneration has hardly begun and remuneration is likely to have to rise significantly in the coming years to attract appropriate talent, given the time commitment.

3. Effective succession planning
A well-run Board also needs a succession plan that is forward-looking and broad-based, covering both executive and non-executive directors.

The plan will map current and expected future skills needs, enabling an understanding of whether the present board is in a position to meet or develop its future skills needs, or if a refresh is required.

In considering new candidates, it is vital to factor in boardroom dynamics. This places a premium on personality types and identifying softer skills. Would the current board benefit from a dominant challenger or a diplomatic consensus-builder?

When planning ahead for key roles such as the CEO, Chairman or Senior Independent Director (SID), companies need to consider various change scenarios and track potential candidates to ensure the broadest possible pool is available when needed. Forward-looking companies should also have internal development plans for high-potential candidates – the “leaders of tomorrow” – which seek to enable the best possible diversity, both of gender and experience.

One key part of that development is the experience gained by more junior executives when given the opportunity to take on a non-executive role, perhaps at a smaller company. It should broaden their skill set, better equip them for a future seat at the Board, and provide an external perspective to complement their existing role.

Boards operating in a global market typically have to recruit from a highly competitive global talent pool. This will entail appropriate incentive packages. The breadth of roles and potential liability, both legal and reputational, attached to board positions means that extremely high-quality individuals with a
rare mix of experience are required. As such, the talent pool is not only global, it can often be small.

Any remuneration decisions need to factor in performance, risk and long-term value for shareholders. Appropriate measures should be in place to protect against payment for failure.

The totality of this approach requires time, investment and ongoing focus. Properly executed, it will provide long-term benefit to the company.

4. Structured shareholder engagement
The Board should be proactive in managing its relationship with shareholders. The CEO and CFO should conduct a well-planned programme of face-to-face meetings, while the SID should also be accessible for meetings with major investors to understand their positions on key issues.

The Chairman should lead a programme of regular engagement with the firm’s key investors to discuss governance matters. Even where there are no specific issues to discuss, being available and accessible ensures that communication channels stay open and relationships need to be built so that future difficulties can be quickly addressed.

5. Quality of disclosure
Standards of market disclosure have increased markedly over the last 20 years and the internet has made it easier than ever to communicate with investors and for investors to engage. The proliferation of information, however, has also made it easier to be informed without engaging, to substitute packaged data for dialogue.

This makes the quality of disclosure just as important as the quantity. Meaningful disclosures are more relevant and beneficial to shareholders than voluminous, boilerplate tomes. Companies must strive to ensure that financial reports, and other disclosures, tell the firm’s story and focus on its company- or country-specific information while avoiding unnecessary clutter.

Information should be presented in an easily accessible way, helping readers to understand the company’s financial
performance and position. Financial statements, in particular, should be clear and concise, ensuring that material data is not obscured by irrelevant information.

**The foundations for long-term success**

We are unquestionably in a process of evolution in the nature of the corporate board. Our shareholders, staff, customers and others have further expectations than was the case when the predecessor to this essay collection was published.

The five factors outlined above provide a bedrock for effective corporate governance and shareholder engagement. Nonetheless, the challenges that will face the Chairmen who contribute to *Creative Tension?* in 2040 will be recognisable, but may well include developments that have moved and formed in unexpected ways.

As such, we must continue to innovate and adapt. In this way, we will be best placed to manage our risks and seize the opportunities that will provide long-term benefits for our shareholders, customers, staff and the broader economy.

May 2016
Shareholders are meant to focus on creating long-term value, but is this possible in an environment that measures returns daily and where analyst reports focus on this and next year’s outcomes? Similarly, public companies’ mission is to deliver superior results over the medium term, yet they are measured quarterly.

The art of creating long-term returns is investing for the future by sacrificing returns today. However, is it realistic for a CEO to take the personal risk of sacrificing returns today for greater returns tomorrow? Given the short survival rates of CEOs, this is questionable. Yet for medium-term value creation it is imperative that they do.

The reality is our public companies are generally unsustainable. Only a few survive as thriving entities over the medium term. In the UK, the FTSE 100 index started in 1984. When the index celebrated its 20th anniversary, only 23 of the original 100 remained.

The reason is industries have life cycles – they grow and fade. Successful companies buy up unsuccessful ones. Companies make mistakes, and fall behind relatively as they recover. Focus is placed on short-term performance, which leads to under-investment for the future and the ultimate decline of the corporation.

Corporate sustainability
A new philosophy is therefore required. At its heart is a genuine focus on long-term returns and the creation of sustainable corporations. A number of themes emerge.

— The purpose of a company should be to produce acceptable returns for shareholders over the long-term while delivering acceptable short-term outcomes.
— Those companies that find their unique place in the world win over others who are not unique. Those that have a sustainable reason for existing systematically win over those who do not.

— Winning companies focus not only on what they can gain financially from success, but on how they can make a lasting contribution to society.

— Leadership of sustainable companies is based on principles.

Winning companies make it their mission to make a long and lasting contribution to all stakeholders, as well as producing superior financial outcomes. They are very clear why a customer should deal with them and not with another, why suppliers give them priority, why their people should invest their working lives in their adventure, why the community should trust them and why shareholders should invest in them.

There is a difference between a system governed by principles and one controlled by rules. Principles define the centre of gravity, or the ideal state, or what is desired. Rules define the boundary of what is acceptable. If the speed limit is 70 miles per hour on a motorway, that tends to become the minimum.

Running an organisation by rules generally leads to a company that operates at the boundary of what is tolerable. Embracing principles requires a strong ethical and moral foundation and a long-term focus that strikes at the heart of what we are trying to create, and creates an environment where people are inspired to do the right thing.

**Shareholders**
In making the shift towards sustainability, we need to recognise
it is no longer sufficient to have an agenda purely around shareholder value. We only need to look at the recent corporate underperformance based on short-termism and greed to realise the limitations of wealth creation as the sole purpose of companies. Such a focus can lead to the wrong behaviour and decisions.

A sustainable corporation requires a more balanced agenda around all stakeholders – customers, suppliers, partners, community, people – as well as shareholders.

We are in business to produce excess returns over the cost of capital. Over time, excess returns fade to the norm. Capability needs to be invested in, and constantly renewed.

Of course it is necessary to survive if we are to succeed long-term. However, the harsh reality of today is that the short-termism of markets means that survival and success today matters more than success tomorrow. Staying alive and living for today in business has come to dominate preparing ourselves for a longer journey. Making money matters more than making a contribution.

Such an approach cannot be justified. The bias of our focus cannot be just on today, but instead it must be on longer-term success.

**Shareholders and stakeholders**
Any discussion on corporate sustainability begins with the premise that we are in business to serve customers, and that we do so with people, partners and suppliers, in order to produce returns for shareholders.

The only long-term source of value is revenue. While cost and capital are important, these are inputs to generating a future revenue stream. It is customers that produce revenues. While a great deal is claimed that “customers come first”, sadly this is rarely close to being the case. The key is to offer customers something important to them that they cannot get from someone else. There needs to be a tangible and sustainable reason why customers should deal with us, that is unique to us. We should position ourselves to then own this space, and ensure we execute this effectively.
At the same time, it is important to consider our suppliers as long-term partners, and to be relationship-based in the way we deal with them, in recognition that we could not succeed without them. They are an essential part of our enterprise.

We often forget that it is our people, and how they work together, that makes a company great. It is our people who serve customers and create new ideas. Our responsibility as leaders is to create an exciting but safe adventure for our people, that is worthy of them devoting their lives to it. How people feel about working in the organisation, and how passionate and engaged they are in its agenda, is what makes the difference between good and great companies. Our people innovate and produce results, and we in turn provide them with opportunity and development.

The responsibility of a company to a community appears obvious on the surface, but for public companies it is more complex, as we need to justify our actions to our rightful owners, our shareholders. As a banker, today I am ashamed of the reputation of our banks. I joined the industry over 40 years ago where the bank manager was the doyen of the community. Not so today. We must return to the philosophy that banking is a profession as well as a business, and that contribution rather than reward is its centre of gravity.

Now what about shareholders? What are our responsibilities to them? This raises a number of questions.

Which shareholders – the ones who are shareholders today, or potentially tomorrow? Since institutions tend to be measured on annual relative returns, rather than absolute, they tend to switch in and out of stocks – overweight or underweight.

This has caused the market to be shorter-term in its orientation, causing a management focus on annual out-performance to reward current shareholders. This, in turn, leads to under-investment in the future and damages shareholders who stay with us and don’t take their profit today.

For this reason, the focus of management should be on superior performance over the long-term, while producing acceptable rather than superior returns in the short run.
Making long-term focus a reality
A company is not simply a financial construction; it is much more than this. A vibrant company is more than the sum of its pieces. It is a synergistic space where one plus one equals much more than two.

We can generally sense when a company is working and when it isn’t when we interact with it. We can tell if it is interested and engaged with us or not. We can also sense when a company lacks the vital ingredients for success. If we can sense these things, a company must be more than its property, its people, its products and its capital. What we sense is its true essence, and how alive, energetic and purposeful the company is.

A company needs to make a return, but it must also stand for something beyond this. It needs a higher purpose that is the centre of gravity that governs all decisions within the firm. At the heart of this is a genuine focus on long-term value creation while finding a balance between all stakeholders.

We are each on this planet to make a contribution to the world in our lifetimes. People are searching for meaning and how they can make their own unique contribution. This is an age where humanity and community matter as well as financial returns. Finding this foundation underpins a longer-term philosophy.

As leaders therefore, we need to take the actions necessary to earn long-term trust and commitment as a foundation for long-term value creation. Our actions and decisions must therefore be socially beneficial, culturally desirable, ethically justifiable, economically feasible, ecologically responsible and, above all, convincing and transparent. The absence of such a balance perpetuates the myth, but its attainment brings alive the possibility of making long-term value creation a reality.

May 2016
Since the publication of the first collection of essays 25 years ago, much has changed in the corporate world. In this essay, I will look at three main areas of change both from the perspective of recent history and prospectively what we should expect in future: corporate governance and the role of a high-quality board, the dialogue between shareholders and company management, and the effects of technological progress on this relationship.

Corporate governance
There have been considerable changes to the model of corporate governance in recent decades. For instance, 25 years ago many FTSE 100 companies had a combined Chairman and Chief Executive. I was one of them and this often meant I ended up talking to myself!

The formal split between the Chief Executive and Chairman’s role caused controversy in some companies, but I think most now agree it was a critical step forward in the governance model. It has enabled the Chairman and the board to concentrate more on effective oversight of strategy, risk and controls rather than manage day-to-day operations, which are properly the responsibility of the executive management team.

Board structure
The structure and quality of many boards has improved significantly. Initially, the appointment of a senior independent director caused much consternation with some Chairmen protesting rather noisily about this imposition. Today, like most Chairmen, I value immensely an insightful outside voice on the board to act as a check on the internal corporate mindset. Twenty-five years ago, the appointment process was opaque and there was no limit to terms of appointment. There were no formal
board evaluation processes. Now most Chairmen take considerable care to consider carefully the domain knowledge, skill, experience and diversity mix to create an effective board.

*The value of diversity*

Three decades ago, women were a rarity in the boardroom as either executive or non-executive directors. This situation had to change. As a member of the Davies Committee, I was a strong supporter of the need for more women at the top of Britain’s major companies. We now have a situation where women account for more than a quarter of directors on our FTSE 100 boards.

We have to make further progress. Greater diversity in the boardroom is critical to a company’s success. In an increasingly complex and turbulent environment, a diverse range of backgrounds, skills and opinions is vital to guard against ‘groupthink’ and to provide adequate support to the executive management team.

One area where we have to make much more progress is in ethnic diversity on boards. Here, the UK lags behind the US. I am currently chairing a committee on behalf of the government to make recommendations to address this issue. We must ensure we are drawing board members from a wider range of backgrounds, to better reflect developments in society as a whole. Shareholder support for this initiative will be critical as there is often insufficient awareness of the growing ethnic diversity of the markets in which many companies now operate.

*The board’s role in corporate strategy formulation*

The process of how we build the strategy with an executive team and engaged board is an important context for discussion with shareholders. Companies do not always approach this topic in a consistent way. In my view, a good strategy process is a collaborative one in which the entire senior management team takes responsibility for the outcome:

— The CEO and the management team should formulate their strategic ideas and plans.
— The board should debate and stress test and adjust as required.
— The board should approve and empower the CEO to deliver.
— The board should hold the CEO accountable for execution and delivery of the plan.

The shareholder should ensure the right dialogue takes place with the Chief Executive on the quality of his resources and with the Chairman on the appropriate composition of the board. Shareholders influencing effective management in well-composed boards with enlightened leadership are likely to get the best results. Similarly, if remuneration systems are well aligned with the creation of value, then just rewards for shareholders and management should be achieved.

**Corporate behaviour and ethics**
In the mining industry, we have been at the forefront of thinking how our business behaviour affects the communities in which we operate. Given the nature of natural resources, this is essential for winning our licence to operate. It is vital that corporate management recognises the need to behave to a high ethical standard to build trust with all of our stakeholders.

For some critics, the maintenance of high ethical standards can often appear to be an unnecessary cost, which undermines the ‘bottom line’. Our social responsibility to manage the impact of our business on the local environment is often seen as a ‘soft’ subject, which shouldn’t attract shareholder attention. Yet I would argue that long-term value is best served through high standards of corporate behaviour.

**Shareholder dialogue**
In the mid-1980s, ‘Big Bang’ ushered in a new era in the City, with the rise of universal banks as investment and commercial banks took over traditional brokers. These structural changes have changed the previously close advisory relationship with brokers of the company. Historically, sell-side analysts worked closely with house brokers, improving the flow of information between companies and investors.

Recent regulatory changes have enforced ‘Chinese walls’ between primary and secondary equity business. While I recognise the regulatory need to avoid ‘insider trading’, I’m not certain the rigid separation that now exists serves companies
and their investors as effectively as in previous times. We could see the potential loss of sell-side resources as brokers cut costs, which would further hamper investor dialogue, especially for smaller companies.

I have had many valuable discussions with engaged shareholders ranging across corporate strategy, the potential for cost savings and what assets should or should not be part of our core portfolio. These are obvious direct value-driven conversations where shareholders with years of experience can add much value to a Chairman or Chief Executive.

There has been much less dialogue around the composition of the board and some of the ‘softer’ social issues that might appear less important to shareholder value. The critical questions about domain knowledge, the specialist experience or the skill sets that may be missing or the gender/ethnic mix seldom come up. Yet these qualities and the effectiveness of the board determines how well it can represent shareholder interests. I think this is an area where we can improve our relationship with shareholders. Most Chairmen welcome direct discussion around the composition and quality of boards.

Improving the relationship
In his review of the UK equity market and long-term decision-making, Professor John Kay highlighted the need for a higher quality dialogue between company management and long-term investors. I strongly believe it is in all of our interests to build these relationships, so that shareholders can better understand the context for management decisions, and senior executives have a stronger grasp of the financial implications of their decisions.

The value of the dialogue should primarily be around the priorities that flow from the company’s strategy. This is an area of legitimate challenge that can add real value to the Chief Executive’s thinking. Transparent feedback from this dialogue is critically important for the board. Brokers can play a role in facilitating a more open and challenging debate between companies and investors. A better quality relationship would enable shareholders to express their concerns to management in a more constructive and informative way than simply selling their shares. There is no substitute for direct one-to-one
engagement between Chairman and Chief Executive and key shareholders, supplemented by brokers synthesising the shareholder views of a company.

**Technological disruption**

Trading patterns have changed dramatically in recent decades. The electronic age has brought instantaneous and simultaneous trading to all parts of the world. Twenty-five years ago, a mobile phone was the size of a brick and carried in the boot of your car and you used it only to make telephone calls. Today, 60% of the global population have a ‘smart’ phone, which enables them to access real-time information whenever and wherever they want.

The pace of change in technology and the instant availability of information has created a starkly different environment for making investment decisions. On one hand, it has increased the availability of information to shareholders, irrespective of their size. Now, anyone can access real-time data on any company in any sector in any market of the world. In principle, better information should enable shareholders to make more informed investment decisions.

On the other hand, this new technology has heightened the risk of ‘short-termism’. Investors can buy and sell shares instantaneously at low cost. In this environment, there is a tendency for ‘over-trading’ among retail investors and greater pressure on institutional investors to improve their short-term performance. Research has shown the growing importance of ‘momentum’ trading, in which investors become more herd like. The rise of hedge funds has exacerbated volatility and put more emphasis on short-term performance, offsetting the benefits of improved market liquidity.

I don’t think it is inevitable that short-termism will continue or even worsen. But as the Kay Review highlighted, it requires a conscious effort among companies and investors to recognise the long-term nature of equity investments.

May 2016
Capitalism has always had its detractors, but over the last 10 years it has been under attack even in the very heartland of the industrial world. Income inequality and the distribution of wealth have entered the political mainstream in a way not seen for the best part of a century.

Financial capital is not the only sort of capital, of course – there are many others, including human and environmental. But the primacy of financial capital essentially defined the democratic free market economic model that rose to supremacy through the 20th century, and it is that which is now under attack.

Before answering the question of “what’s the point of capitalism?”, it is worth reflecting on the problems with capitalism, for even its most ardent supporters would agree that there are a few.

The first, and perhaps counterintuitive one, is that the less well-off are much more entrepreneurial than the better off: you have to be much more entrepreneurial just to survive if you are living at close to a subsistence level. All in all, in poorer countries people are more likely to be self-employed by a factor of between 10 and 30 times. We in the richer developed world are much more likely to take a comfortable pay check than risk a hit-or-miss start-up, so capitalism appears first to encourage entrepreneurship only later to stifle it.

The second problem with capitalism is that, despite globalisation, capital doesn’t flow freely to the budding entrepreneur in a developing country to allow her to grow her one person businesses to something larger, because, in practice, capitalism involves more than money. The heroic individual
entrepreneur who truly goes it alone is something of a myth. Most benefit from institutions and organisations of collective entrepreneurship such as farming co-operatives or seed corn capital, which give the small business the support to reach a wider audience. Developing countries often lack these collective mechanisms and thus entrepreneurs struggle to develop their businesses beyond a certain level due to a lack of skill or resource to expand further.

Capitalism therefore needs more than money – it needs collective structures to support it.

The third problem of capitalism revolves around the question of, “when is an owner not an owner?” The answer may be when they are a shareholder. The first joint stock company was created in mid 13th-century France. With the creation of the first stock exchange in the 17th century, it became even easier to attract capital from investors, because they could now more easily dispose of their shares. This was in some ways a retrograde step, because now FAST MONEY, more interested in the price of a share than in the long-term good or value of the enterprise, entered capital markets for the first time.

This difference between fast money and slow money is at the heart of the challenges that perplex many investors today. The interests of the shareholder who invests with a 10-year view are very different to those of the day trader or high frequency trader. Yet on most exchanges there is no distinction between the holder of 10 years and 10 seconds nor in their respective voting rights. Arguably, employees, suppliers, bond holders and possibly customers have interests much more aligned to the long-term
interests of the business than short-term shareholder “tourists”, yet only shareholders have a vote.

They have a vote because, in theory, they are last in line when a corporation fails – except, since the introduction of the limited liability company, they have less on the line than one might think. Prior to that, owners of businesses risked everything, including personal property and even their freedom if they couldn’t meet their debts. No wonder the limited liability joint stock company, where the upside could be infinite yet the downside was always limited, became the capitalist vehicle of choice. Even Adam Smith was nervous about limited liability, saying:

“Directors of joint stock companies..., being the managers of other people’s money than of their own, it cannot well be expected that they would watch over it with the same anxious vigilance with which private partners frequently watch over their own... Negligence and profusion therefore, must always prevail, more or less in the management of the affairs of such a company.”

His view highlighted neatly an unintended side effect of joint stock ownership: the rise of the professional manager. In theory, such managers have incentives which align their interests to those of shareholders. In practice, it’s quite difficult to work out who those shareholders are, because, just as shareholders have outsourced management of the businesses they own to other people, they have also outsourced responsibility for deciding WHICH businesses they should own too – to professional investment managers. No surprise then that share owners are sometimes described as absent landlords and no surprise either that some of the people they have hired to be their proxies have interests that are not particularly well aligned to their own.

It may seem strange that one of the biggest supporters of the joint stock company was Karl Marx. He believed that the joint stock company was a stepping stone to socialism, because it separated ownership from management and the capital from the capitalists.

He clearly didn’t foresee how those professional managers would end up being the real winners: over the last 50 years, average CEO pay has gone from around 30 times the average wage to around 300 times.
It is therefore not difficult to spot what is wrong with capitalism, but what is right with it?

The first thing is innovation. Individuals are much better at innovation than organisations. People are motivated by many things, but one of the biggest drivers is spotting a better way of doing something and turning concept into reality. Inventions have happened in other economic systems, but it is noticeable that the communist regimes of the 20th century were notably less innovative than others.

Again, quoting Adam Smith:

“It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinners but from their regard to their own interest.”

No one has succeeded in finding a better motive for a societally optimal outcome than that of profit, though many have tried.

However, something else that is right about capitalism is that it DOESN’T always just run on naked self-interest, despite its worst excesses. But big business itself has sometimes acted as if misdemeanours were only a problem if they got caught, which is a value system completely at odds with the rest of society.

To make the case for capitalism, we therefore have to be willing to change it. After all, capitalism itself has not been static down the ages, and the view of what is acceptable has altered over the years – think of the match girls who went on strike over phossy jaw or the Dagenham women who did the same over equal pay.

Here are four things that are worthy of discussion:

1) When the banks failed in the financial crisis, it became evident that shareholders weren’t last in line to bear the risk when things went wrong. Government, society, the tax payer and employees who lost their jobs all suffered. Professional executives, for the most part, still got paid as they were protected under the law of limited liability. Incentives to make large sums of money without accountability for the decisions that go wrong are a recipe for – well, the great financial crisis, amongst other
things – so we must tackle incentive structures to get better alignment of interests between executives on the downside as well as the upside.

2) Absent landlords can be a problem. Perhaps executives should be more accountable to their wider stakeholders, such as employees, bond holders and the community, who may be more involved day to day with enterprises than shareholders alone.

3) In today's world, it is possible to trade at just about any hour of the day or night. How much worse would it be if trading were only possible once per day, per week or even per month? Slowing down trading would rebalance the playing field between fast and slow capital – or between patient and impatient capital.

4) Should voting rights be instantly available on purchasing a share or should they be earned? Or should providers of other capital, such as human capital, also have a vote?

In conclusion, capitalism links those with ideas to those with money, those with needs to those with solutions, creating jobs and prosperity.

The point of capitalism is that it gives us choices: about how hard we work; about how we raise our families; and how we save for our future.

These are OUR choices, not the choices that other people or governments might make on our behalf. Unfortunately, we’re human, which means we don’t necessarily make good choices and that is why accountability must go hand in hand with capitalism. Capitalism inevitably descends into racketeering without it.

Capitalism is a bit like democracy. It is the worst form of market structure, except for all those other forms that have been tried from time to time.

May 2016
Short-termism and the decline of productivity

Sir Simon Robertson
Founder, Simon Robertson Associates LLP

With over 50 years working in the City of London, I have long felt that the continuous decline of productivity in this country has been directly, but by no means exclusively, linked to the short-term actions of management. Why has this happened when it does not seem to have occurred in other parts of Europe like France and Germany? Why does it afflict publicly listed companies more than privately held ones? The answer has to be due to the ownership of companies. Privately held companies or closely controlled public companies, where the fortunes of the owners who work in the business are inextricably entwined, cannot afford to take short-term views. They are more likely to take a long-term view of the business and therefore have to make long-term investment decisions to survive. They have continuously to increase the efficiency and productivity of the business. The very best are there for all of us to see such as JCB and Schroder Asset Management to name two in different industries.

I remember some 30 years ago a conversation I had with the Chairman and Chief Executive of a leading French group when we discussed this vexed question. France was enjoying a far higher level of productivity than we were in the United Kingdom. At that time, public French companies were largely owned by domestic shareholders who clearly took a more long-term view of value creation. US activism had arrived in the UK but not yet in France. Following that conversation I became quite clear that the malevolent attitude of some investors for short-term results had a direct bearing on the attitude and psychology of management.

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1 Some of this essay has been inspired by the thoughtful work undertaken by Martin Lipton and his colleagues.
and not for the good of the long-term health of the company they managed or long-term investment and productivity. Of course much of this continuous decline in productivity and competitiveness has been mitigated for exporting companies, with which most of the productive sector in the UK is engaged in one way or another, by the steady depreciation of sterling over the last 50 years.

More recently, the short-term attitude of investors, and even more recently the rise in importance of indexers, mixed with activist hedge funds has made directors and management even more fearful of taking long-term investment decisions for growth and job creation. I draw a distinction between activist shareholders and active ones. The former are only interested in maximising short-term profits from the investments they make. Active shareholders include hedge funds but also include the ordinary investment institutions. These can be positive for the companies in which they invest and often are. However, the requirement for quarterly or semi-annual performance reporting inevitably puts pressure on investment managers to perform in the short-term. In addition, their compensation is either directly or indirectly linked to this short-term performance. Superior performance leads to more funds under management and therefore indirectly more compensation. There is nothing inherently wrong in this cycle, but it does not always lead to long-term support for companies. One only has to look at the situation of Cadbury’s a few years ago. Putting aside whether one thinks the Cadbury’s board acted with courage, that takeover, which was decided by the hedge funds but only after the so-called long investment funds had sold out to the hedge funds, resulted in the loss of independence of a great British brand, loss of jobs in the UK and the closure of factories in the UK. But the investors got a short-term fillip to their performance. A more recent example of where a board showed particular courage, and were supported by one major institutional shareholder, which say they take a long-term view and do indeed take one, was the failed takeover by Pfizer of AstraZeneca. If this takeover had succeeded, I have no doubt that jobs would have been lost over time in the UK, factories closed down in the UK and research and development lost to the UK. Despite the prevailing view I believe firmly it does matter who owns companies.
There is in reality a subliminal alliance between management of listed companies and the managers of the investing institutions as each benefit through their compensation arrangements from short-term events such as takeovers or share buy-backs which usually do nothing for the well-being of the other stakeholders of the company or indeed the long-term health of the company.

It sounds from what I am saying above that I do not believe in the Schumpeter effects of “creative destruction”. That is not the case. But I do believe we need to get a better understanding between the directors and management of publicly listed companies and their owners and the public institutional shareholders.

As the biggest investment managers gain more and more power they bear a heavy responsibility as to how they exercise that power. Their actions can influence employment, national productivity and competitiveness and indeed economic policy for good or ill. Part of that responsibility has to ensure a balance between short-term and long-term corporate goals and between short-term value creation and long-term needs of society.

An insidious result of the “success” of activism on a company can have perverse results. An activist attack on a company may produce a short-term increase in the share price of one portfolio investment; but the defensive reaction of the management of the other companies in the portfolio, that have been advised as a result to manage like an activist, has the potential to distort the overall portfolio, and not necessarily for the longer-term benefit. Last year, Larry Fink, CEO of BlackRock, in a letter to CEOs said: “More and more corporate leaders have responded to activism with actions that can deliver immediate returns to shareholders, such as [share] buy-backs or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth.”

One can only expect major institutional investors to support the long-term plans of a company and support its management against activist attacks if the institutions understand the long-term plans of the company; the company has good corporate governance with quality independent directors with the necessary expertise; regular discussions take place between directors and the investing institutions; there are regular and
quality evaluations of the performance of directors; and the executive compensation of management is tied substantially to long-term performance and total shareholder return. The lesson of the recent past is that the directors and management will have to devote much more time to ensuring their major shareholder base understand their strategy and are supportive.

None of this is meant to be a licence for management to pursue a flawed strategy. In the cases where a change of strategy or management is clearly warranted, active intervention by institutions is appropriate. However, unless institutions recognise that they must confine their support for active involvement to those few situations, they are in effect condemning all companies to manage as an activist would with the inevitable reduction in research and development, capital expenditure, new product introduction and most damaging of all to increased employment.

I contend therefore that an important factor in the decline in productivity and competitiveness in the UK over the last few decades has been somewhat due to the compensation packages of both the management of companies and the investment institutions as well as to the activist culture imported from the US.

This has led to a loss of jobs, a negative impact on the long-term growth in the UK and indeed the independence of too many companies in the listed sector. It has also resulted in a slower growth of GDP and therefore job creation. Unless this trend is reversed, and the responsibility for achieving this lies with both the investment institutions and the directors and management of companies, I can easily see the day when the politicians will try and legislate for investors to focus on long-term investment, which would be highly undesirable. Investors have to recognise that the directors and management of companies have by legislation wider responsibilities other than value creation for one group of stakeholders. Their overall responsibility is to ensure the long-term prosperity of the company and all its stakeholders, whether they are its employees, suppliers, customers or its shareholders, and of course the environment in which they operate.

May 2016
It has become standard practice for companies to include substantial information on their social and environmental record in their annual report and accounts. Unilever’s annual report featured a section on “delivering value for our stakeholders”, with 10 pages given to “our consumers, society and people” versus three for “our shareholders”. BP presented five pages on corporate responsibility in addition to a further five pages specifically dealing with the Gulf of Mexico oil spill. At Sainsbury’s, we provide 14 pages on the company’s strategy including sections such as “there for our customers”, “colleagues making the difference” and “our values make us different”, together with two pages on the work of our Board Corporate Responsibility and Sustainability Committee.

Most asset managers, however, do not yet seem to have shown the same enthusiasm for the topic. In my experience, investor meetings almost always focus on company strategy, its business model and the short-to-medium-term financial outlook. Then, if time remains, a perfunctory reference is made to the social responsibility agenda before pleasantries are exchanged and the meeting concludes. Many investors (or more specifically their asset management intermediaries in the form of pension funds and insurance companies) seem unsure of the relevance of this part of the company’s agenda, and lacking in any evaluatory framework to assess its effectiveness. As far as they are concerned, the company’s social responsibility is delivered by a business successfully generating employment and income.

Perhaps companies have not done a good enough job of explaining to investors why they place importance on the social responsibility agenda. Perhaps asset managers are paying lip service while regarding it, at best, as a hygiene factor or, worse, as a frivolous distraction from the real objective of increasing
their returns. But either way, I believe the dialogue needs to become more engaged and the importance of the topic better understood.

I spent the first 11 years of my career at Unilever, which was (and is still) influenced heavily by the approach taken by William Lever. He and other enlightened entrepreneurs, such as John Cadbury and Titus Salt, saw no conflict between making money and the pursuit of socially responsible practices. John Cadbury’s factories in Bournville, William Lever’s in Port Sunlight and Titus Salt’s in Bradford pioneered workers’ rights, eliminated child labour and cleaned up pollution. It was only the formation of the joint stock company and the creation of levels of financial intermediation, and hence the division between management and ownership, which led to the increasing focus on shareholder value and to Milton Friedman’s acerbic view that once a company had obeyed the laws and paid its taxes, its only responsibility was to maximise returns for its owners.

The UK Companies Act, contrary perhaps to common belief, says nothing of the sort. Since 2006, it has required directors to promote the success of the company and in doing so to have regard to a broad set of factors, including the community, the environment and high standards of business conduct. And the Law Commission has confirmed that pension trustees and fund managers are free to take account of social and environmental factors when making investment decisions.

Such factors are still thought of by some asset managers as being of niche interest, as evidenced by a large number of “green” and “ethical” investment funds. However, increasingly the research is showing that no investor sacrifice is necessary. Baruch Lev of New York University, for instance, has established that companies with better CSR results enjoy better revenue growth. In general, there is no observable trade-off between ethical business and investment returns.

To many company executives there seem good, simple reasons for this. It is clear that many in the millennial generation seek out employers who provide the opportunity for them to make a positive contribution to society. A company’s social
responsibility programme can be a source of pride for employees, and pride leads to better motivation and retention. Many “green” practices make good business sense, leading to a reduction of waste and energy consumption. Suppliers will be stronger, more committed, and more willing to share investment if they perceive that they are treated fairly and can share in the success of their customers.

Company executives are also, rightly, concerned about the general decline in trust in business and the effect that is having on their brand strength and their ability to engage positively with their customers. To be sure, trust is declining in almost all institutions, including government, the media and even charities – and of course financial institutions too. The 2015 Edelman Trust Barometer showed a sharp decline in the trust that consumers hold in businesses, both in the UK and worldwide. Respondents to that survey thought that companies were more driven by “greed” than by “making the world a better place”. Businesses have not yet convinced their public that they can make a positive contribution to social and community issues.

At Sainsbury’s, we have a long track record of leadership in sustainability and ethics. We are an industry leader in the sale of British products and support for farming and rural communities. We transformed the market for Fairtrade products and are now the world’s largest Fairtrade retailer. We have championed community investment, for example through support for Comic Relief and the Paralympic Games. All of this is based on an understanding of what is important to our customers, colleagues and other stakeholders. For example, our customers have told us they expect us to help them buy British and to waste less food, and that these issues affect where they choose to shop. We do not see these things as a separate “responsibility” agenda, somehow added on top of our business model; rather we see them as core to what we do.

I think increasingly many businesses are reaching the same conclusions: “Corporate Social Responsibility” as a term is being dropped in favour of developing a sustainable core business model. The CSR team is being re-integrated into the business. The focus is no longer on some “charity” activity on the side, but
on what are the right actions to ensure long-run resilience and success of the company.

So, should asset managers be responding to this trend and, if so, how?

There are of course some who are already concerned and engaged with the sustainability agenda. These investors usually have a specialist team who interact on these matters with listed companies in which they are invested. Unfortunately, this dialogue can often be very separate from that taking place between the asset managers of the institution and the company. The decision takers at the institution are nearly always the asset managers. So, the result of this is that senior management at the company tend to focus on these latter conversations – which can lead to share price movements as investors buy and sell – and not on those with the investor’s specialist sustainability team.

I have spent my career over the last 40 years working in UK listed companies. It is clear to me that the majority of investors are playing a relative game. Their success will be judged by their client against a yardstick of the market as a whole. They are cheering for the companies they have invested in and not nearly as interested in the others.

For passive management companies, however, this is not the case. They invest in a pool of companies to replicate their chosen market. They are interested in the success of the listed company sector as a whole and should therefore be the champion of sustainability standards right across the sector.

Companies have a long-term interest in looking after their environment, supply chain, employee relations, public reputation etc. All this should help them to create long-term sustainability and to reduce risk. Long-term investors – not just passive management investors – should be supportive of this. They should be supportive of companies investing money – affecting profits in the short-term – in order to underpin the long-term. Unfortunately, however, many institutions find it difficult to assess the value of this spend, especially if they are orientated to relative outperformance in the short-to-medium term of the companies in which they are invested.
Seen in this light, asset managers should be concerned that we increasingly find ourselves in a volatile, uncertain, complex and ambiguous world. The biggest threats to ensuring good returns for savers are not the relative performance between different companies, but crucial challenges which society faces as a whole such as climate change, exploitation of the world’s resources and biodiversity, and access to sufficient food to feed a rapidly growing population.

To take just the first, climate change: although the recent Paris agreement was a positive milestone, the firm commitments give only a two-thirds chance of holding warming to less than 3.5 degrees Celsius. At this level of warming, sea levels rise by up to 10 metres, heat stress has a major impact on crop yields and human health, and extreme weather events become commonplace. Appreciation of such risks is now beginning to weigh on sectors such as insurance and fossil fuel extractors. At Sainsbury’s, of course we are concerned about our ability to maintain our supply chains even under less severe scenarios. More generally, businesses should be looking at ways to deliver additional cuts in carbon emissions as well as preparing to mitigate the risks for their stakeholders.

To take another example, the cocoa which forms the key ingredient of all the world’s chocolate is under threat. Most cocoa producers have very small farms, often with less than five hectares of land. They face significant problems with the crops, including Black Pod disease, which is killing roughly one in 10 cocoa trees globally and causing a drop in yield of 20–30%. The advanced age of many cocoa trees means small-scale farmers are producing less cocoa every year; yet poor returns mean farmers are unable or unwilling to invest in new trees. The average age of a cocoa farmer is now over 50 because the younger generation cannot be attracted to cocoa farming. For the world’s chocolate brands, there are now fears of an impending world shortage. We may have already reached “peak chocolate”. The more progressive companies are seeking to increase farmer incomes, to support the planting of new, higher-yield, disease-resistant trees, and to provide training and support to farmer organisations to help them become more successful.
The world’s oceans are under similar threats. Fish can and should be a sustainable, renewable resource, but pollution, habitat loss and acidification due to climate change are placing immense strain on the ocean’s food chains. Responsible and controlled fishing could permit species to adapt to these stresses, but over-exploitation is reckoned to threaten four-fifths of the world’s main fish stocks. An irreversible collapse in fish stocks could be devastating, not only for the marine environment, but for employment, communities and companies which rely on the world’s seafood supply chains.

The asset managers can benefit their customers – savers and pensioners – and society as a whole if their activities promote and sustain good performance by investee companies. This should help protect those companies against the risks of a volatile world and ensure that they can continue to grow.

There are some signs that this is happening. The Association of British Insurers, whose members own more than 20% of the companies on London Stock Exchange, publishes guidance on how its members should integrate environmental and social considerations into investment decisions.

Currently, information to permit asset managers to engage with investee companies on these topics is variable and unreliable. But consistent collection of company performance is possible. One example is Oxfam’s campaign “Behind the Brands”, which produces a league table of the world’s 10 biggest food and beverage companies on ethical and environmental issues such as climate change, the sustainable use of water and land, and the treatment of small-scale farmers. Oxfam has been successful in holding these companies up to scrutiny and forcing policy change, for example in requiring them to conduct social, environmental and human rights assessments of their suppliers. But investors could use similar public information to assess and, where relevant, challenge the sustainability strategies of their investments.

To do this, more effective engagement by asset managers on the topic will be necessary. So will a more robust way of probing behind the statements and commitments and evaluating the performance of companies’ sustainability plans. I look forward to
these debates featuring more prominently – and robustly – in meetings between companies and asset managers in the future.

May 2016

David Tyler would like to thank Michael Jary of OC&C Strategy Consultants LLP for all of his help in preparing this paper.
A practitioner writes...

Trelawny Williams
Head of Corporate Finance, Fidelity International

Corporate governance has grown up in the last 20 years and has gone from being the preserve of a few eccentrics to become a mainstream discipline supported by a small army of specialists. The market landscape has changed radically since 1990, but many of the issues have not changed and questions about how shareholders should best interact with companies, how Boards operate and whether investors have a sufficiently long-term timeframe are as relevant today as they ever were.

I first became involved in corporate governance in the early 1990s and this was an exciting time because shareholders were beginning to rediscover their rights and the potential influence which these rights gave them. This period coincided with the decline in conglomerates which historically had imposed market discipline on underperforming companies. Boards were at first resistant to accept the more active style of shareholder behaviour and there were occasional misjudgements on both sides such as when shareholders over-reached themselves or when Boards underestimated shareholders’ resolve to have input into questions of strategy or governance. Within institutions at this time, corporate governance remained a niche activity and was subordinate to the mainstream investment process, but on the plus side this meant that all governanc-driven shareholder engagement was wholly focussed on practical value generation rather than pursuit of a theoretical ideal.

As in all times of change, the period was characterised by some disputes between companies and investors as the respective parties adjusted to the new reality. This culminated in a high-profile controversy following the merger of Granada and Carlton Communications in 2003 when investors objected to the CEO of Carlton Communications becoming Executive Chairman of the combined group in combination with the CEO of Granada.
becoming CEO of the combined group. A significant group of shareholders led by Fidelity International took the view that this management combination would simply not be workable in practice and a better solution had to be found. The dispute received widespread media coverage and to the surprise of many observers the shareholders prevailed. The episode marked a key moment when shareholders emerged from the shadows and it stimulated an energetic debate which ultimately gave rise to the Stewardship Code some seven years later.

The view that shareholders might want to consider intervening in the affairs of a company when it was in their best interests to do so has now evolved into an expectation that institutional shareholders should always act as owners, with all of the attendant responsibilities, as an integral part of their obligation to their clients. This has had the positive effect of making it more difficult for third party shareholders simply to sit on the sidelines and piggyback off the efforts of others, but it has also led to an increasing reliance on codes and guidelines as measures of good behaviour. The risk is that governance becomes an end in itself rather than a means to an end, the end in this case being the better performance of the businesses in question.

At the same time that stewardship and its related investment disciplines have become a mainstream part of UK institutional investment practice, these same UK-based institutions have been losing scale in the market itself. Mainstream UK institutions now own a smaller proportion of the UK market than they have for the past 60 years and new entrants, such as sovereign wealth funds, overseas institutions and hedge funds, have come in to fill the gap. Sometimes these new entrants can be powerful catalysts for change and we have recently seen an influx of activist American investors who seek to work with
established investment houses to the benefit of both parties. However, other new participants are not always so easy to access and the Investment Association has recently sponsored the creation of the Investor Forum to facilitate the involvement of a wider universe of investors in stewardship-related matters, but the task is a challenging one.

Companies themselves have become much more sophisticated in the way in which they interact with their shareholders. Most large companies now have large and sophisticated investor relations departments to oversee relations with shareholders as well as resources devoted to social and environmental matters. A key role of the investor relations team is to facilitate dialogue with shareholders, but the investor relations team is also tasked with promoting the Board’s view of the world and in ensuring that shareholders remain suitably sympathetic to that view. On balance, I think most shareholders believe that investor relations departments provide vital support to shareholder dialogue, but as with all intermediaries the clarity of the debate can sometimes be diminished.

Another curious consequence of the more hands-on role which is now expected from institutional shareholders is the belief that shareholders are better judges than Directors as to what constitutes a company’s best interests. This started to become apparent in the wake of the financial crisis in 2008 when a number of commentators and even regulators expressed the view that if only shareholders had had a more influential role then many of the problems could have been avoided. This completely mischaracterises the role of shareholders. Shareholders own companies but Boards of Directors are responsible for the day-to-day management of companies, and shareholders have neither the information nor the resources to supplant Boards in this role. Also, the power of shareholders is often exaggerated in that it’s very difficult to get a company to change direction in the face of a resolute and intransigent Board. It can be done but it takes a lot of time and effort and assumes that the shareholders themselves hold a single, common view; something which is very much the exception rather than the rule.

The UK remains a world leader in promoting high standards of corporate governance and stewardship, but no system is perfect
and there is always room for improvement. This is a notoriously difficult area to regulate and hard rules will often give rise to unexpected and undesirable consequences. However, recent successful reforms in addition to the Stewardship Code include the broadening of Directors’ responsibilities as well as granting shareholders a binding vote on remuneration policy. These initiatives have broadly worked very well and we are beginning to see the benefits as new behaviours are taking root.

Directors’ pay remains a highly sensitive area and the evidence shows that it has increased far in excess of the pay in other walks of society in the last 20 years. Buttressed with a binding vote on pay, shareholders are now much more diligent in policing Directors’ pay but shareholders are not social engineers and the landscape is not going to change overnight. The UK competes in an international market for talent and it’s impossible for shareholders to determine the “right” level of award for a given role, but shareholders are increasingly insisting that Directors receive a greater portion of their reward in the form of shares and also that these shares are held for a meaningful period of time. In this way, senior managers should become substantial shareholders in their own right and the interests of shareholders and managers should align.

Company Chairmen play a much more prominent role than in the past and best practice now requires Chairmen to maintain regular contact with leading shareholders. Non-executive Directors also play a critical role, although their direct contact with shareholders remains limited. This is a recognised gap, but it’s been difficult to devise a mechanism to improve this dialogue in a timely and resource-efficient manner. One possibility which should be considered is that (a) non-executive(s) should accompany management in their post-results meetings with the top shareholders so as to meet the key shareholder decision-makers face-to-face and be able to witness the interaction between management and key owners. This should give non-executives a better understanding of what shareholders are thinking and give both sides the ability to reach out and make direct contact should the need arise.

Robust shareholder rights remain the bedrock of a well-functioning, self-regulatory governance framework and one
share/one vote remains a key principle. There have been calls, particularly in the context of takeovers, that the one share/one vote approach should be modified to favour longer-term shareholders or at least pre-existing shareholders, but any departure from a level playing field risks becoming arbitrary and could result in a small number of shareholders wielding excessive power. It’s entirely reasonable for Government to impose restrictions on takeovers if they choose to do so, but shareholders should be left free to act equably in the perceived long-term best interests of their clients. It’s also worth noting that the Takeover Panel has recently strengthened the rights of offeree companies through the introduction of the Put Up or Shut Up Deadline for offerors and this should go a long way to introducing more grit into the system, but without compromising shareholders’ rights.

At its core therefore good corporate governance should be all about value creation. Shareholders should provide diligent oversight and guidance when required, but the creativity and energy of Boards should not be stifled. There has been much progress in the last 25 years, but life never stands still and new solutions will doubtless be required for new challenges.

May 2016
Creative Tension?
1990
A collection of essays on issues arising from the relationships between the management of public companies and institutional investors
Foreword

Successful public companies are at the heart of the free enterprise system. It is of vital importance to us all that our companies are robust and able to compete internationally. The way they are governed and the way our markets work are critical ingredients in their success, so I welcome warmly the widest possible discussion of the roles of shareholders, directors, managers and other stakeholders in companies in contributing to that success.

Given the differences between countries’ histories and traditions, it is not surprising that there are many different roads to success. Companies themselves are as diverse as the people who run them. It is however vitally important to keep our own system under review, to make sure that the corporate sector is healthy and making the maximum contribution to the nation’s prosperity. I am sure that the quality of corporate performance in the UK has made great strides in the last decade or so. The search for further improvement does not imply we can expect to find a panacea, but I do believe there is still more to achieve.

I commend this booklet which the NAPF have commissioned as an excellent contribution to this continuing review and to the debate which such crucial issues deserve.

Rt. Hon. Robin Leigh-Pemberton
Governor, Bank of England
Preface

There has been growing criticism from some parts of Britain’s corporate management of the attitudes and actions of institutional investors. Within this context the National Association of Pension Funds considered that it would be particularly helpful to provide a thoughtful background against which both corporate management and institutional investors could consider their response to, and consequent inter-relationship arising from, the changing environment in which capital is provided and used.

Most discussion of issues in this area tends to occur during the evolution of a particular controversy – a takeover, a reconstruction or a controversial capital raising, for example. Away from the emotion which may surround such a controversy, I hoped that it would be possible to present a rather longer-term view.

Furthermore the pension funds, with their long-term investment horizons, ought to help with the development of constructive thought in an area where Britain’s long-term economic success can so easily be damaged by misunderstanding between the owners and managers of companies.

Accordingly, in order to take the first step in providing such a background, I invited a number of prominent people (both institutional investors and corporate managers) to contribute to this collection of essays. Not all facets of British economic life are included – there are no trades unionists or politicians amongst the authors – but I have no doubt that the quality of the authors will make this collection worthy of serious consideration by all who participate in the process of allocating, and supervising the use of, capital. There will be ample opportunity for further contributions from other sources should this be appropriate.

Each author was given freedom to write on any aspect of the inter-relationship between corporate management and institutional shareholders. Whilst this risked repetition, the benefit has been that the collection represents the concerns of the authors untrammelled by an agenda set by the NAPF. Indeed, the extent to which there is some overlap between contributions is perhaps surprisingly small, and where it exists
the reader may find himself viewing the same problem from several distinct perspectives.

For the investors these essays present a challenge. No contribution has been changed in any material way, and where there is criticism of our funds as investors – explicit or implicit – the pension fund movement must take note and respond appropriately. It is a sign of the increasing maturity of pension funds as investors that the NAPF is able to publish critical comments about the behaviour of its members.

The NAPF will, after proper consideration, respond to these challenges and, I hope, so will institutional investors in the widest sense, perhaps through the forum of the Institutional Shareholders Committee. It is my central wish that this volume will provide the foundation for a wide ranging and constructive debate.

To prepare such a volume is a simple task in comparison with the effort required to be expended by the authors. It is a great tribute to such very busy people that they found the time to write such thoughtful contributions. There are many calls on their time and I, and all my colleagues at the NAPF, wish to record here our appreciation and thanks for their hard work, understanding and participation.

I wish to record my personal thanks to Roger Marshall, Secretary to the Investment Committee of the NAPF, without whose terrier-like qualities this volume would never have existed, to Angus Matheson for patient reading and to Debbie Jordan and Lynn Price. Michael Elton and all his staff at the NAPF have been wholly supportive as have all the members of the NAPF Investment Committee and Council.

Finally, I record my gratitude to the Governor of the Bank of England for gracing the book with his foreword.

Donald Brydon
Chairman, NAPF Investment Committee
February 1990
Investor relations – does the British system work?

Lord Alexander of Weedon
Chairman: National Westminster Bank Plc
Former Chairman: The Panel on Takeovers and Mergers

Introduction
The relationship between investors and management in British companies has been the subject of critical comment for most of the post-war period. Much of this criticism may have reflected the fact that British performance has not been particularly good. Blame therefore has tended to be distributed somewhat indiscriminately, and our corporate structure and industrial culture has been contrasted with that in other, more successful countries. The British culture is essentially based upon one principle: ownership of shares determines control, and management’s duty is to shareholders. In recent years this has raised important misgivings. Is there too much short-termism? Are share markets less dominated by capital raising than trading activities? Can management take a medium-term view of a company’s needs? There are no easy, or agreed, answers, but to look at the differences in various systems may be valuable if, as is uncontroversial, other countries have outstripped our performance.

Japan and Germany
The situation in the UK contrasts sharply with that in some other countries. In Japan corporate finance for the major companies is based on the system of “keiretsu”, or company groups. Some of the large groups are household names worldwide such as Mitsubishi. These keiretsu include a family of companies, with a bank, a trading company, and a wide range of manufacturing and commercial companies of various sizes. These companies will have mutual holdings of shares in each other, as symbols and the substance of support. The bank is often the lead company in a keiretsu, although that is not always the case. It is not uncommon for top level meetings to take place every month or so between the
member companies, when strategic issues are considered, including future investment plans and their financing.

For much of the post-war period Japanese banking was uniquely fitted to the requirements of industry. In general inflation was low, and interest rates were controlled by the authorities and held at low levels. Long-term fixed rate finance was readily available to the corporate sector from the three long-term credit banks, and this was at relatively low rates of interest. Much of the finance was raised by back-to-back debentures through the banking system.

This financing was to a large extent a non-market system, since the price of credit was determined by the government. Credit was on tap for credit-worthy companies, if not arranged through internal consultations within a keiretsu. For smaller companies outside the keiretsu families, relationships with their banks are to a far greater extent at arm’s length, and credit may be offered or withdrawn on normal credit-worthiness criteria, without extra-market consultation.

This system has to some extent broken down in recent years as the government has been forced to accept greater deregulation of the financial system. Companies, with their massive profits, have become more independent of the banks, and have been moving more towards equity finance and independent asset management, and away from dependence on bank financing.

As far as raising capital is concerned, major Japanese companies are at exceptionally high price-earnings (p/e) ratios by European and North American standards, which many Westerners find
difficult to understand. The Japanese interpretation is that if one analyses company finance correctly, taking into account and netting out cross-shareholdings, and giving proper regard to the companies' cash flow, then these p/e ratios are not excessively high. But the idea persists in many Western minds that the massive personal savings flow, combined with the oligopolistic position of the main securities houses and the tendency of Japanese investing institutions at times to behave as one, may have some relevance to the p/e ratios seen, and hence to the low cost of capital-raising for Japanese companies.

The German system is also to a large extent dominated by banks, although the structure differs significantly from that in Japan. In Germany many banks have substantial shareholdings in major companies, the result of the banks being used both at Germany’s original industrialisation and also after the depression to back the development of an industrial nation. It is commonplace for bankers to sit on the supervisory boards of companies, under the German two-tier board system. The banks are also influential on the stock exchanges, with banks acting directly as brokers. It is difficult for companies to raise equity except through the banks. Many German shareholders leave their shares on deposit with the banks, and unless action is taken to the contrary the banks are able to vote those shares by proxy.

We thus have a situation that German banks are major shareholders of companies, they vote shareholdings deposited with them, bankers sit on the supervisory boards, it is difficult for companies to raise equity capital except through the banks, and banks are substantial creditors of the same companies.

Given Germany’s low inflation since the war it has been possible, as in Japan, to maintain a system of long-term, low interest, fixed-rate finance, often on the basis of back-to-back debentures raised through the banking system. This form of finance has been of great benefit to the industrial sector.

The German system, with the interlocking links between banks and industry, provides the opportunity to deal with situations behind the scenes and even at times to engage in restructuring of industries against the will of the industry. It is difficult for
other banks to break into the German banks’ position with their customers. Because of the emphasis on bank finance the German capital market lags somewhat behind those elsewhere in terms of liberalisation and efficiency.

In Germany the equity markets play a much smaller role than in the United Kingdom. A far higher proportion of investments by pension funds and life insurance companies is in bonds rather than equities.

In many ways the Japanese and German systems are very convenient to companies and it is tempting to credit those systems with the economic success of Japan and Germany. But there are other factors. Let us not forget the commercial acumen of the manufacturing companies and the skill and hard work of their work forces. Japan’s manufacturing methods have been extremely efficient, and she has produced a wide range of new and highly popular products. Likewise, Germany’s manufacturing has been very efficient and the country has been able to obtain high prices for the undoubted quality of much of its output.

**The United States**

The United States situation differs very markedly from Japan and Germany. The United States reflects almost the extreme of the market system, with whatever is legal being possible. The legal framework and legal possibilities dominate corporate finance and takeover and merger activity.

In the United States the alleged conflict between shareholder and management interests has been emphasised by “raiders” such as T Boone Pickens as the justification for their acquisition activities. The burden of their accusation is that managements run companies for their own benefit, and that it requires takeover activity to bring back shareholder value. As with many theories which gain some popular credence, there is just enough truth in this to make it difficult to dismiss it out of hand. But the real reason for some of the colossal profits made from mergers and acquisitions in the early-1980s was simply that the market grossly undervalued assets, such as oil reserves in the books of the oil companies. It was not so much mismanagement as misvaluation of reserves which led to the possibility of massive profits from launching takeovers of such companies.
As ever in the United States, the response to this situation has been not just a reasoned public debate on the issues, but also recourse to the law to protect the various interest groups. In certain States managements have been able to obtain legislation which legalises various “poison pills”, which make it far harder to take over companies incorporated there. Congress has entered this arena with various bills being suggested which might have the effect of removing the alleged tax bias towards using debt instead of equity finance. The United States approach has led to accusations that many companies have been overly burdened with debt through being subject to highly leveraged transactions (HLTs). This in turn has led to accusations that companies have been stripped of their cash reserves, and the long-term future of companies has been put in jeopardy. Once a company is subject to a highly leveraged transaction the new management has to ensure that it manages the company for cash for as long as is required to obtain control over the company’s finances. The fact that some major HLTs can fail shows that this is no trivial problem. The accusation has been made that equity in United States companies has been sharply reduced in recent years.

In the United States there has developed at times a stark conflict between management and shareholder interests. The use of “poison pills” is a clear example of this. It is difficult to see any justification for legal steps which have no purpose other than to protect the existing management.

The British system
The British system is that control moves with ownership of shares, and shares are traded generally in liquid open markets. The number of companies quoted on the London International Stock Exchange is far higher than in Continental countries, and the total market capitalisation of the London market is also somewhat higher than in any single Continental market. The fundamental social attitude towards corporate ownership and control is as effected by parliament in the Companies Acts, together with the legislation establishing the Monopolies and Mergers Commission, and the Office of Fair Trading. The rules of the International Stock Exchange establish certain features of the trading environment for company shares. The regulatory structure of the Takeover Panel also helps determine the rules
under which mergers and acquisitions may take place. In none of these areas has there been any real, sustained challenge to the fundamental principle that control should go with share ownership. The prime objective of the Takeover Panel is, for example, to ensure fairness to all shareholders.

The British system has been subject to persistent criticism in recent years. I have strong sympathy with many of the critics. It must be extremely irritating for the chairman of a company on his way to work to learn over his car telephone or radio that his company is in play and somebody has already bought 29.9% or more of it. It is also reasonable to ask whether that sort of system is the best way of handling the major industrial and commercial interests of the country. Is there a better way of enhancing output? Why do we slip behind Germany and Japan?

**The CBI report**

So is there a better way? This issue was the subject of intensive study by the CBI/City Task Force, whose report “Investing for Britain’s Future” appeared in October 1987. This report from those of great experience explored a wide range of possible changes. The fundamental conclusion was that the nature of the interests at stake made it more difficult than many realised to change the system. Perhaps the key statement in this vein is (paragraph 83):

“In fact it is very doubtful whether the structure of the UK financial system could be fundamentally changed. An examination of the origins of systems of industrial finance shows them to be largely the product of historical development... Each country’s system has developed both in respect to the specific internal needs of the domestic economy as well as the historical and social structures of each country... Any policy prescription for the UK must be of a kind that can be built upon the existing system of industrial finance.”

The 12 specific recommendations for action refer strongly to the need for better communications between industry and investors. The role of non-executive directors is examined closely, with recommendations that at times non-executive directors should have the responsibility for channelling investors’ concerns to management.
It was recommended that the appointment of trustees to pension funds should be reviewed, and that such trustees should bear in mind both their responsibilities as long-term shareholders as well as their responsibilities to members and pensioners.

The Takeover Panel
Concerns were soon expressed again, at the 1998 CBI Conference, notably by Sir Hector Laing and Mr John Banham. So the Takeover Panel decided in November 1988 to ask a working party, chaired by Lord Rockley, to examine whether any of the issues raised should form the basis of amendments to the Takeover Code. This working party received a wide range of views, including from the CBI, the Stock Exchange and the Bank of England, as well as from representatives of long-term investors, merchant banks, the securities industry, and from certain industrialists. The report appeared in October 1989. The Panel was concerned to be responsive to the views of industry.

This comprehensive review of current issues led again to the conclusion that there was no widespread demand to make any root and branch changes to the present system. This was, in large part, as a result of the submissions of the CBI Companies Committee, and other industrialists, against substantial change. The basic objective of the Panel, of ensuring fairness to shareholders of offeree companies in the course of bids, remained unchallenged, both in the City and in industry. At the end of the day the three specific changes recommended in the rules were detailed and technical, although of considerable importance in relation to the handling of takeovers. The first related to the restrictions imposed on share purchases by offeror companies when there may be a reference to the Monopolies and Mergers Commission. The second recommended that a cash alternative should be required under certain circumstances where an offeror has acquired 10% (instead of 15%) of the offeree’s shares. The third was that the Panel should support any movement by the Department of Trade and Industry to take action in relation to the disenfranchisement of shares where full beneficial ownership was not disclosed.

These proposals, which to the uninitiated may appear highly technical, by no means exhaust the coverage of the report itself, which deals with a wider range of issues. One key point is
whether companies should be forced to make a full offer when they have a stake lower than the present 30% limit. The Panel, with virtual unanimity, concluded that 30%, having stood the test of time, is the right figure. The level of shareholding at which control is exercised does not appear to have changed, so the case for reducing the 30% level was not considered to be made out.

The report also faced the issue whether action should be taken to make it more difficult to “put companies into play”. The conclusion which emerges is that many of the possible ways of doing this have substantial disadvantages, or might even be counter-productive. It would be difficult to slow down the speed of acquisition of up to 29.9% of a company’s share capital. Requesting a statement of intent from a 5% shareholder could be meaningless and indeed the market is often well able to make up its own mind when it knows whom such a shareholder is. The offer of a “golden share” to the pension fund of a company, as a form of potential defence, is legal for a company and its shareholders. But institutional shareholders generally, and that pension fund in particular, might not welcome the creation of capital structures which distribute votes disproportionately to the equity.

**Public interest considerations**

The present Government rarely intervenes on public interest grounds except where competition issues are involved. Its view is founded in the belief that intervention on other grounds has not had a successful history. In the past we have not been efficient at running the kind of dirigiste system which we associate with France, nor at running the Japan Inc. or German Bank – related systems which we see in those two countries. So the Government has taken the view that we are better to leave developments to market forces.

We have undoubtedly seen improvement in competitiveness and efficiency of industry in the last decade. We have rid ourselves of working practices dominated by union established restrictions. There is a general belief that the only safe job is a profitable job. Only the efficient companies can hope to survive.

All this is positive and purposive, but will the simple doctrine of competition and market forces, allied to takeovers, be enough to bring about a long-term improvement in progress? Or will we need an adjustment in the structure of corporate responsibility,
plus a higher degree of long-term, involved support for companies from institutional investors and financiers?

**The role of investors**

The view is sometimes expressed that private sector investors might be able to give hands-on guidance to companies. In the UK there are very few cases where non-executive directors sit on boards as specific representatives of arm’s length investment funds. All directors are appointed as representatives generally of shareholders. In certain cases companies may have stakes in other companies, and thus demand the appointment of directors to represent their interests. But there are very few cases, if any, where directors are appointed to represent specific investment funds, such as say a life insurance company or a pension fund.

This leads to the issue whether we should look towards making it easier for investors to act in detailed situations, such as when a company needs turning round. How could investors act so as to have a general influence on companies beyond that exerted by existing statute and company behaviour?

It is very difficult for any individual investor to exert any direct influence on company management. The vast majority of investors has an incentive to vote with its money long before such a situation arises. One or two prestigious investors might be able to exert such influence in a few specific cases. Banks and investment institutions have worked closely together to rescue major companies, such as was the case with Dunlop in the 1980s. The fact that these collective endeavours occur may lead to the impression that such could be an efficient policy for dealing with the majority of corporate cases. The generality of corporate relationships with investors remains that of arm’s length share trading.

**Shareholders and management**

The issue of reconciling shareholder and management interests has been faced by many companies in recent years, who have asked themselves more deeply the question of what their corporate objectives should be. Managements know perfectly well that they operate in competitive markets. In many cases their markets are now global. The financing arrangements they make are often global. Their shares are freely traded. Investor
Relations is an active part of the management of most large companies. Profitability and criteria such as earnings per share are both of direct importance to investors and are increasingly used by managements as the guide to future policy. Shareholder value and share prices are increasingly objectives of management, particularly if they wish to embark in future on an acquisition trail. In banking the primary focus of executives and non-executives/directors alike is the recognition that shareholder value is the main aim, and not any other concept such as asset size. Many companies are introducing various types of share schemes for their staff, including approved share option schemes, savings schemes linked to options, receipt by staff of shares as part of profit sharing, and performance related reward systems linked directly to measures such as costs, sales and profits. In some cases schemes such as share option schemes may be triggered only if matters of direct relevance to shareholders are satisfied, such as earnings per share growth or relative share price performance.

These measures are intended to focus the attention of senior staff on shareholder interests, and to maintain and create a wider consciousness of shareholder interests throughout the staff. About half the eligible staff of National Westminster take advantage of the various savings option schemes. In this regard the take-up of these schemes comes up against the rolling pre-emption limits. Once schemes are in operation the take-up is determined by the attitude of the staff. For example, up to 17% of our staff take their annual profit sharing in the form of stock. That figure is entirely outside management’s control. It is ironic, incidentally, that these measures which are geared towards increasing the consciousness of profitability and of direct shareholder interests among the staff should come up against the pre-emption limit. Consideration should be given to rethinking this matter in the light of the particular circumstances of schemes such as these.

Conclusion

Whilst there are positive moves to ensure that the interests of shareholders and management coincide, and are mutually understood, there is little momentum at the moment to change our system radically. There is the belief that it facilitates the raising of capital, maintains an effective and open market in
which shares can be traded and that the threat of takeover provides a stimulus to management to run a company efficiently.

Yet, for how long can we ignore the very positive performance of competitors whose systems are not so driven by the need to produce short-term rewards for shareholders? Can we ignore, in international trading, the advantages of our German and Japanese competitors where they can both take long-term investment decisions and yet be supported to an extent which enables them to trade on a healthy p/e ratio? Does our Stock Market, when analysed, do less to raise capital than serve as a market for what Jonathan Charkham, of the Bank of England, has recently called “the gaming chip”? Has Government no role to play in guiding the structure of industry? Have institutional investors, who hold 60% of shares, and financing banks got ultimately to become more involved in allowing and facilitating a long-term strategy?

In spite of the conclusions of recent studies, I am sure we will have to consider these issues again. I doubt whether we would ever wish to move as a matter of law in this country from the concept of shareholder control. In any event, most investors and management would probably agree that companies best serve their shareholders by also taking account of the interests of employees, customers and the communities. So probably, to be effective, any change will evolve subtly and will be a change of culture. Clearly, closer investor relations, to which many companies are working, is highly desirable. But the major impetus is likely to be our closer links with Europe. As our companies affiliate with companies from other countries of the Community fully to exploit what will be our domestic market even ahead of 1992, they will inevitably to some extent adapt to the social and economic consideration on which their new affiliates are based. In an area where progress is pragmatic, this may well be the most promising way forward. We are going to need management to plan and implement its strategy efficiently. But in turn this management is going to need the sustained support, medium and long-term, of those institutions who can shape our industrial and commercial corporate structure.

January 1990
Tension to continue

R. E. Artus
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Prudential Portfolio Managers manage assets for in-house funds and for outside clients (mostly pension funds) which include British equities amounting to over 3½% of the entire market. For over three decades now the Prudential has probably been the largest single shareholder in more British quoted companies than any other investor, which has inevitably meant that it has had a high degree of prominence in the areas where companies interface with their shareholders. Whereas a smaller investing institution may be able to approach its investment management role in terms of managing a collection of tradeable paper claims relating to the equity interest in industrial and commercial companies, with little regard to the proprietary responsibilities attaching to the ownership of these claims, this is not an approach which is possible for us. In any given week our senior investment managers and specialist support staff will have contact with a dozen or more companies and their professional advisers, concerned with the relationship between companies and their shareholders, and quite distinct from the programme of meetings with our analysts which aims at improving our understanding of company operations, their management strategies and of the investment merits of companies at current prices.

Shareholders in public quoted companies impact upon company managements at a number of points. Collectively they determine the valuation of companies in the secondary market, their consent is needed in a range of matters, including appointments to the board, the issue of new capital, acquisitions and disposals which substantially alter the nature of the business, and for executive option arrangements. Above all shareholders collectively determine the outcome of contested takeover bids.

Each of these areas has considerable potential for generating managerial dissatisfaction with the activities of shareholders.
Managements are rarely happy about either the absolute level of their company’s share price or the price in relation to that of others. The exercise of shareholders’ voting rights other than simply to approve management initiatives may cause resentment. The acceptance of a predator’s offer for a company is seen as evidence of both disloyalty and “short-termism”, as well as being unpatriotic if the bidder happens to be foreign. With institutional investors controlling over two-thirds of all UK quoted equity any friction in the relationship between shareholders and company managements tends in practice to be expressed as criticism of the institutional investors. Thus, even if contested bids were as infrequent and unlikely of success here as is the case in some other countries, the relationship between shareholders and company managements would not be without occasional problems. It is however the central role of shareholders, and the crucial part which the institutional shareholders play therein, in relation to the market in the control of companies which generates the most heat.

No doubt more attention on the part both of investors and companies to better communications aimed at fostering a higher level of mutual understanding, as recommended by the CBI’s City/Industry Task Force, would help somewhat. But the underlying reality is that tension and dissatisfaction is inevitable since many industrialists have strong reservations about the system within which they are required to operate. We have in Britain probably the most unconstrained market in the control of companies of any major industrial nation. Mergers may be frustrated by the authorities on competition grounds, but there currently appears little chance of interference on other considerations except perhaps that of defence interests. Nor is there significant protection for companies against unwelcome bids from any system of defensive cross-holdings, or from a business culture which frowns upon then. Many institutions including my own approach contested bids from the viewpoint of a predisposition to favour an incumbent management in good standing which wishes to retain its independence, a position which involves a willingness to accept the possibility that the failure of a bid will lead to a short-term fall in the biddee’s share price below the bid value. This, together with the loyalty to their board of many private shareholders, contributes to the fact that more than half of all contested bids fail. Nonetheless a number
succeed. Awareness of the possibility of a bid may impinge on company policy and, win or lose, a bid battle involves a high cost in both money and management time.

The primary justification of such an unrestrained market in control is the proposition that the economic use of resources is optimised if they are controlled by those who value them most highly. Economic fundamentalism of this sort faces the difficulty that the most successful of our competitors internationally appear to do very well without it, and that moreover their relative success may have something to do with the greater freedom to pursue strategies aimed at building long-term strength which a degree of protection from unwanted attack may encourage.

Any system requires some mechanism for monitoring managerial effectiveness in the use of resources. The basic fallback position is natural selection by the faster growth of the successful, and the decline and eventual demise of the unsuccessful. Efficiency is probably helped as against this slow natural process, if management improvement is brought about earlier by acquisition by better managers. But in this case the shareholders of the company acquired must expect to have to pass a substantial part of the benefit of change to the acquiring company. Surely, it is argued, shareholders should neither supinely allow managements to preside unchanged over protracted decline, nor pass the benefits of improvement to a bidder? They should rather themselves intervene to force management strengthening. Such intervention by shareholders does in fact occur from time to time, and we have been concerned with some well known instances as well as many more less publicised cases. But the extent of such activity by shareholders in Britain does not remotely approach the level where it is an effective substitute for the involvement of the banks in Germany or the Keiretsu system in Japan. Jonathan Charkham has recently argued strongly for an increase in activity by institutional investors aimed at promoting more effective management in the companies in which they are invested. My guess is that any conceivable increase in such activity will not amount to a major new element of accountability in our system matching that of the bank-based economies, since share ownership unaccompanied by the additional involvement in providing finance and other services
will never provide the depth of knowledge and commitment that arises with the combination of banking and proprietary interests.

Not all contested takeover bids, and even fewer agreed mergers, arise out of attempts to replace underperforming managements by more successful ones. Many have as their rationale the creation of entities better able to operate efficiently and compete effectively than either can do independently (i.e. the belief that 2+2 can be made to equal 5). Yet others are the result of a management’s wish to diversify its activities away from mature or declining fields. As a corporate strategy this particular reason for acquisition has recently become a matter giving rise to divergent views as between some members of the investment community and some company managements. It is very much a central point in the debate that has been going on in the USA for some time regarding corporate governance and the market in the control of companies. Professor Jensen of the Harvard Business School argues that at any rate for mature cash generative companies it is no longer clear that we should assume an identity of interest between shareholder and company managements. The self interest of managements in such companies may well predispose them to use the surplus cash generated by the mature business to expand the span of their management control, with benefit to their pay, prestige and status when it would be better from the shareholders’ point of view for the cash to be returned to them. The whole subject of highly focused company activity as against diversification and conglomeration has recently been brought into the forefront of debate here too as the result of the Hoylake bid for BATs. Even prior to this a good deal of contraction back to a few core activities had begun to characterise management strategies, following decades when diversification had been fashionable. Clearly if institutional investors now choose to attempt to accelerate this process by encouraging managements to review their corporate strategies to ensure that market valuations more closely reflect underlying values, and especially if they join with what Professor Jensen terms “active investors” who pursue the realisation of full underlying value, then a new source of tension will arise and once again the charge of “short-termism” is likely to be levelled at the investment management community. In the United States over the last decade or so, the matter has become more complicated since increasingly company managers have
themselves often initiated or joined in the process of restructuring via the extensive use of “Management Buy Outs” usually by way of highly leveraged vehicles. It is Professor Jensen’s contention that the trends evident in the United States are gradually changing the corporate system to something more closely resembling the ownership systems in Germany and Japan. I would expect these American trends to gain some further ground here. It seems unlikely however that they will go so far or so fast as in the US, where in every year since 1983 some 5% of the outstanding value of quoted common stock has disappeared as a result of stock repurchases, takeovers and “going-private” transactions.

The many studies of the impact on corporate health of these trends in America produce, as one might expect, a confused picture. In many cases leveraged buyouts have resulted in the vigorous pursuit of cost efficiencies and waste elimination to the benefit of corporate effectiveness. In some cases the burden of debt has proved too great, and this would no doubt become a more frequent outcome if the economy suffered a protracted downturn. It does not however appear that US experience justifies a public policy stance on the matter here which goes beyond the need to keep a careful watch on the degree of exposure of the banking system to the low quality debt. In the absence of a lead from public policy, it would seem likely that renewed interest in such activity will develop here when economic activity begins to accelerate again, particularly if interest rates are then somewhat lower.

Public policy in relation to the acceptability of bids from overseas sources appears to be that there is no case for official intervention, other than in the defence industries. We have a long tradition of investing abroad ourselves and of being open to foreign investment here, and I would think that most industrialists feel happier to base their concern for some protection from overseas bidders not on the more general nationalist considerations, but rather on the fact that in many cases the foreign companies left free to bid here enjoy effective protection against unwelcome foreign bids in their own market. Once again the potential benefits and possible dangers to the long-term well-being of our economy from relative openness of our market to all comers is not a straightforward issue. In as far
as there are national interest issues at stake which justify greater protection against such bids, then the case needs to be made for a change in public policy: it is both pointless and unfair to impugn the patriotism and good sense of investors if without official leadership on this matter they prove ineffective protectors against foreign takeover.

In summary then I do not believe that we can look forward to an era in which all parts of our corporate system work happily and contentedly together no matter how much attention is given to better communications. Some increase in institutional investors’ activities aimed at bringing about more effective and better structured company boards and management may occur, but not I would suggest to a dramatic extent. Such activity can of course involve tension between the dissatisfied shareholders and the management. But if properly targeted and sensibly conducted such intervention gains the respect and approval of the industrial establishment generally. It seems likely that, given a growing management belief in the greater efficiency of highly focussed activity, companies will increasingly go in that direction of their own volition, and that those who do not will continue to risk attack from predators. The possibility of becoming “seriously rich” through participation in a successful management buyout will increasingly tempt managers to take their companies private if this can be arranged. UK institutional equity backing for such moves would probably be available, but it is less clear whether the long-term debt finance to leverage such activity would be so readily available, at any rate from British sources. Where the authorities take the view that the national interest and public policy does not justify their intervention in the market process, it is unrealistic to believe that the fragmented investment community could somehow take a different view and effectively impose it.

January 1990
Financial institutions and their role as shareholders

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This article is written in a personal capacity and the views expressed herein are not attributable to the Legal & General Group plc. I am however grateful to Joe Palmer and David Prosser for comment and assistance in its preparation, although they are to no degree responsible for the sins of commission and omission that it contains.

My approach to the subject matter dealt with below has been shaped by experience as the Chairman of a major financial institution for nearly a decade and my concerns as a professional economist for over three decades. I see the problems that arise from the relationship between institutions as shareholders and the companies in which they invest both as a practitioner and as an academic – from the micro and the macro-economic view.

The role and performance of the “City” has been much discussed in recent years. Tension between the “City” and its customers has always existed – it is not simply a phenomenon of the more recent past. From time to time it changes its character. At the time of the Wilson Committee in the 1970s, the principal emphasis was laid on what was perceived as one aspect of “short-termism”, namely the unwillingness of financial institutions to provide sufficiently long-term funds to meet the needs of business. Such complaints led the minority report of the Wilson Committee to recommend a new institution for industrial lending, an idea that has resurfaced in the recent Labour Party Policy Review.

In the 1980s, the emphasis has shifted. The eighties, like the late sixties before it, has been a period of extensive takeover and merger activity. This has raised questions not about the supply of finance as such, but about the pressures exerted by fund
managers on corporate performance, as reflected in dividend growth and the short-term performance of share prices. This in turn has been linked to the vulnerability of corporations to takeover and the perceived willingness of institutional shareholders to sell stock for short-term profit. Shareholder loyalty is seen to be at a premium and this in some cases has encouraged the management buyout as a means of breaking out of the vicious circle.

Whatever we might wish for in an ideal world, it should be recognised that these tensions between the suppliers and users of finance are almost inevitable. Whatever the merits of the Wilson Committee and the recent CBI Task Force, no form of enquiry is likely to be successful in settling arguments as to whether financial institutions operate efficiently in their customers’ interests. The problem is chronic. The interface between the world of finance and non-financial business reflects pressures that will continue to exist, whatever the “facts” that are presented. Thus, as Sir Brian Corby pointed out in a recent speech with reference to the City:

“… I believe the tensions are natural and that rather than try to eliminate them, the task we face is to manage them.”
(International Stock Exchange Conference, 6 November 1989)

It should also be pointed out that the “City” is not a homogenous entity. While it is true that the degree of financial specialisation has been declining as the fishermen increasingly fish in each others’ ponds, nevertheless it remains important to distinguish between the roles of commercial banks, merchant banks, insurance companies, dedicated fund managers and unit trusts and corporate pension funds. They intersect, but are by no means congruent in their activities. In the latter part of this essay I focus on the role of the institutional shareholder, but it must be borne in mind that, in so doing, I speak from the perception of a number of different institutions. In this symposium, the others will speak for themselves.

In responding to the title of this essay, it is not simply enough to define the institutional nature of the organisation as shareholder. The role of the institutional shareholder cannot be determined in the abstract. It must be set in the economic and organisational environment in which the activity of shareholding is carried out.
Against what rules of the game are we playing? Part at least of the disagreements between shareholders and management relate to differences in viewpoint about what these rules are – or increasingly, what they think they ought to be. In this context, there seem to me to be two key issues that require examination before the role of the shareholder is specifically considered. They are the nature of capital markets and of corporate governance. I have nothing particularly original to say about either, but it is important to at least set out one’s stall on both these issues before commenting on the role of the institutional shareholder.

In his analysis of corporate governance in four countries – West Germany, Japan, USA and UK – Jonathan Charkham argued that the governments of the four countries were:

“... committed to the principle that resources should be allocated by the processes of the market rather than by the government.” (Bank of England Panel Paper No.25)

Unfortunately, it is not always true that the citizenry share that belief in market forces – particularly those who need access to and are judged by those forces in the capital market place. Part at least of the disagreement between the suppliers and users of finance relates to how capital markets are seen to operate in the interests of their customers.

There are a number of factors that tend to lead the users of finance into believing that capital markets do not function well from their point of view. While in theory the primary function of the market is to provide fresh capital, the vast proportion of the supply of new capital generated in the United Kingdom stems from retained earnings and borrowings from outside the equity market. Consequently, the user of new capital often tends to perceive the market as almost entirely secondary, promoting the idea of the lottery or the casino in which buying and selling takes place, with no material effect on the real assets that the financial assets represent. There is in fact a respectable argument that says that large retentions are undesirable from a national economic point of view – but that is another story for another day.

Few Chairmen in my experience believe that their shares are “fairly” valued – particularly when they begin to compare valuations with
those of their nearest competitors. Moreover, it is frequently asserted that markets cannot be valuing shares correctly if one day a stock is trading at £4 per share and the next the company is sold for £10 a share – the so-called double pricing problem.

Modern financial theory rests on the proposition that capital markets are generally efficient. The purpose of the market place is not to allocate funds between alternative users, but to value the returns on particular classes of asset. The secondary market plays two roles. It provides liquidity that lowers the overall cost of capital. It provides the basis for the pricing of primary capital issues. The assumption of capital market efficiency is not that the market always, and in every instance, is correct in valuing the prospects of a particular company. In an efficient market (excluding insider dealing) the valuation of a company should incorporate all known information and its valuations in general should be unbiased – i.e. neither significantly above or below the “true” value of the business (hence the difficulty that fund managers have in “beating” the market average).

The importance of the efficient capital market hypothesis in the present context is that it implies that investors will not typically incorrectly value business prospects in the light of known information. In particular, they will not systematically undervalue corporations so exposing them to takeover prospects. The double pricing problem arises from the fact that current market prices most of the time reflect marginal trading of stock as a going concern. Inevitably, there is a premium for control of all the stock, but the market (in the absence of information) cannot build that into the current share price. It also emphasises the importance of dialogue between investors and companies in determining share prices. In the strictest sense of the word, capital markets are unlikely to be perfectly efficient, but that is not the point. The position I adopt is that the efficient market hypothesis is much more right than wrong and is a reasonable assumption against which to discuss shareholder behaviour.

While disagreements about the function and role of capital markets divide the suppliers and users of capital, they are also divided by the crucial question of ownership and control. It seems to have been widely forgotten, as part of the background to current debates, that the development of corporate enterprises in
the later part of the 19th century suggested clear distinctions between the role of the owner qua owner and the control of the business. Early patterns of corporate organisation tended to fall into two classes. The first reflected the combination of ownership and control in the hands of individuals or families. The second consisted of boards of directors who directly represented investors in enterprise, who hired professional managers to run the business.

The establishment of the principle of limited liability provided the basis for widespread individual participation in profitable enterprise and for the diffusion of ownership. As the scale of business increased the owner/manager structure largely disappeared, while in many enterprises the role of the professional manager substantially, if not wholly, blurred the distinction between ownership and control at board level. The balance of power shifted from the owners of the business to those who managed the business. Such developments were recognised by economists and others as long ago as the early 1930s.

The problem that these developments have raised can be characterised in different ways, none of them, perhaps, entirely satisfactory. Sometimes it is posed as a question of the accountability of management to the ultimate owners of the business. On other occasions, it is said that the central issue is to distinguish in some way between direction and management. Others focus on internal or external mechanisms that act as stimuli to more efficient management performance. The general question however should be clear; what is the appropriate relationship between the ultimate owners of the business and professional management? In the space available it is only possible to sketch a response to this question.

My personal view is quite clear on two counts. The first is that until recent years, shareholders have been considerably neglected by companies. The remote plausibility of the introduction of worker directors canvassed during the Bullock period rested, largely, on the perceived absence of effective external influence exercised by the shareholders on the performance of corporate management. To the public eye, large corporations were self-perpetuating oligarchies whose external line of responsibility was unclear. While as a result of some of the traumas of the eighties, attitudes of companies have
changed, this has been accompanied by allegations of “short-
termism” and shareholder disloyalty. There is no general agreement
at this stage as to how the interests of shareholders and managers
should be balanced. It is not enough to assert as some do that good
management will always have the interests of its shareholders at
heart – even if in many significant cases it is true.

This leads me to a second point, namely that it is not sufficient to
advocate measures directed to damage limitation such as
increased dialogue between the management and the ownership.
Of course such dialogue is of major importance. No system will
function efficiently without mutual trust. However I doubt that
matters will improve greatly without serious structural change,
not simply a change of attitudes. I suggest that there is a need for
structural reform of both the internal and external mechanisms
that influence managerial performance. This is predicated on the
assumption that while mergers and takeovers are not generally to
be criticised, it is certainly the case that where the market for
corporate control is concerned, other efficient mechanisms should
exist that enable management to be stimulated to better
performance or, in the last resort, be swiftly removed from office.

No system will be perfect and it is necessary to trade off
objectives. Some argue for example, that a distinction could be
made between the roles of non-executive directors in monitoring
performance on the one hand and contributing materially to the
running of the business on the other and that it is only through
the unitary board that a contribution of this kind can be made.
In common with others I believe that the role of objective
monitoring can only be carried out by non-executive (or
independent) directors. I go further and recommend that their
role in this respect should be written into company law, but I
emphasise that this is a personal and not a corporate view.
Given such a development, it is important to distinguish between
direction and management and in my judgement this is best
achieved by some form of two-tier board structure. The unitary
board system tends to confuse direction and management
and moreover, unless run by extraordinarily enlightened
management, often makes it difficult in practice to create a
critical mass of independent directors with the power to push
through major changes in management structure if these are
thought desirable.
So much for the question of the internal mechanism of shareholder representation and the monitoring of performance. The question of the external mechanism is related to the role of the institutional shareholder to which I now turn.

Against the background that I have discussed, I think it is helpful to distinguish between the system and rules of the game on the one hand and the relationship between institutional shareholders and individual companies on the other. As already pointed out, the appropriate behaviour of institutional shareholders from a social point of view cannot be established in a vacuum. It is an important part of the responsibility of shareholders collectively – certainly those who can collectivise for the purpose – to show leadership in the discussion and the presentation of the issues. It has been argued by Jonathan Charkham that shareholders collectively have a strong motivation to improve managerial performance at the individual company level by pursuing VOICE (after Albert O. Hirschman) rather than EXIT. Insofar as that is the case (discussed below) it is true a fortiori that institutional responsibility exists at the structural level to reach conclusions about and advocate what they see as appropriate relationships between the supplier and the user of finance.

As far as the institutional shareholder is concerned, this raises the question as to how its assumed influence should be exercised. The distinction has already been drawn between the internal and external appraisal systems to which corporate performance may be subjected. To the extent that internal monitoring is strong, independent and effective, the principal ways in which the institutions would exercise their options is through the normal channels of shareholding communication (voting at AGM’s etc) and through EXIT, which would not reflect necessarily discontent with management, but a fundamental view of the prospects for the firm’s industry. Capital must move from places of low to places of prospectively high returns.

Much of the current discussion of the role of the institutional shareholder simply accepts the world as it is – a world of predominantly unitary boards (outside the financial sector) where professional management is dominant, individual shareholders are weak and the company’s Annual General Meeting fails to deal with the company’s performance and strategy in depth. It is under
these circumstances that in some quarters at least, there has been a demand for VOICE and much criticism of the practice of EXIT.

My concerns about a major expansion of VOICE under the present system include the following. As presently conducted, there is more VOICE being exercised than is commonly supposed, and this has certainly increased in the 1980s. Nevertheless, the nature of this VOICE is unsatisfactory. It is not systematic. It takes place behind closed doors. The process itself is not subject to any serious kind of monitoring. Moreover, in the absence of the serious possibility of collective action by shareholders (however esteemed), there remains relatively little in the form of sanctions that can be applied other than a resort to EXIT – which presumably we are trying to avoid.

The extent to which VOICE becomes widespread, leaving aside the problems raised in the last paragraph, will make it even more difficult for the system to be reformed. VOICE will take up some of the strain externally that results from weak internal systems. As I have indicated, while such change might result in some increased external pressure on corporate managements, it could defer the development of a more satisfactory structure of corporate responsibility.

These remarks on the extended use of VOICE under the present system have taken for granted that the prime concerns of the institutional shareholder relate (in my company’s case) to the policy holders and through them the shareholders of the business. It is often argued that institutional shareholders should act in what is asserted to be the national interest, since if the national interest is not served there will be no benefits for the policy holders to enjoy, or profits for the shareholders to share. From this proposition, some specific responsibility is deduced – such as, for example, the prime need to support manufacturing industry, or to provide “venture capital”, or to refrain from investing overseas. Leaving aside the economic fallacies associated with some of these propositions (overseas investment for example) there is no agreed way of defining the national interest in such a way as to make the concept operational. Both in terms of practicality and recognising the fiduciary responsibilities that lie with the institutional intermediary, maximising the prospective rate of return on the investment portfolio can be the only sound guide to investment decision making.
As stated at the outset, this brief essay reflects my own personal opinion. Nevertheless, I conclude with a brief description of where my own company stands at the present time in relation to its specific dealings with companies.

It will come as no surprise if I say that Legal & General regards itself as a long-term and responsible investor. We are certainly not passive, nor are we disinterested in those companies where we are an investor. We take an active interest in the management of businesses we have invested in, the analysts and fund managers generally see about 500 quoted companies each year. When we are interested in a company we like to meet directly with the managers of a company, generally in a one to one meeting, and we like to focus on the strategy of the business. We are not seeking “insider information”, although from time to time we are put in the position of being “insiders” because a particular company may wish to sound us out on a particular course of action. In such cases we are quite prepared to withdraw from the market place as either a buyer or seller. Fortunately, this does not happen too often. Perhaps I should say that we regard the responsibility for running a business as resting on the shoulders of the directors and management. Shareholders as a whole are the owners of the business but day to day supervision and some policy issues are delegated to the directors and managers.

I think the position which is taken at Legal & General is not so very different from other major financial investors. Like us, most large institutions do not sell into dawn raids, most wish to consider the merits of a bid having heard both sides of the argument and do not make hasty decisions and most wish to discuss major issues directly with the companies.

I believe that institutions all take their wider responsibilities seriously, although the manner in which this is reflected in the decision making process will vary. In our case there is a flow of information on major cases between the analysts and fund managers to the Investment Director, the Chief Executive, myself as Chairman and the Board as a whole. Given the size of our portfolio, the number of holdings and the fact that the Board meetings take place broadly on a monthly basis, our decision taking has to be very extensively delegated. Subject to these practical constraints, I believe it is important to ensure that Board
members are kept regularly informed and, where a decision is still outstanding, have an opportunity to put their point of view. Some of the decisions we are asked to take inevitably raise issues which benefit from a wide discussion that a Board of well-informed and interested non-executive directors provides, and I believe strongly that the quality of our decision making benefits from this.

January 1990
The basic change which has taken place in the relationship between the ownership and the management of companies, during my time as chairman of a public company, has been the replacement of individual shareholders by institutional shareholders. At the time of the merger between Cadbury and Schweppes in 1969, over two-thirds of the shares in the Cadbury company were owned by individuals and the remainder by institutions of one kind or another. Ten years later those proportions had reversed. This change in the pattern of shareholding could be described as a move from ownership to investment. Institutional investors are placing funds belonging to others in a wide variety of financial instruments, while individual shareholders entrust their capital to a limited number of enterprises, of which they see themselves as part-owners.

If I look back further to the time when I joined the Cadbury company in the early 1950s, the shareholding transition has been even more dramatic moving from the family, to the wider public and then to the institutions. In reflecting on that transition, it is instructive to look back on the relationship between family shareholders and the companies which they owned. As owners they took a long-term view. They expected their relationship with the company to be a continuing one and so their interest was in seeing that their dividend income and the value of their capital stake increased steadily, on a par with those of comparable companies. They held on to their shares out of loyalty, because they still had family links with the management of the companies concerned, or simply through the lack of an open market for their shares. Their judgement on the balance to strike between profit now and profit in the future was usually much in line with that of those who ran the business. For whatever reason, they found themselves following Mark Twain’s advice:

Owners and investors

Sir Adrian Cadbury
Former Chairman: Cadbury Schweppes Plc
Chairman: PRO NED
“There is a great deal to be said for putting all your eggs in one basket and then watching that basket carefully.”

Watching the basket implied the acceptance by shareholders of responsibilities as well as rights. They had rights in the form of claims on the company and responsibilities for ensuring that the company lived up to their expectations. They discharged those responsibilities, in successful companies, by taking a close interest in how their businesses were managed and in particular by whom they were managed. They also felt a responsibility for their company’s good name, especially if it was the same as their own. They understood the value of brands and of reputation long before the market as a whole began to appreciate their true worth.

The responsibilities of investing institutions are, however, different from those of the family shareholder. Their first duty is to those whose funds they are investing. The family often had to make the most of what it owned, because it was locked in to that investment. Institutional shareholders are free to invest wherever the balance of returns seems highest and they compete on the basis of their skill in achieving the best results for their customers. But what is true for institutional investors individually is becoming less true for institutional investors collectively, as the proportion of the shares which they own in British companies grows. Increasingly, they can only sell to each other and so their ability to switch between companies becomes progressively more limited.

As the market in information on companies becomes more efficient (in economic terms), even the institutions individually will find it increasingly difficult to sell out of companies, whose performance falls below par, except at a significant loss. All of which means that collectively the institutions are locked in as owners, rather than being free as investors, and even individually they are moving in that direction. Their interest as owners is in a consistent improvement in the performance of companies, rather than in occasional windfalls from bids and buyouts. Pension funds, for example, can most directly match their need for a progressively increasing flow of sterling income by investing in sterling companies with a past record and future promise of consistent increases in dividend payments.
If this analysis is broadly correct, then the degree of common interest between institutional investors and the companies in which they hold shares is growing. What companies are aiming for is consistent growth in their capital value and in the income which they distribute and this is in line with the longer run needs of institutional investors. The question which it still leaves open is how the institutions can best judge whether the companies in which they invest are likely to achieve their growth aims.

Here the institutions can learn from the experience of family shareholders. The family’s prime concerns were that the running of the business should be in the best available hands and that its reputation was being enhanced. These priorities suggest that the institutions should concentrate on just two features of the companies in which they invest – their aims and the effectiveness of their boards.

To become an owner rather than an investor, you have to have confidence in the long-term value of whatever it is that you own. In shareholding terms that confidence comes from believing that a company has chosen the right goals and that those in charge of it will attain them. Shareholders have neither the capacity nor the standing to intervene in the running of the companies in which they own shares. What they can and should do is to see that their companies are competently run.

This in turn will require a dialogue of greater depth between companies and their major shareholders than is as yet common practice. Only from a more regular and open exchange of views will it be possible for the institutions to get a better feel for the aims and abilities of those who run the companies whose shares they hold, and for companies to learn what it is that their institutional shareholders expect of them. There are a number of ways in which a closer relationship between institutions and companies could be established, but my main purpose is to consider how institutions can evaluate whether the companies in which they are shareholders will live up to their expectations of them.

Clearly a company’s track record and its statement of aims are useful indications of past performance and of future intent. But the answer to the question “what is this company likely to achieve in the future?” lies in its board. What the institutions as
owners, therefore, need to focus on is the effectiveness of company boards.

There are certain structural tests which the institutions can apply to the boards of the companies whose shares they hold. Are the chairman and the chief executive two different people and what kind of records of achievement do they both have? What is the balance on the board between insiders and outsiders? How many of the outside directors are independent of the company? Finally, through what process are directors nominated to the board? These are some of the basic questions which institutions should put to chairmen and chief executives. By sticking to the central issue of board effectiveness, the institutions would be carrying out their proper responsibilities as owners and they would be doing so in a way which was manageable from their point of view.

The purpose of these questions is to assist the institutions in judging whether companies are competently led and have properly constituted boards. I do not believe that there are any immutable rules over how boards should be structured, because of the infinite variety of companies and of individuals running them. Nevertheless boards have certain inescapable duties if they are to do their jobs properly; these include appointing, and if necessary replacing, the chief executive and monitoring the performance of the company as a whole. The way a board is structured can either help or hinder it in discharging these duties.

If the chairman is also the chief executive, then the board’s task in assessing how effectively the chief executive is carrying out his responsibilities has to be made more difficult. The same person in their role as chairman is being asked to review dispassionately their own record as chief executive. There are, of course, other issues arising from combining the two posts, such as the concentration of power which it represents and the problems over succession which it is likely to pose. The fundamental point, however, is that by choosing not to have a separate chairman, a board is making it harder for itself to accomplish one of its basic tasks. The question which such a board needs to answer, to itself and to its shareholders, is why it has not adopted the constitutionally stronger position of separating the two top jobs.
Similarly, it is possible for a wholly inside board to invigilate as a board of directors its own performance as a board of management, but it requires the same people consciously to change roles to do so. By having the right kind of independent directors on a board, not only will the board be helped by them in its deliberations, but it will be better placed to carry out its essential monitoring functions. Competent outsiders bring a breadth of view, a knowledge of the standards being set elsewhere in the business world and a certain detachment to the board’s task of assessing the company’s aims and achievements.

Whether a board has on it the necessary balance of skills, experience and personalities to make it effective is a more difficult question to answer than simply whether it has outside directors on it or not. Nevertheless, two useful indicators of a board’s potential to be effective are the presence of independent directors on it and the means by which such directors were appointed. Independent directors are those whose only connection with the company is through their membership of its board. This does not mean that outside directors from a company’s merchant bank or its firm of legal advisers cannot contribute usefully as board members; they can and do. The one quality, however, which they cannot bring to the board’s discussions is complete independence.

Having an adequate leaven of outside directors on a board provides a good basis for effectiveness, but cannot of itself guarantee it. For one thing much depends on the chairman. If chairmen are not really prepared to use their boards other than as rubber stamps, the outside directors will have little influence over their companies’ activities. This is why institutional investors should concern themselves with the competence of chairmen and with their attitude towards their boards.

The second point is that for a board to be effective it must provide leadership and drive and be prepared to challenge in a constructive way accepted thinking within the company. This stimulus and challenge is most usually encouraged by having independent-minded outsiders as board members. If these outside directors are to express their views freely and to be prepared to be critical if necessary, they must not feel too beholden to the chairman.

This leads directly on to how board members are selected. The traditional approach to board appointments was one of patronage.
Chairmen would collect names of likely candidates from their colleagues and from their contacts in the City. They would then give weight to how well the individuals concerned would fit in with the existing board members. Boards made up in this way, however competent the people appointed to them, suffered from two drawbacks. One was that the circle from which the names were drawn was unduly restricted, so limiting the points of view and backgrounds which were represented on the board. The other was that the directors owed their position to those who had put them there, so that a margin of independence was lost.

Boards now have the opportunity of adding to their number in a more professional manner, by using the services of an outside agency, such as PRO NED, the Institute of Directors or specialist search consultants. There are a number of advantages in finding directors through an appointment process which is more formal than was usual in the past. One is that it concentrates the board’s mind on what kind of a person they are looking for. Another is that the pool from which board members are chosen is considerably enlarged. Thirdly the independence of directors appointed in this way is safeguarded; they are not on the board by grace of the chairman.

As chairman of PRO NED, I have an interest in promoting a more businesslike way of filling board vacancies than relying on a network of personal acquaintances. I am not, however, advocating the professional selection of outside directors because of my involvement with PRO NED. I am involved with PRO NED because I believe that competent independent directors, appointed after a systematic search, can improve the effectiveness of the boards of British companies.

It is board effectiveness which is the key to company performance. The institutions would be looking after their own interests and helping to make British companies more competitive, if they pressed the chairmen of the companies in which they were shareholders to have properly constituted boards. That is to say, boards led by chairmen who were not also chief executives, which have a sufficiency of independent directors on them and whose directors have been chosen systematically from as wide a circle of competent people as possible.
The Governor of the Bank of England made an important speech in 1984 on “The developing role and responsibilities of institutional shareholders”. In it, he set out the obligations of boards of directors and underlined that they were accountable to the shareholders for the discharge of those obligations. He went on to say:

“The reciprocal of this obligation is the obligation of the shareholders to satisfy themselves about the competence of their boards and the way in which they are functioning. Where the shareholder is a significant individual holder, this reciprocal obligation is of course the same thing as his own direct self-interest, but the position is not substantively different when a large holding is that of an institution, acting for the interests of its own pension beneficiaries, policyholders or shareholders. Just as it is the responsibility of the board to satisfy itself as to the competence of the management, so it is that of the shareholders to seek to ensure the quality of the board.”

It is the responsibility of the owner to see that his property is kept in good repair. When the property involved is a company that means ensuring that it is led by an effective board. If the institutions concentrate their attention on the composition of boards, they will be meeting their obligations, serving their own cause and improving Britain’s ability to compete in the markets of the world.

January 1990
Are shares just commodities?

Jonathan Charkham
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Introduction
Once shares are quoted and traded on a stock exchange (as distinct from being held privately), purchasers tend to be divided between two types of user of the market, which we might (provocatively) characterise as “investors” and “speculators” – without defining either too clearly, since the language is imprecise. Bookmakers call bets investments. Both types make their contribution to the market’s liquidity and it is not the purpose of this article to stigmatise either but to point out some of the consequences which do not generally attract attention, especially as the distinction is not as clear cut as it once was and the rapid spread of index matched funds is changing the landscape.

The “Commodity School”
Members of this school for all practical purposes regard shares as if they were commodities, objects of value like gold or cocoa or pork bellies to be traded, but without any intrinsic qualities or value other than that of being readily tradeable in an active market, preferably in derivative as well as substantive form (futures and options). What the company itself does is largely irrelevant: its staff are of no consequence. It is a line on a chart, an object of risk assessment, a percentage point in an index matched fund, a name on a spreadsheet. Nothing matters about it except what may affect the immediate movement of its share price, such as a change of fashion, a brokers’ lunch, a market rumour of disaster, the whisper of a bid. It is a buy at 180 and sell at 230. It is an element in a portfolio theory complete with algebraic equations which might equally apply to a basket of traded commodities. Changes in the income stream are only relevant insofar as they affect the market price.
The non-speculating investor – or the fundamentalist school

Such investors do not of course ignore the kind of information which guides the actions of the commodity school, because they have to assess the extent to which short-term information is a guide to longer-term expectations; and if they intend entering the market they must get their timing right. They do however primarily approach their investment with an eye to its appreciation over a longer term. From such an attitude stems naturally a greater interest in the function and conduct of the business and the composition of its board, its plans, prospects and competition, and its expenditure on research and marketing: in short, “the fundamentals” which govern the prospects of success. With such an approach the time span of investment moves away from taking advantage of temporary fluctuations of the share price towards comparative and absolute assessment of medium- and long-term prospects. Decisions to invest or disinvest will naturally be made at the most propitious time in the cycle with the end in mind, not of taking quick profits but of participating in longer-term prosperity: circumstances may dictate adjustments in the holding from time to time, but the intention and aim do not themselves falter. Chartism becomes a secular aid to timing not the latest occult religion.

The “speculating investor”

The third and newer category is the hybrid – the class of investor whose horizons are essentially long-term and strategic, but whose operations in the market are tactical and short-term. They are unlikely to buy “speculative” shares and deal almost exclusively in blue chips, but they seek constantly to take advantage of market fluctuations. They may end a year with the same stocks as they started but have been in and out of many and some more than once. As long as the transaction costs are
less than trading profits they argue that neither the fund’s trustees nor its beneficiaries have cause for complaint and they are quite right. Such calculations can take into account their tax exempt privileges. This category does not for most practical purposes belong to the commodity school, but constitutes a sort of elite membership of it since the commodities they buy or sell are bits of better companies.

**The consequences of the “Commodity School” approach**

I have expressed these attitudes as starker alternatives than the facts often warrant, in order to draw out the far reaching conclusions of the first for corporate governance. What does it imply if many shareholders do regard their holdings in this way?

The commodity school approach effectively destroys the notion on which the Companies Acts rest, that a board should be accountable to its shareholders. Accountability after all implies a willingness to receive information and to react to it. It is a two way process. It cannot exist if shareholders take telephones off the hook, as it were, except for messages which have a bearing on short-term market movements.

When there were many long-term investors in the market, the deafness of the short-term operators was in principle not serious. But if the balance has changed seriously, the consequences are that much greater.

The diminution in accountability matters in several ways. Politically it presents a spectacle of power without responsibility which may in time attract political solutions. Economically it places upon boards and the market the whole burden of ensuring that corporate governance stays up to the mark. Boards have the primary responsibility for this anyway but they cannot discharge it unless both their structure and dynamics are satisfactory. Structure is largely a matter of a proper balance between executive and non-executives (which many companies have yet to achieve), but dynamics are less obvious to the world as is apparent when an ostensibly well composed board may fail to function well, or run out of steam.
When this is so there is nothing between management and the market. Market solutions, i.e. takeovers, may be the right answer but this is chancy as many analyses show, and they are certainly costly to implement.

For time to time boards need outside influence to help achieve and maintain high standards. In Germany and Japan the banks play a leading part in exerting such influence because they are historically the main source of funds, often supplying a wide range of services: they have shareholdings and (in Germany) a seat on the supervisory board. In Japan associated companies, customers and suppliers (all of whom may be shareholders too) may exert influence. All of this is done quietly without public confrontation except in extremes. We do not have these options. Our banks have never seen their relationships in this way, and their industrial customers agree with them. We lack the Japanese “network”. We dislike supervisory boards. Yet we need accountability and, on selective occasion, external influence, the point of which is, by restoring the balance of the system as a whole, to help management raise and maintain its standards. It does not imply constant and costly investigation, or public confrontation. The occasions when drastic action would be required would be rare indeed.

Given outstanding top management, especially when operating with a board well balanced between executive and non-executive directors, many a company can prosper for years. Unfortunately it sometimes happens too that yesteryear’s charismatic leaders become so addicted to power that they stay till they are past their best. Sometimes too, even well balanced boards gradually and imperceptibly deteriorate. In the UK system there is nowhere to look except the shareholders to keep boards up to the mark, if the boards themselves fail in this task.

Another consequence of treating shares as commodities is to accentuate an existing difference between the UK on the one hand and its German and Japanese competitors. All boards have to strike a balance between retention (for investment) and distribution. Where they strike it must to some extent be governed by the nature of the business. Even so, if investment is
construed broadly to include marketing costs as well as capital expenditure, it follows that the heavy investor must put himself at an all round advantage compared with competitors who invest less. If share prices give greater weight to distribution rather than earnings, boards will be inclined to pitch dividends at a level calculated to maintain the share price. They know that if they go too far in the other direction, the share price will drop and expose them to a takeover from a predator who will increase the dividends by cutting back the retentions. If the UK were alone in the world it could be argued that this did not matter. As however we are faced with competitors who strike the balance differently, and much more in favour of retentions, it follows that the workings of our markets do put our boards at a relative disadvantage. This is the rationale which underlies the proposition that, other things being equal, patient money will always beat impatient money in competitive situations. This presents competition with an opportunity which the Japanese have exploited with great skill and tenacity. The more shares become a commodity the less chance there will ever be of patience being widely exhibited: patient money comes from investors’ confidence and confidence itself is largely a product of knowledge and experience.

The stockmarket has stood at the centre of this problem since over the last 30 years it has become a market for companies as well as for shares. We take it for granted that this is a natural state of affairs, but it is not so. It depends on voting rights. If no shares had voting rights and companies could not be taken over in a contested bid, shareholders who felt themselves locked in would have to take action. No William Tell could ride to their rescue, bid in hand. The distinction between share and commodity would be once again worth making. As it is (and I for one would not want to disenfranchise shareholders), the likelihood of takeover is just one of the short-term factors governing the price of the “commodity share”. There is no such thing as absolute loyalty in the stock market: every company has its price. The alacrity with which short-term “commodity share” holders make their exits is wholly consistent with the scale of their time horizons. There is nothing the ablest, most dedicated management can currently do to change this, even with the finest investor relations campaign yet designed. It is like asking a ravenously hungry man to forgo magnificent
roast beef today because he may get caviar next year. Or to use a more apt phrase – good gamblers know when to take their profits.

Total acceptance of the “Commodity School” approach is to abandon in practice the logical and continuous process of the accountability of the board to the shareholders in favour of the vagaries of the “market for companies” which tend so often to produce an ownership solution to a management problem. In any sensible sequence influence would when necessary be brought to bear on poor management to induce improvement; if this failed management would change but ownership would not. The profits from subsequent improvements would go to the existing shareholders. In the market sequence a predator pounces at an opportunist moment, generally produces a grouping or structure that is not superior and may be worse and (although the bid premium provides some comfort for old shareholders), seizes for himself much of the value that should have been theirs. Of course, this is a caricature for the sake of illustration, but there is far too much truth in it for comfort – as any analysis of takeovers over the last two decades demonstrates. It is wasteful to change ownership when all that is needed is a change of management, but it is inevitable if enough investors treat shares as commodities, since they have turned their backs on the alternative strategy.

Of course, shareholders and managers who treat their shares as commodities are intelligent, capable people, who know as much about company structure as any of us, and are perfectly well aware of the alternative strategy but feel impelled to eschew it. The reasons for this are well worth considering. To start with there is the doctrine of spread: if a fund feels it must spread the risk very widely, it cannot afford to consider the fundamentals of all the companies in which it is invested in sufficient depth to contemplate the alternative strategy. Second, the fund manager cannot only be concerned with long-term performance (which is what the consideration of fundamentals implies), since he may well have been sacked if he has dropped behind the herd for a quarter or two. He is concerned with short-term performance relative to other fund managers since this is how he will be measured. The consequence of this for industry is to force him to think short-term, to treat shares as commodities and to
institutionalise the herd instinct. No wonder that index matched funds are becoming more popular – they at least put the herd instinct on to a rational, low cost footing: what is more, with all their juggling, churning and gambling, few fund managers consistently beat the index (according to a US survey between one quarter and one third in any given year, and then not always the same ones).

This inexorable pressure for short-term performance is the root cause of why shares have become commodities for so many fund managers, with all the consequences for industry that ensue. There is a fissure between the stock market and industry as a consequence, and I believe this is to industry’s disadvantage.

**An alternative strategy**

The desirability of an alternative strategy is based on the premiss that the dislocation of accountability is not in the public interest because of the unnecessary economic and human costs it imposes, and not in management’s interests either because the market is a harsher and more capricious taskmaster than interested shareholders could ever be. An alternative strategy does however depend on two factors – fewer shareholders seeing themselves as members of the commodity school, and the “fundamentalists” being prepared to organise concerted action when it is necessary.

The first as noted above depends on changes in fund managers’ remits and modes of measurement (and, some would argue, on the tax regime). The second is often attacked on the grounds that it is unreasonable to expect individual institutions to incur private costs for the public good. This argument has extra force if it is presented in a way which suggests costs would be high and action impracticable.

Fund managers are indeed not experts in industrial management and should not aspire to be. In any case most of the companies in which they are invested give every appearance of being perfectly well run. UK industry is not made up of ailing companies: much of it is competitive and healthy. Fund managers are however already adept at spotting the companies where things are going wrong. If a selection of fund managers were to be asked to list the major businesses that were a cause
of long-term concern I believe there would be a degree of consensus. What is more, decline would be seen generally to have been gradual rather than sudden and dramatic.

An alternative strategy therefore is not one based on a vastly expensive supervisory operation but on a readiness to exert influence – jointly if necessary – in that handful of cases where the knowledge they already possess makes this look a sensible alternative to takeover or to walking away from the shares. In these few instances they might well wish to look more deeply. Paradoxically the widespread use of index linked funds provides a platform for joint action since all investors in them are locked permanently into shares that constitute the index. There are indeed already some major institutions who do their best to act as positive shareholders in the cases where this is necessary – seen through their eyes any benefits that flow from their activities are visited upon the “free riders” as well as themselves – and they cannot help but feel discouraged. To them one can only say, “Say not the struggle naught availeth”. They accept with regret but with good grace that the shareholders of the Commodity School place an additional burden upon the remainder.

None of this is new. The need for more non-executive directors on boards was recognised as far back as the seventies (vide CBI’s Watkinson report), but it took till 1981 for PRO NED to be set up to persuade companies to correct a widespread inadequacy. It was felt that it would somehow infringe market principles if there were a move to make mandatory what nearly everyone agrees to be wholly desirable. This particular problem has been put in sharper focus by the recent spate of MBOs. It is all very well to give non-executive directors the responsibility of looking after shareholders’ interests when the management ranges itself against them, but what if there are no NEDs at all, or they are too few, or too feeble, or tied up with the management?

Placing the primary emphasis on getting the board right must surely be correct. External influence is bound to be less well informed and more difficult to exert. All the more reason therefore for the institutions to do what they can to get companies to follow the PRO NED Code. Even so, and as a long-stop provision, the shareholders have a part to play.
The value of such an alternative strategy was agreed years ago when the Institutional Shareholders Committee was first established. Alas, in the succeeding years, the individual cases in which it intervened in regard to the composition of the board have been few and far between though when they did success was often spectacular. Since those days the powers of the institutions have grown apace – particularly the power of the fund manager to whom so many more pension funds are now entrusted. If we extrapolate present trends very little of the UK equity market will be left in private hands in 20 years’ time. What this means is that purchases and sales will in reality be between Mr X’s pension, Mrs Y’s life insurance, Miss Z’s units. Any transaction will diminish the combined wealth of Mr X + Mrs Y + Miss Z because of its costs. The only sizable transactions possible will take place between those who look after their interests and all the commissions paid to intermediaries will represent a deduction from the beneficiaries’ combined savings. Those who take care of these savings therefore will have less incentive to play “pass the parcel” with each other and more incentive to consider how best to ensure that the companies in which they are invested can be assisted.

One of the difficulties about constructing an alternative strategy is that each and every person’s notions and actions in the present state of things look reasonable and justifiable in their own terms, yet the sum total – high transaction costs, only a one in four chance of beating the index, and that inconsistently – a disconnection from any form of interest in corporate governance (still less a responsibility for it) – all these things do not sum up to the public good, if that is taken to include the prosperity of British industry, which rests upon international competitiveness.

Of course there is no one single factor which governs this competitiveness; there are many others, like the social attitudes which affect the flow of able people to industry and the quality of the education they receive before entry and training afterwards.

There is therefore no simple answer to why UK industry has declined in relative terms, and no simple solution. The contention of this paper is that an element in the solution is somehow to try to build on what is best in the UK system not by
cramping the style of dynamic management, but by making sure it operates within a framework in which its success is more likely to be sustained. Even boards and shareholders cannot ensure success, but they can do something to arrest unnecessary decline – as has been shown in many cases where they have done so.

There must be some concern that this lack of a more positive approach will invite other solutions – for instance for the proponents of a supervisory board to return to the charge. And it will be an invitation too to lessen or abolish the taxation privileges accorded to many fund managers on the grounds that they are being abused. There are critics aplenty for the ideas expounded above, but few with constructive suggestions on a better way forward.

January 1990
The institutional investor’s responsibilities as owner

Alistair Graham

Director – The Industrial Society

Institutional investors bring enormous benefits to ordinary people through their activities, but their considerable power has perhaps only recently been sensed by many as a result of wider share ownership through privatisations, our greater general awareness of the City, and highly publicised takeover battles.

There is, however, no greater understanding generally of how institutional investors operate although it will be increasingly important in the 1990s for their power to be perceived in a positive light.

Managements and all employees need to feel confidence in their owners. It should be part of their overall feeling that they work in a worthwhile and stable business. The institutional shareholder needs to demonstrate the responsibilities of ownership to the company and its employees by filling the role amongst the shareholders of an established, known quantity with genuine interest in the future development of the business.

Companies should take the opportunity to explain who the institutional shareholders are in their Annual Reports to employees. Most employees would feel reassured to know that household name insurance companies or the pension funds of major firms had the confidence to invest substantially in them.

This is not a cosmetic exercise. Businesses which we have been accustomed to regard as impregnable are now vulnerable to takeover. The buying and selling of companies in ways which produce great financial gain, but often make little or no contribution to the strengthening of our industrial base, is commonplace. It has never been more important for the
institutional investor to exercise sound judgement in the longer-term interests of companies and UK industry, especially manufacturing, at the same time as meeting obligations to produce the best return.

The immense financial strength of our investment institutions also gives them a unique opportunity to protect businesses and their employees from short-term manipulations in the City.

In other words, I see further considerable scope for the institutional investor to set voluntary standards of conduct in the buying, selling and ownership of public companies. This is, of course, a role which the Investment Committees undertake, but most people do not even know they exist. I envisage a more publicly perceived role which helps to dispel the growing feeling for many managements and employees that they have no influence whatsoever in changes to the ownership of the businesses in which they work, nor in how such developments take place.

For these reasons, it is also especially important that institutional investors play a leading role in establishing informed discussion across industry and commerce, not merely in City and financial circles, in what I believe will be two vital debates of the 1990s: about the extent of employee involvement in public companies; and how far an element of ownership of these businesses can be brought about as a constructive factor in involving people at work and improving performance.

The debate on involvement of employees through information and participation in decision-making and decision-taking in
major businesses has been given a particular focus by proposed EEC legislation over the last 20 years. It has reached a new high point with both the advent of the European Company Statute, on which there is currently a UK government consultation exercise, and of the proposed Social Charter.

The ways of involving employees suggested by draft EEC laws need a great deal of consideration to produce a solution which both satisfies the manner in which British companies operate and offers a measure of involvement that reflects the effort and commitment people make to the businesses in which they work.

Proposals have now been put forward by UK interests to add equity participation to the current proposed EEC Company Law options for involving employees in board level representation; rights to information and consultation; or involvement through collective bargaining. Indeed, more recently the EEC Commission has indicated its interest in employee share ownership as part of the Social Charter.

Although the issue of involvement has made little progress in the EEC in the entire period of our membership, and although the Government’s opposition has remained trenchant, I am sure our public companies will eventually be obliged by EEC law to involve employees. It is crucial that any law lays down conditions which suit the way we work in the UK and enables employees to enhance their contribution to the efficiency and competitiveness of our businesses. The voice and experience of the institutional investor should figure significantly in resolving the complex issues this debate has raised.

For example, the present level of equity participation which is currently open to most UK employees does not of itself give rise to the degree of employee involvement envisaged in the other EEC options. In addition, large companies, financial and banking experts, whilst not dismissing the idea, have expressed reservations for financial and technical reasons on the specific equity participation option put forward.

The Industrial Society has long encouraged employee share ownership as a useful contribution to help workers identify with and develop a long-term interest in the business. In our
experience the share scheme will usually only achieve these benefits if it stands alongside other management practices which are genuinely designed to encourage employee involvement and which are applied consistently over the years.

Although there have been fiscal incentives to encourage the introduction of employee share schemes, their development has been slow, albeit steady, with the exception of the widespread takeup of executive schemes. We are concerned that share ownership for employees at all levels should develop from being perceived either as an interesting but very limited and marginal add on to an employee’s benefits in a considerable number of public companies or a substantial factor in a very few companies where common ownership is an essential ingredient of a participative culture. The latter is often admired from afar but dismissed as only relevant to that particular organisation or even the result of an original owner’s idiosyncratic whim.

It is now generally acknowledged that we have to find ways of both widening and deepening share ownership. I am of the view that ownership of public companies in our democratic society must entail a strong degree of individual as well as institutional shareholding and we need to find ways of enabling the non-institutional shareholder to express his or her voice. In this sense employee share schemes provide a useful vehicle, because the employees are recognisable groups whether their shareholding is direct or through a trust.

I am not suggesting, for example that one by-product of the development of the ESOP in the United States, in which employee share blocs can be seen as a useful weapon to a company in event of a hostile takeover, is desirable. I do however believe a significant degree of ownership can give employees a necessary positive voice in securing prosperous long-term development for the company, and that institutional and employee shareholders can develop fruitful partnerships.

I fully understand the concern amongst institutional shareholders that equity must not be diluted but urge the Investment Committees to reconsider their very cautious limits on the level of employee shareholding, both in terms of amount of equity for distribution to employees and the length of time before an
employee can build up a significant stake. It is of course true that the aggregate level of employee shareholding overall does not meet the present limits, for a variety of reasons. However, there is evidence to suggest that a significant number of companies would allocate more shares if they were able to do so.

Although the statutory Employee Share Ownership Plan (ESOP) was seen initially as a vehicle for a private company, numerous quoted companies have expressed interest. It is to be hoped that the Government will heed the calls to improve the legislation since an ESOP could play a useful role in a public company in creating an internal market in the shares, thereby avoiding dilution through the issue of new shares for the employee scheme.

Wider share ownership can be significantly pushed forward if ways are found of enabling our major companies to offer meaningful measures of equity participation to employees which the companies themselves firmly believe contribute to their long-term prosperity. The movement to wider share ownership now has many influential advocates. The full backing of the institutional shareholders would be decisive.

January 1990
It is now some three years since I retired as Chairman of M&G Investment Management when the majority of my time was spent on City matters but it was combined with various non-executive directorships in industry. During the last three years my position has been exactly reversed with the majority of my time spent as Chairman or Vice Chairman of two large public companies with only a small involvement in City affairs. I have kept my peace since “Big Bang”, but I thought it might now be helpful to consider why there has been a deplorable decline in relations between the City and Industry during the last three years.

There is always bound to be a certain conflict and tension between the two, but the City neglects the present situation at its peril because the word “City” has become a term of abuse. The crux of the matter is distrust and it stems from the new relationship. Whereas two years ago the majority of the people in the City were working primarily for their clients and only secondarily for their own profit, the reverse is now the case, with the majority putting self-interest first and the devil take the client. This is clearly an over-statement, but the change in attitude of mind, which is particularly prevalent amongst younger people, has been accompanied by an arrogance that one does not meet elsewhere in public affairs. This arrogance seems to arise because people, like institutional investment managers, analysts and corporate finance men and women in merchant banks, seem often to have forgotten that they are the servants of their organisations. They in their turn may well be servants of a larger community of shareholders and investors, whose purpose may be different from their own and whose views should be taken into account.
But it is not just mental attitudes that have led to the decline in relationships, it is also a change in priorities and objectives. Whereas once upon a time analysts and merchant bankers were presumed to be advising clients with their interests in mind, they now seem motivated by the desire to create business and they seem to be not too fussy about how this is done. Indeed it is not unknown for analysts inside the different parts of the modern financial City conglomerate to be advising bits of the organisation with contrary advice. This may help to make markets and create turnover. The trusting assume that it is carried out within “Chinese Walls”, but industry may not necessarily see it in those terms.

For private individuals, and even for Boards of Directors, one sometimes wonders where one can now turn to gain impartial advice. The warnings that the competition of “Big Bang” and the construction of financial conglomerates would lead to American and Japanese as well as continental operators taking over our financial strongholds has proved too correct. It seems illogical of the Government to be slow about European financial union when they have played such a substantial part in globalising world markets with possibly lower standards of conduct than those to which we were accustomed before “Big Bang”. It is comic, too, that a Conservative Government dedicated to liberty and the subjugation of bureaucracy has introduced the Financial Services Act, with its myriad layers of regulatory authorities and mountains of paper. There is no indication so far that sensible controls can be exercised in this way. There is only one suitable Compliance Officer in an organisation and this is the Chairman or Chief Executive, who merely says, “If you do that again you are out!” Compliance Officers become self-defeating when they are too complex, and all we need to bring things to a grinding halt is an Association of Compliance Officers accompanied by their own Financial Services Act.

What then do we do about this? Obviously, the City has to take cognisance of the problems but the Bank of England can hardly do much because they were primarily responsible for the changes, based on the undoubtedly splendid conception that a free-for-all would make London the centre of world markets. Ironically, the resolution of many of the problems rests in the hands of industrialists, chairmen, chief executives and directors
of public companies. They need to be far more open and less secretive, they need to pay far more attention to the needs of their private shareholders rather than the institutions and they need to act far more responsibly as trustees of their own pension funds and other investment funds such as insurance, investment and unit trusts and charitable funds.

Taking first directors’ responsibilities to investment funds, there are three points which need discussing in detail:

1. Performance Tables and Actuarial Valuations of Pension Funds.
2. Behaving with their own pension and other investment funds in the same way as they expect their own shareholders to behave, including “short-termism”.
3. Approval by Boards of Directors of Certain Investment Decisions.

1. Performance figures and actuarial valuations
One of the most serious disadvantages of the computer age is the cataract of performance figures relating to pension funds produced by the actuarial profession. The philosophy of overall return is understandable in the context of actuarial valuations and predictions, but when transferred into monitoring of investment performance they are totally inappropriate, particularly if produced on a weekly basis. All good investment decisions have a two year perspective and the best ones are normally taken when markets and individual shares are falling and have still further to fall, because nobody ever gets in at the bottom. By definition, therefore, good investment managers may perform badly in the short term.

But there is another aspect of these figures which is extremely dangerous as one cannot judge investment performance with one set of statistics. Three are needed and these are to show:

(a) The change in the market value of a fund when compared with market indices;
(b) The increase in annual dividends (i.e. return on assets);
(c) The variations in yield compared with the average.

(a) and (b) above should not be added together for the purpose of monitoring investment performance because an increase of, say,
2% or 3% in dividend distribution can be excellent, but when added to capital values can be so small that it is statistically of no importance. Indeed individual investment managers are good at different things and the ones who are good at both increasing dividends and capital growth are very rare indeed. The necessity for (c) is that Trustees should be aware what is being achieved by changes in the portfolio structure and that portfolios are not being churned to gain yield. Having got the three performance sets of statistics, Trustees should then occasionally glance at them, but make a self-denying ordinance that they will only discuss them at most once a year. A major review should only take place every three or four years.

2. Short-termism
Anyone who has managed capital investment for industry or companies going through a managerial revolution knows that the timescale for improvement is between three and ten years. Wise investment managers may not think in quite such a long term, but they are ill-advised if they think shorter term than two to five years, unless of course they own up to that fact that they are speculators and “wheeler dealers”, for which there is a place in any market. But what there is no place for is humbug on this subject. It is also perfectly clear that the decline in British industry in the 1960s and 1970s was due to inadequate research, replacement and modernisation. In the 1980s some progress has been made, but recent events may be turning the clock back. This cannot be good for the prosperity of the UK in the conditions of 1992 and beyond and although there is a lot of smug talk about investment managers having to consider only the financial interests of their beneficiaries, this is often the excuse for not thinking about the wider long-term prosperity of the country, investors and savers. There was nothing in the Megarry judgement that suggested that Trustees had to consider short-term rather than the long-term financial interests of beneficiaries. There are good biblical precedents in both Deuteronomy and Leviticus for taking the wider view of financial responsibilities, and there is proof in the results of consumer-orientated companies like M&S and M&G that if the interests of clients are put first, profits follow. The reverse is not always so; equally there is evidence to show that long-term investment decisions prove more profitable than short-term activity.
3. Approval by Boards of Directors of certain investment decisions

Some 15 years ago we introduced a system at M&G Investment Management by which every decision relating to a takeover bid or controversial interference in the management or financing of a third party company had to be decided by the Board and, in particular, by the non-executive directors. The management would make clear recommendations but they were always discussed. There were huge advantages to this process, for not only were the investment managers made accountable, but they were forced to take into account wider considerations and the long-term implications of decisions affecting industry, the City and the country.

There were the added advantages that in any negotiations the investment managers were speaking with the authority of their Board who had in their turn considered the full implications and what was more important and less important.

Now that about 75% of the equity of UK industry is held by investment institutions these three proposals would go some way to answer the criticisms of the City about short-termism and arrogant non-accountability.

There are two other fields where a change of attitudes and procedures might help to counteract the view that stock markets are now merely a casino for the large and powerful:

1. Forecasting company results

The Bank of England and the regulatory authorities in the City need to have a fundamental rethink about the forecasting of company results. I cannot understand why such secrecy has to accompany how a company is performing from week to week. The good Chairman or Chief Executive knows how things are going and, if he is wise, he sees that the people who work for the company know. There is no fundamental objection to shareholders being told roughly whenever they ask how the year is going. This would mean that analysts would no longer need to spend hours of time speculating and calculating what they think has happened and there would be a much fairer market. It would obviate much insider trading and false markets when the market makers change their figures in order to make
business. There would be pitfalls, but rather fewer than the pitfalls of the present system. It would also be rather more economical.

2. Protection of small investors
There is little doubt that “Big Bang” was beneficial to the large institutions by reducing expenses of dealing; on the other hand expenses have increased for small investors who have found it increasingly difficult to find investment help and advice. It is questionable whether the liquidity of markets in adverse conditions for any class of investor has improved. All experience of markets over the years has shown the importance of healthy private client investors. The impression is given by the International Stock Exchange that this side of their activities is unimportant and, indeed, unrepresented in their counsels. In addition there must be doubts over Taurus and its implications for the private client and there is also the ludicrous situation that the I.S.E. insists on having company announcements before they are communicated to shareholders. This is another example of the City trying to be on the inside track. Company chairmen and indeed the C.B.I. should help to protect the private investor against the power of the City and it is strange indeed that the Office of Fair Trading and the D.T.I. do not worry themselves more with these problems.

This article concerns itself with the problems of investment management and conduct in the 1990s. The recent Bank of England Discussion Paper No 44, on aspects of the shareholders’ role in corporate governance and the market for companies, shows how the wind is blowing. Unless change comes voluntarily by self-imposed standards of conduct, any Government will eventually have to take a legislative hand. There is no doubt that an Investment Management Conduct Act would be yet another disaster with a diminution of personal responsibility. The lessons of DRG, BAT’s and Pearl etc, leveraged bids and junk bonds, and various scandals, must be learned and the recent Bank of England strictures on the banking community reflect the growing concern with the public interest rumbling in Westminster, Whitehall and the media. There is still time to put things right, but not much.

January 1990
Shareholders are the owners

Sir Martin Jacomb
Chairman – Barclays de Zoete Wedd Ltd

Ever since the idea of limitation of liability by incorporation first became a reality, management and ownership has tended to separate. Nevertheless, in most cases communication between management and shareholders remained close, when companies operated on a local scale. It was only when expansion went beyond the local environment that new money was needed on a much larger scale. When local finance ceased to be appropriate a Stock Exchange quotation might be sought and external shareholders who had no emotional attachment to the business were, for the first time, involved as owners.

Today the vast majority of large companies have as their most significant shareholders the investment institutions of various kinds. The paths of communication which existed between local management and local shareholders have disappeared. In their place are the periodic public announcements and the Annual Statements which are, only too often, not very informative. But if things are going well, requests from shareholders for fuller information are not often heard. So long as management is seen to run the company properly, to expand operations and to provide an increasing stream of profits and dividend, shareholders have been content to remain passive.

Some feel that it is not the role of institutional shareholders to take upon themselves the burdens of supervising management.

After all, the presence on most boards of non-executive directors is designed as protection for the shareholders at large. But however good non-executive directors are at fulfilling their proper role, in my view there is no substitute for direct action by shareholders when things look like going wrong. The trouble is that under our system, unlike systems which involve supervisory boards, there is often no adequate flow of information to alert shareholders that
something is going wrong. And even in cases where there is, there is no tradition of shareholders taking direct action.

In my opinion the reason for this is often that information which reveals management inadequacies arrives with the shareholders too late. There is nothing like the continuous assessment that occurs with a supervisory board.

Moreover, when there is a crisis in the company’s affairs, for instance a slump in corporate profitability or a takeover approach from a third party, the lack of past communication is often acutely felt. Shareholders can be faced with the need to take decisions without a full understanding of the company’s affairs.

It has to be said that such a lack of knowledge may not entirely be the fault of management. If it is true that shareholders are, perhaps, too inclined to pay little attention to the affairs of the companies in which they are invested, except when matters are brought to a head, then in part at least, they have themselves to blame. Furthermore management is nowadays precluded from giving price-sensitive information to shareholders on a selective basis and publication of detailed information can be commercially sensitive.

However, this is the gloomier side of the picture. In recent years, there have been a number of improvements in communication between companies and shareholders. Companies are now much more willing to talk about their objectives and, indeed, to publish them in their Annual Reports. But it is not much good if these are simply broad generalisations, such as “to remain a leading company in the Widget industry” or “to continue to satisfy our customers with our traditional levels of service”.

Sometimes objectives are somewhat more focused, for example, “to increase both profits and dividends by more than the rate of inflation”, or “to increase our market share by x% in the current year”. Surprisingly enough, though, UK companies do not often have, even as an internal objective, the maximisation of their share price. This attitude contrasts with that of most major American companies. For them the share price is a key statistic to be watched as regularly as production and sales figures or borrowing requirements.
There is often only a generalised feeling that if the price were higher, the cost of capital would be lower and an unwelcome takeover bid less likely. Perhaps this will change as companies use their power to buy their own shares more freely; and directors will also be influenced by a number of cases recently when it has only been after an external shock that management has brought forward plans designed specifically to increase their stock market rating.

Some more progressive companies have established shareholder relations departments whose business it is to deal with investors and to answer their legitimate queries. However, such departments have their limitations. They are staffed by employees who are beholden to senior management; and everyone knows this limits what they can say. Nevertheless their existence must take a significant burden away from senior management and is a step in the right direction.

What, then, should be the attitude of investors towards the companies in which they invest? It should not be necessary to draw a distinction between institutional and other investors. The interests of both classes of shareholders are identical, the only difference between them being that institutional investors are fewer in number and hold more shares. Obviously, if a company wishes to contact the holders of a given percentage of its capital it is easier for it to talk to institutional shareholders rather than individuals; and they are usually more accessible. But there is one point of difference; institutional investors are, themselves, responsible to others; pure self-interest does not prevail. They may be the trustees of pension funds responsible to pensioners, both present and future; they may be the investment managers of an insurance company, in which case they are responsible either to the policy holders, or, in the case of a proprietary company, both to the policy holders and to the shareholders of the company itself. Institutional investors therefore are not totally free to do as they wish. An individual owner is free to act quixotically; whereas institutional shareholders cannot forgo a certain profit opportunity in the vague hope of jam tomorrow. This leads to complaints that are heard from time to time, that institutional investors adopt short-term attitudes and are therefore unwilling to support management in their longer-term objectives. But institutional shareholders, just like individuals, can and will take a
long-term view if they are given enough information on which to base it. Managements are, fortunately, coming to realise this. This is not going to provide the complete answer to complaints about “short-termism”, but it should markedly improve matters.

A competent investment manager is continually evaluating the existing investments and adjusting the portfolio as circumstances change and knowledge develops. An institutional investor is always looking for undervalued situations where a higher return than normal can be obtained. At the same time, the investor is looking for overvalued situations where it is appropriate to sell and take the profit. This can lead to the case where a manager will sell a holding although the long-term prospects of the company are excellent. But this is not “short-termism”.

Company management often misunderstand the reasoning. However, the efficient market theory proposes that current share prices represent the sum of existing knowledge concerning the share concerned. If this were literally the case then there would be no room for under or over-valuation. In practice, however, there is always a tug-of-war between buyers and sellers, and the share price at any moment represents a tenuous equilibrium between investors with different views. There will always be some situations which are overvalued in the opinion of some investors.

The accusation of “short-termism” is most often brought forward when a takeover bid is put on the table. Such a bid is inevitably at a significantly higher price than the current market level and thus represents an opportunity for investors. It raises the question whether to accept the bid or reject it, involving a judgement about the future prospects of the company if the bid is defeated, and about the likelihood of another, higher, bid either then or in the future.

A takeover bid raises, in other words, in an extreme and immediate form, the same fundamental question which is continuously there: whether to hold or sell.

What the shareholder needs is accurate information.

One of the most satisfactory means of communication is through investment analysts. Analysts are independent and their primary
responsibility is to investors. They have no particular axe to grind since their reputation depends on the successful interpretation of a company’s results and prospects. An analyst is in a position to apply a broad set of criteria to his work and, through work done on the sector as a whole, and competing companies within the sector, has access to comparative information which makes his analysis more penetrating.

There is sometimes friction between a company and analysts which follow it. Company chairmen are never happy to see adverse comment, for not unnaturally they want to see the market rate their shares highly. That is in the interests of their shareholders. However, if the relationship is soured this is to be deplored. A good analyst will always check the facts with the company but must be left to draw his or her own conclusions. Any suggestion that an analyst can be swayed by a company in the presentation of facts or conclusions strikes at the core of his or her reputation. That is not to say that an analyst is never prepared to change his view of a company, after listening to the company’s comments on his work; for it is the mark of a good analyst that he or she should be prepared to listen carefully and alter his judgement as circumstances change.

Although the principal contacts between company and analysts take place in the period around the announcement of company results, there are many other occasions where it would be in the company’s interest for discussions to take place. Examples might be a formal change of strategy, the launch of new products or any other significant change in a company’s activities or prospects.

It is not the function of an analyst to propose new strategies for a company nor will an analyst seek to influence directly the policies which may lead to a re-evaluation of a company’s prospects. These areas are reserved to management. On the other hand, if he has regular meetings with a company and has the confidence of management, he may well be in a position to act as a sounding board for new departures of this nature. A company should always keep in touch with the marketplace, and not leave this until a crisis has already developed. The role of the analyst at the company’s brokers is of prime importance in communicating with shareholders. There are, of course, limits to the amount of communication between management and analysts. Price
sensitive information which makes the recipient an insider should obviously not be disclosed prior to its becoming publicly available. The insider dealing legislation is, quite rightly, designed to ensure that no one in the know should deal before such information is made public. Subject, however, to these constraints, the use by companies of investment analysts usually enables information about the company to be disseminated more widely and with a better chance of correct interpretation than would otherwise be the case.

The final judgement is in the hands of the shareholders and rightly so. If they decide to sell, having all the information, they are entitled to do so and management should not complain. This is the public market in action. If, on the other hand, they continue to support the company they may be proved wrong if the company’s expectations are not achieved or they may be right, in which case they will be rewarded.

January 1990
The balance of responsibilities

**Sir Hector Laing**

*Group Chairman – United Biscuits (Holdings) Plc*

“Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. When the Capital development of a country becomes the by-product of the activities of a casino, the job is likely to be ill-done.”

*John Maynard Keynes*

Just as the prevailing wind in the UK is from the west, so it is with many aspects of financial and business thinking: we tend to follow American trends. There seems to be increasing concern, even disenchantment, in the United States about the spate of hostile takeovers during the 1980s and their recent financing by high levels of debt. It is to be hoped that this concern will be more widely and more loudly echoed in Britain.

I am a firm believer in the validity of the market economy but to work efficiently over a long period it needs to be in a healthy state of balance. The weakness of a state-controlled economy lies in the concentration of power in the hands of the few and the undermining of individual initiative and responsibility. Similar dangers exist in the market economy if a monopoly is allowed to develop or if control of wealth or power is concentrated in the hands of a limited number of people. To prevent those dangers, a market economy has to be so regulated that concentration of power does not adversely affect the interests of the national community.

Regulation is a responsibility of government. Until their power was curbed, monopolistic representatives of working people – some trades union leaders – were not accountable to their millions of members and could cast their votes without consulting their wishes. That concentration of power was seriously damaging the economy and legislation was required to redress the imbalance between the trades unions and industrial management.
Today there is a concentration of capital power in the hands of relatively few institutional fund managers. While the fund managers may be given investment guidelines by their own boards or trustees, they are likely to have wide discretion. In effect, therefore, they probably have complete control in the disposition of the funds entrusted to them, and in the buying and selling of publicly quoted companies – they can cast the votes of millions of savers or pension fund beneficiaries without consulting their wishes. This too poses a threat to our future economic well-being.

The London stockmarket, like that in New York, used to be a market for raising capital and for buying and selling stocks and shares. Today there are two prices for shares: the trading price and the takeover price. An enormously profitable game can be played by anyone who can persuade the market to change the basis of valuation and this is precisely what happens, and why it has become so lucrative to put a company into play. “When there is an economic incentive to make something happen, Wall Street makes it happen,” commented Wasserstein Perella recently. For some finance houses and market operators it has become almost a necessity to “make something happen” because traditional core business activities are not sufficiently profitable.

Share price used to be determined by a company’s expected profit performance; today it seems that its share value sometimes dictates the way the company has to perform. Thus the stock market is coming to be not a means of allocating capital to productive use, but an end unto itself – a computer game for those who compete in the “Finance League”. But it is an eroding game, which undermines the true value of the counters with which it is being played – the national industrial commercial base. A wedge is being driven between the providers of capital and its productive users; each seems to be living and operating in a different world with a different timescale, and this is extremely unhealthy for the national economy.

The justification for incorporation of a business was, and is, that the enterprise gains strength from the legal differentiation of roles – the segregation of the rights and liabilities of shareholders, creditors, employees, investors, management, suppliers, customers, the community and the state. The role of management has traditionally been to derive optimum value from the financial,
human and technological resources employed in the business – to serve the best interests of the company in its entirety.

Unfortunately management’s duty to enhance the value of resources employed appears to have been discarded in favour of one for enhancing the wealth of the shareholders, who are likely to derive greater wealth in the short-term from the fabulous gains offered by financial opportunism than from their share of a company’s wealth creation – from dividends and reasonable capital growth.

While it is right to assert that a company must be run for performance rather than for the benefit of its management, it is wrong to define “performance” as short-term gains for shareholders. This subordinates all other constituencies to the immediate gratification of people whose only interest in the business is short-term payoffs. I cannot believe our society will tolerate this for very long – and if it does it will self-destruct.

Immediate shareholder gains do not optimise the creation of wealth. That requires a balance between the short term and the long, which is precisely what management is supposed to provide. Apart from being aggregations of property – things people own and buy and sell – companies are social organisms, in which men and women realise, or fail to realise, purposeful and productive lives. Their effectiveness and productivity are arguably the most important barometers of the effectiveness and productivity of a nation.

This country’s comparatively poor productivity record in the three decades following the War can be attributed to insufficient investment in manufacturing industry. While subject to various controls imposed by government, of which price control was probably the most damaging, industry was insufficiently profitable to invest adequately, and when union power was unconstrained, funds which should have gone to investment were conceded in unjustifiably high pay awards. Both those difficulties are now behind us: industry has become much more profitable in the last few months and investment has been at sensible levels, although we have a long way to go to catch up with our major international competitors so that a continuing high level of investment is essential.
An impediment to continuing investment during a downturn in the economy is the attitude taken by the City to bottom line and gearing. Maintaining an adequate level in a recession may lead to a company’s gearing becoming what the City would consider unacceptably high and/or to the bottom line being affected. If that situation continued for two years, the shares would be marked down with an increased threat of takeover and predators claiming that “shareholders’ assets were not being utilised efficiently”. Management’s response to threat of takeover by taking a short-term view of their company’s performance and concentrating, probably to excess, on their share price, may protect their own position, but could damage the company’s long-term welfare. As Lee Iacocca commented: “choosing to modernise your factory instead of increasing your dividend might make shrewd business sense, but it is also like putting fresh blood in the water – a sure fire way to draw the sharks.” Choosing to defend long-term market share by continuing to export when our currency is strong could be similarly dangerous if it is at the cost of short-term profitability.

According to the Chairman of Sony, Akio Morita, however, “a company that reinvests in itself instead of concentrating on profits alone will in the long run be returning more to the shareholders.” In my opinion, that is the most important factor which any shareholder, and particularly the professionals – the fund managers – should bear in mind. In the long run our shareholders will lose out if the British economy is weakened by industry’s inability to build on the productivity improvements of the last decade because threat of takeover means that short-term earnings performance has to take precedence over investment.

Japan, Germany and France do not have these constraints and of course while we are having to cut back investment, many of our major competitors are not, so we slip even further behind. In those countries attitudes are very different: unwanted takeovers are blocked either by government veto or by safeguards written into a company’s articles of association, which are possible because their shareholders appear to recognise the importance of protecting the nationality of their major companies. A City banker said of the DRG takeover that it was “a case of cash today is better than performance tomorrow, so the company was handed over. It wouldn’t have happened in, say, West Germany where
shareholders either have faith in the company so they do not want it to be taken over, or they have no faith, in which case they call for new management.” The long-term growth and prosperity of a business here is of no interest to opportunistic financial speculators and conglomerate jugglers.

The UK, with one of the most open stock markets in the world, is uniquely vulnerable to takeovers. It is by far the easiest place in Europe to buy companies, either for expansion by Community companies in the run up to 1992 or as a foothold for outsiders.

The Government’s view that Britain should not join the ERM until all EEC countries have liberalised their capital flows – and no doubt other things – seems to me to be inconsistent with their acceptance that continental companies which are themselves inviolate are free to take over UK companies. As things stand, successful British businesses can be hijacked by Europeans with bullet-proof waistcoats. Since “the playing fields are far from level” it is being suggested that the Continentals must mend their ways, but they will not do so unless we oblige them to and the surest way to persuade them to change is to deny them access to our companies until we have reciprocity.

Having said that, the chairman of a major French company told me recently that come what may, it would be inconceivable for his government to allow a takeover of his business from outside France – and that “the people of France” would not like it! What a contrast with our attitude.

I have no wish to see British industry “protected” – that is not an answer – but I understand the French chauvinism, or what I would call loyalty, better than I understand our “take the money and run” approach. By the time it becomes evident that our totally free market in corporate control is seriously damaging to the nation, it will be too late. Denys Henderson said recently that although ICI could be taken over and broken up, he did not believe that would be in the national interest. Sadly, the national interest seems to be of little account where there is a profit to be taken.

To quote Akio Morita again: “Economies are at the mercy of financial opportunists – companies have become commodities to be traded, bought and sold. This is not the natural and rightful role
of industry which is to improve existing products and create new ones. For industrialists, money is a scale: to measure the economic activity of our companies, our assets, our inventories and the results of human effort. As some industrialists invest in the money trading game instead of the future, the ability of some countries to produce their industrial necessities is diminishing rapidly.”

Being a firm believer in the old adage “he who pays the piper calls the tune” I find it difficult to divorce national economic independence from political independence. If too many of our major companies are taken over by non-British owners, and free market forces make that more rather than less likely, then the UK would become increasingly a satellite economy. We could be drained of our brightest and best business leaders who will want to be based at their companies’ power centres – which won’t be in the UK.

As a Scot, I have not enjoyed seeing the control of many large businesses moving away from Scotland because of the concentration of wealth and power in the south-east of England where those who call the shots are more likely to be based. As a Briton, I do not want that to happen to the United Kingdom as a whole.

Much attention has been focussed on Britain’s takeovers in the United States but a very much smaller percentage of their GDP is foreign-owned than of the UK’s. In 1988, United States buyers spent $6.2 billion on British companies, twice the total for the rest of Europe put together.

The main justification for the capitalist system is that it provides the best climate for innovation and risk-taking. If, however, the objectives, priorities and timescale of the managers of capital discourage risk-taking by industry, discourage investment for the long-term growth of the business – in research and technology, in building world market share and in developing people – then capitalism itself is called in question.

With the increasing application of technology, the quality of people is crucial. Modern industry doesn’t require just bodies, it requires trained minds, of which there is a shortage, and
increasingly it is employers who are having to invest in the training, whether directly or through government-sponsored schemes and agencies.

We are also being asked to develop close links with schools and universities through education compacts, teacher liaison programmes, university research funding and so on. This is, of course in addition to what the Government is asking us to contribute as socially responsible corporations to urban regeneration, enterprise promotion and other initiatives – investment which will certainly not show a realistic return in the short term.

In the national interest – as well as in our own interest – I hope and believe that industry and commerce will continue such investment. But if it is judged by the financial community to be inefficient utilisation of shareholders’ assets, that private sector investment will dry up, and the nation will be the loser. A Times leader on 4th January, on Michael Howard’s appointment as Employment Secretary, touched on the subject of training with the comment that “it does mean Government creating the conditions in which industry and commerce will invest in human capital as well as fixed capital”. The “conditions” referred to are at least as much for the City to create as for Government, and we have to hope that this crucial aspect of the national interest will be seen by the financial community as worthwhile investment which is of ultimate benefit to their clients.

I understand the dilemma for institutional shareholders and fund managers whose responsibility is of course to obtain the best possible performance out of the monies under their control as required by their client. Over 30% of shareholdings in UK quoted companies are owned by pension funds but it seems that their fund managers have not been asked to view their responsibility as being to both the working members of the companies in which they have a stake and to pension fund members, essentially the same people.

Industrial managements expect to see their own pension funds performing well, without considering whether or not that means the fund managers operating short term. By contrast the same industrial managers expect their institutional shareholders, in
essence those same fund managers, to take a long-term view with regard to the company’s profit performance.

Trustees of company pension funds can be seduced into appointing managers with the best short-term track record, and one way to achieve that is to participate in takeover speculation. Company managements have therefore aided and abetted speculation – we cannot afford to play Pontius Pilate on this issue. Finance and Industry have a complementary symbiotic relationship – we need each other.

In order to try and ensure that each gives and derives benefit from the other there are a number of constructive steps which could be taken – some requiring minor changes to existing regulations or Company Law, but others requiring no more than a change of attitude on the part of shareholders.

With the goodwill of major shareholders, a company could change its Articles of Association so as to give it a greater degree of security against damaging speculative dealing:

Once a company is subject to takeover speculation, this almost becomes self-fulfilling in that arbitrageurs end up with a large proportion of the equity and will wish to see a successful offer for the company. Shareholders could be required to hold shares for at least 12 months before being able to exercise voting rights, so that only longer standing shareholders would be able to deliver a company into the hands of a hostile offeror.

Any shareholder who did not vote at a general meeting of the company could be deemed to have appointed the Chairman or his designate as proxy. This would have the effect of enfranchising the large number of shareholders who would normally take no action. In view of the large proportion of shareholders who do not currently vote, it is possible for dissenting shareholders with a relatively small holding to vote down a resolution. This proposal would ensure that the management, acting in the interests of shareholders as a whole, could at least rely on the support of the apathetic.

I would welcome more vigorous participation by shareholders in company meetings. When shareholders have questions or
concerns about the management of their company they should make those concerns public in the forum at which management has a responsibility to give an account of its stewardship. This would also provide the opportunity for the analysts and commentators to make better-informed judgements about the management and its performance.

A form of protection enjoyed by companies in some other European countries may be thought unacceptably restrictive in this country: Nestle – and no doubt other companies – have the approval of their shareholders to restrict the percentage of the company’s issued share capital which can be voted by any one shareholder so long as earnings per share continue to rise at a defined minimum rate. I hope this may come to be seen by shareholders in this country as a positive step.

Legislation can play a part in curbing manipulative and abusive tactics of corporate raiders, and it is interesting that in the State of Philadelphia amendments to strengthen their Corporation Law are being proposed “to allow corporations to function more effectively and with a long-term focus”. Among other things, the proposed provisions would:

- make explicit that directors owe their duties to the corporation, rather than to any specific group such as shareholders, and explicitly permit directors to take into account long-term as well as short-term interests.

- give shareholders the opportunity to vote on and approve a change of control of their company effected by the purchase of a control block of shares, in the same way as they must currently vote on and approve any change of control effected by a merger, consolidation or sale of substantial corporate assets.

- require short-term speculators who have put a company “into play” and made significant profits by being unsuccessful, to return such profits to the target company.

Our Government could, relatively simply, encourage longer-term thinking and make a contribution to redressing the balance between finance and industry:
It seems to me that there can be no justification for pension funds being exempt from tax on “churning” gains. Because pension funds must by their nature provide for the long term, dealings in stocks or shares held for less than a year should be liable to tax. This would be a useful encouragement to longer-term view, and would require a change in Fiscal Law.

Where a UK company is the target of a hostile bid from a Continental European company which is itself effectively bid-proof, either due to its national law or because its shareholders have agreed restrictions on voting rights in their Articles of Association, the bid should automatically be referred, and lack of reciprocity be a reason for its rejection.

The balance between bidding and target companies is presently weighted in favour of the bidder and this should be redressed. The current situation allows a bidder to acquire 29.9% of a company in two steps with no requirement on the bidder to disclose his intentions, and by dealing with a relatively small number of institutions. Individual shareholders are in practice excluded from any debate up to that point. All shareholders should not only have access to the same information as the market makers, but should be able to act on it.

When a purchaser’s stake reaches 14.9% they should be required publicly to state their intentions. If they intend to remain at that level, i.e. to hold the stake as an investment, one year should elapse before they can change their intention unless it is to reduce their stake. If, however, they state their intention to go beyond 14.9%, they should be required to make a bid with an offer to all shareholders.

The present position whereby interests in shares can be concealed for some time if they are hidden behind a succession of nominee holdings is not dealt with swiftly enough under present mechanisms. I strongly support the proposition that company boards should be able to disenfranchise shareholders who do not comply with a S.212 Notice adequately or timeously within, say, seven days. Present court procedures are too slow and cumbersome.
In addition, I feel that the ultimate holder should have to declare all his holdings, including those of concert parties, and not just the holding to which the S.212 Notice refers.

I believe that a combination of accelerated disclosure of S.212 replies and provisions whereby company boards have power to disenfranchise shareholders would assist in ascertaining ultimate beneficial ownership.

I am delighted that the Companies Act 1989 provides for the reduction of the disclosure level to 3%. Penalties for non-disclosure should include the automatic suspension of voting rights for, say, two years.

Now that the five business days formerly allowed for disclosure has been reduced to two, there should be a further constraint providing that a ten business day period should elapse before further purchases can be made to bring the holding up to 9.9% and a similar holding period should occur before the purchase can move up to the 14.9% level. All purchases between 2.9% and 14.9% should be disclosed on a daily basis.

It would be too much to expect that all these suggestions will be accepted even in the medium term but I very much hope that, in the national interest, there may be a measure of agreement that some correction of the balance would be sensible.

The institutions and the pension funds own about 60% of the total equity of listed companies and they ought perhaps to work out a concerted policy on the damaging effect of destructive speculation and wild takeover operations. I hope they may also have some constructive suggestions as to how to improve the level of investment in British industry – investment in world market share as well as in technology, in research and development and upgrading the skills of our people. Managements need the confidence of their owners if our investment in our businesses is even to approach the levels in Germany, Japan and the United States.

The destiny of this country's industrial base rests in the hands of the investing institutions – the destinies of an operating company's employees, customers and suppliers as well as of
individual shareholders. Those who exercise great power have a great responsibility to use their power wisely.

If that responsibility is abdicated, their victims will be unforgiving and the financial services industry will come to have such an unacceptable face that they could deal a death blow to the heart of the free market economy: their activities will be severely curbed and constrained. The ultimate interest of their clients, customers, policy-holders, pension fund members and their own shareholders is identical with that of the companies in which they invest, and that interest will be best served if they take a positive and constructive attitude as shareholders and as citizens.

January 1990
Corporate strategy and the institutional shareholder

Sir David Plastow  
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Anything that promotes greater understanding between industry and the investment community is to be welcomed most warmly – and it is therefore highly appropriate that the National Association of Pension Funds should take the lead in drawing together examples of good practice in the area of institutional investor relations.

Whilst always being a feature of corporate management, communications with institutional investors has, until recent times, been primarily conducted through the intermediary role of the company stockbroker, with limited face to face contact.

This system worked well enough. But over the past three years or so, the pressures to achieve increased efficiency on an international scale, for both industry and the financial markets, have given rise to the need for much closer levels of understanding in the relationship between companies and their major shareholders.

The result has been that the late 1980s have seen the emergence of direct relations with institutional investors as an increasingly accepted means by which more forward-looking companies maintain a dialogue with the City, founded firmly on the basis of common interests.

By direct or indirect means, many companies have long maintained good relationships with key investors, based on knowledge and understanding, which have stood them in good stead in times of corporate crisis. Many more however, have been rudely awakened to the disadvantages and problems which can ensue as a result of not having well established relationships with their major shareholders.
The period following the stock market downturn in October 1987 was a difficult time for a number of companies. It was not uncommon then to hear of businesses threatened with a hostile bid, failing to raise capital, or with a share price not reflecting their true market value, complaining that the reason was that “the City institutions don’t understand us!” Alternatively, such situations were attributed to a short-term attitude amongst the investing community.

In the event, the blame was far more likely to have lain with the management of those companies.

The problems referred to are typical of the issues which would be minimised or overcome by a consistent long-term investor relations programme which ensures that the company and its objectives are properly understood by those who choose to invest in it, with the expectation of a fair return.

There can hardly be a successful business that does not rely on the use of a well planned marketing programme to build long-term customer demand and satisfaction. Investor Relations is simply the effective application of such techniques to the marketing of a Corporation. Whether one is concerned with manufacturing, services or, indeed, equity the ultimate purchasing decision will directly reflect the marketing effort that has been – and continues to be – applied.

For investors, such purchasing judgements are based on the perceptions, beliefs and facts about a company together with an understanding of its prospects and its management skills. A key task of management therefore is to ensure that it clearly understands the needs of investors, builds the right kind of relationships and, of course, imparts the kind of facts which enable the fund manager to make decisions which result in long-term benefits to both parties.

Good investor relations cannot be built overnight or established by merely using many highly paid consultants and throwing money at the problem.

Shareholders have the right to expect management commitment to investor communication at the highest level.
That commitment must also be to dialogue rather than propaganda, and explaining problems as well as trumpeting success. My own belief in this stems from personal experiences of both difficult and successful periods at my own company, Vickers.

Following my appointment as Chief Executive of Vickers on the merger with Rolls Royce Motors in 1980 a detailed examination of the diverse portfolio of business then forming the Vickers Group was undertaken as a matter of priority. Inevitably, this revealed that a new direction and strategy needed to be determined and put in place if the business was to survive and ultimately prosper in the harsh international business climate signalled for the 1980s.

It was equally apparent in instituting such a change that explaining these broad intentions would go some way to reassure the investors whose interests we served and whose goodwill and support was to be so essential to the successful outcome of this long-term plan. The detail, however, would only be revealed as the strategy developed over time. It was vital to ensure our shareholders were given the background knowledge against which our long-term strategy would evolve.

In those days a clear and simple company strategy was not as familiar an idea as it is today and we were careful to start by establishing the basis for our thinking. Our strategy was and is to ensure that each Vickers business should be internationally competitive and active in a growing sector or market, as well as being large enough to influence the development of that market. In addition, each business should be a technical leader in its particular field and last, but by no means least, each should be relevant to the skills of the corporate management team.

It is easy enough to say these things in press interviews and in glossy annual reports. It is more important to be able to prove their relevance to the company in a dialogue with shareholders large or small. Vickers has now been following this strategy for 10 years and over this period the Group has been radically restructured. Eighty-five diverse Vickers operations have been pruned down to around 30 and regrouped into five key divisions. Today these comprise Rolls Royce and Bentley Motor Cars, armoured fighting vehicles, medical equipment, marine engineering and advanced materials and components for the aerospace industry.
Although with hindsight this restructuring can be seen to have been successful and profitable for shareholders – illustrated by the fact that profit per employee has risen from £1,170 in 1980 to £4,500 in 1988 with progress continuing in 1989 – sometimes our actions have needed to be carefully explained in detail to make sense of them.

A quite recent example of restructuring and realising shareholder value at Vickers was the sale in 1989 of Howson-Algraphy, a world leader in the manufacture of lithographic printing plates, to DuPont the American chemical manufacturer. Some years before, an emerging trend had been identified in the printing plate industry towards providing the customer with a much wider range of related printing products. This was providing benefits through economies of scale and printers were finding it more convenient to use just one supplier for all their requirements – plates, films, chemicals, processors, cleaning equipment and so on.

The conclusion was that, whilst highly successful, Howson-Algraphy would only be likely to continue to retain its successful marketing position as UK leader, second in Europe and third in the world, if it was linked to a chemical company which would provide a similar, broad-based, product range.

That all sounds logical if, like some Vickers management, you have been in the business for over 20 years. It is folly to assume that if you blandly trot out the logic it will be obvious to everybody. Given that it had been a consistently high performing key business, the sale of Howson-Algraphy must have initially seemed a surprising decision. However, there was a quite well established level of background knowledge on the business and its markets among our shareholders and very quickly the merits of the deal were understood and appreciated.

It is interesting to note that advisors to the Company reported that this was the first time that a British company had sold one of its key activities when it was at the very top of its cycle.

Approval of such a major move in a complex and not particularly well understood sector of industry may not have been so forthcoming had not effective lines of communication been established over many years.
Vickers has, of course, also acquired operations to help strengthen the position of its businesses in world markets. It is very easy for commentators to opine that a company has paid too much or has bought the wrong company. It is also all too common for management to resort to the empty shibboleth of “short-termism”, whilst making no attempts to explain the detail of benefits. Longer term strategic benefits are not always obvious to those outside a business and unfamiliar with the complexities of an industry.

At the end of last year, Vickers bought Ross Catherall PLC, the manufacturer of super and special alloys and ceramic cores for the aerospace industry and high technology requirements in other sectors. This company, the European leader, represented a perfect fit with the existing aerospace components business, Vickers Precision Components, and would create a substantial world player in this key market, where most manufacturers report full order books up to five years ahead and foresee strong demand continuing well after that.

Nevertheless, in the short term, this purchase entailed some small level of dilution for shareholders. Whilst not of major significance it was necessary to ensure that investors were aware of the profitable long-term benefits that would accrue as a result of this move.

Sound preparation plus the facility for open dialogue with shareholders helped make sure that the message was received and understood.

The changes that have taken place in British industry have, not surprisingly, given rise to consistently improving financial performance. But it is not the time to rest on one’s laurels. The pressures to perform have never been greater and it requires just as much effort to maintain relationships with institutions in good times as it does in bad times.

The success in British industry would not have been successfully accomplished without the huge improvement in management, and the City has clearly recognised this. Investor research frequently cites the quality and strength of management as one of the prime criteria used in the evaluation of company potential.
This has not come about by accident. The support given by institutional shareholders to managers of companies who were prepared to take painful and harsh action in the long-term interest of our manufacturing base has been critical. I do not believe it has always been easy for investors to understand complex and fast changing industrial activity but through long-term dialogue we seem to have made some progress. On the other hand, it has not always been easy for industrial managers to get to grips with an equally fast changing City.

The starting point in developing the investor relations programme for Vickers was to research and classify existing and potential major shareholders and the major “buy” and “sell” side analysts who were following the fortunes of the Company. This may sound straightforward but with such a plethora of finance houses, the increasing specialisation in fund development within the large investing institutions, and the constant movement of key personnel, some careful research into identifying the key categories and targets is, and continues to be, both necessary and time very well spent.

Having identified and prioritised the prime audience sectors within the investing community, a great deal of time and energy is expended in keeping ourselves informed about key aspects and developments in the investment community.

This is a continuous process. Understandably, the institutions do not like surprises and a programme of periodic contact ensures a build-up of background knowledge, confidence and understanding about Company developments. Against this background, hard news – both good and not so good – can be evaluated and put in perspective from an investor’s standpoint.

Having done this work, key items of news on Vickers are now given directly to major shareholders. Not only is this a matter of courtesy, it also ensures that the information reaches them before they read it in the press – and is in the form that it was intended, rather than having been distilled and distorted. In addition, where it is judged that the nature of the information justifies it, the Finance Director or I will make a point of telephoning them as soon as a Stock Exchange announcement is made, to reinforce the reasons for what is being done and why.
In order to help put across more general strategy a varied programme of activities is undertaken. Our prime aim is to meet as many major investors as possible, face to face at least once a year. This normally takes the form of meetings or presentations at which the Company is always represented by a main board team including the Finance Director and Chairman. If they are based outside London, time is specifically set aside for management to travel to meet and discuss plans with them.

A number of fund managers and analysts find it helpful to make site visits to manufacturing and sales operations within the Company for the opportunity to speak first hand to divisional management and sales personnel. This can be a time consuming and expensive business, but there is no substitute for direct contact for getting to know more about the esoteric value of many industrial processes.

An ongoing programme of visits both in the UK and to overseas markets has proved for a diverse company like Vickers to be a valuable means of improving the level of understanding between the Company and its key shareholders and advisers. The point is made frequently to Board members and those running our operations around the country that there is no more important call on their time than building a productive relationship with those who ultimately own their businesses. And when a representative of one of the institutional investors is visiting a Vickers business, it is a rule that they should spend time with the chief executive of that particular operation.

All the institutions seem, without exception, delighted at the time we spend talking to them and explaining our activities – if we can believe the independent research conducted on our behalf into their attitudes. If we have a complaint, it is that too little feedback is received. I do sometimes wish our investors were on the telephone to ask for more details of an acquisition, for example, or a management decision, or a press report. Personally, I think all institutional investors could, and should, do more to question and encourage the management of public companies.

Operationally the needs of major shareholders should be served on a day-to-day basis by the Finance
Director. This is certainly the role which I encourage our Finance Director to play within Vickers.

My own experience makes me a keen supporter of strong non-executive directors and their ability to play a crucial role in safeguarding the interests of shareholders. They bring the guidance and vigilance not only in respect of the development of strategy but also to the ensuing decisions which are taken in pursuit of that strategy.

I believe they should be given the power and indeed, where necessary, the money, to take on the executive board members of public companies when they are judged not to be performing properly.

In this regard I prefer the nomenclature “independent directors” to “non-executive directors” because it makes it a great deal clearer what their job ought to be.

Having a first rate set of independent directors is not just a check on the wilder notions of a chief executive or of the executive members of the Board. It also, more importantly, provides a company with a pool of talent at the very highest level that ensures the board fulfils its duty and turns in the kind of business performance that shareholders have the right to expect.

Perhaps most importantly, they must be independent of the executive, and particularly of the Chairman. In Vickers, the Deputy Chairman has a committee of non-executive directors whose principal role is to determine my salary and, should circumstances ever require it, to tell me my services are no longer required.

Vickers corporate strategy continues to be implemented in response to changing circumstances, and I like to believe that we are continuing to keep our shareholders abreast of our thinking. The policy implemented after the merger with Rolls Royce Motor Cars in 1980 was absolutely right at the time it was determined, and it remains correct in terms of the on-going development of our five key businesses today.
There is currently much talk of “unbundling” conglomerates in order to optimise shareholder value and, allegedly, to provide a tighter focus on key activities.

BAT is currently under the threat of a hostile takeover bid on this basis. Critics say its key activities are worth more to investors if sold off separately than if kept together as a unified whole.

For almost 20 years I have run companies which could be defined as “diverse” or “conglomerate”. While I cannot disagree with the argument that a number of diverse companies may not have organised their activities to always ensure maximum shareholder value, the suggestion that unbundling is a new idea or has to be done under the full glare of publicity is total nonsense.

The best industrial companies in this country are in a constant state of watchful evolution to ensure that they stay ahead in ever changing world markets. As a matter of course this involves continuous reassessment of portfolios, restructuring, making the right decisions to get into and out of particular activities and identifying where particular management skills can further add to shareholder value. Of course, focus is a good thing, but it is perfectly possible to be focussed across a range of activities at the same time.

If a business has reached a level of maturity and has a higher value outside the company, as was the case with Howson-Algraphy, referred to earlier, then it has been demonstrated that Vickers will consider optimising its return on the market value of that business, thus facilitating additional investment in areas where we can further develop other existing businesses to ensure long-term value and return.

Even an effective programme of planned institutional investor relations is, of course, no guarantee that any public company, including Vickers, will remain immune from hostile takeover activity. Indeed, as a firm believer in the capitalist system I have to say that if anyone reading this believes they can run Vickers better than the present management team they had better come and try.
However, the fact remains that a well informed institutional investment community is in a better position to understand our objectives, and appreciate what we are seeking to achieve on their behalf, thereby enabling them to make well balanced decisions about the future of their investment.

We are only too aware of the needs of both our shareholders and our employees and seek to create a long-term profit for both. Size for size’s sake does not interest us in the least. Our concern is to sustain consistent growth in earnings per share. That, linked to a clear understanding of the direction in which we are headed, is the best long-term guarantee that productive relations between manufacturing industry and its institutional investors will continue in the years ahead to our mutual benefit.

January 1990
The return of Rolls-Royce to the private sector in May 1987 posed particular problems of investor relations. We started from a rather difficult base, since the memory of the 1971 bankruptcy remained for many of the older people in the community. Sixteen years in government ownership meant that there was little incentive for analysts and investors to remain in contact with the company’s products, markets and management, and finally, the company was emerging from a period of extensive rationalisation, and consequential indifferent financial performance.

To compound these difficulties, the experience of our senior management of city matters was almost non-existent.

We tackled all these problems by an intensive communications exercise, involving analysts, fund managers and the press, including presentations, but also (and very importantly) visits by them to our leading civil and military customers, airframe manufacturers, and overseas collaborators, to emphasise the strength of our market position and technical capability. In addition, we arranged for analysts, fund managers and the press to visit our major sites and to meet management at many levels.

In parallel with all of this, and having in mind the intention that our workforce should, as far as possible, become shareholders, we carried out a communications exercise to them on the
company at large, and also on the technicalities of shareholding. As a result, a large majority of employees are now shareholders of the company. This is a great aid to good internal communications and employee involvement, and has impressed many of our North American customers.

The intensity of the investor relations activity placed a considerable strain on management at all levels, as did the formal procedures which had to be followed in parallel, for example the accountants’ long form report and preparation of the prospectus. The beneficial effects on our staff were dramatic. The need to explain things previously taken for granted and to answer penetrating questions on almost a daily basis, resulted in a totally different attitude to running the company.

The outcome was a highly successful flotation at a point near to the top of the Stock Market Index, and heavily over-subscribed. After the flotation and in common with most other companies, our share price fell and its recovery since the market crash of October 1987 has been sluggish in the face of low volumes of trading. Our particular problem was compounded by the fact that, uniquely among privatisation flotations, provision was made for payment of instalments, without provision for a formal instalment agreement.

As a result, although we floated in May 1987, we were not able to begin assembling the shareholders register until the second instalment had been paid in September. Even when that point was reached, the volume of paperwork resulting from an initial allocation to more than two million shareholders (rapidly reducing by half) and the further difficulty of identifying foreign shareholders whose total was limited to 15% of the issued equity, meant further delays. As if this was not enough, the quality of the paperwork processed by the receiving banks was very low, with many clerical errors.

All of this meant delay and frustration for shareholders in receiving their share certificates, and sometimes their dividends. Even more seriously, the late identity of foreign shareholders coupled with the need to restrict their number to 15% of the equity meant that forced sales took place after the October stock market crash at substantial losses to foreign shareholders.
All of this, though not of the company’s making, has, I think had a negative effect on our share price, and has certainly resulted in a more than normal volume of correspondence with individual shareholders.

However, those days are well past and I believe that we now enjoy a good relationship with the investment community and the financial press which we maintain by regular presentations and contacts. The recent agreement by Government, as holder of our golden share, to an increase in the foreign shareholding limit from 15% to 29.5% greatly simplifies our regulatory task and offers opportunities of attracting new investors.

By contrast, T&N is a well-established company which ran into serious difficulties six years ago, but has recovered steadily since then to a point where it too is an Alpha stock. The movement of the company away from asbestos and its concentration upon automotive components and engineering materials has required a consistent effort to explain developments and the important changes in markets, margins and geographical locations.

I believe that this process has been a fruitful and successful one and it was, of course, accentuated by a takeover bid for AE in 1986, which brought its own particular pressures and intensities. In the case of T&N, there is a special problem in relation to the perceived asbestos litigation risk, occasionally exaggerated by the media, which requires special treatment.

But both companies share the general problem of reconciling the need for adequate communication with the investment community with the general duty of the directors to avoid selective release of information.

This is a difficult topic which some companies have met by virtually suspending communication; such a course, in my view, is not in the interests of the company or of its investors.

The essential point is that all contacts need to be seen as a necessary part of communication and to be directed at a better understanding of the company’s performance and objectives, in a way which is not itself price sensitive, but contributes to a fuller understanding of the nature of the company’s activities and prospects.
Analysts form an important link in the communication chain as do financial journalists, but companies must recognise that both groups deal with a wide range of differing companies, and the task of differentiating particular issues relating to a company is difficult for them. As a result, generalised perceptions sometimes dominate in a way which is unhelpful to a particular company.

One example of this is the way in which whole groups of companies are often regarded as being equally sensitive to the dollar exchange rate. We, in Rolls-Royce, have expended much effort to explain that our net exchange rate exposure relates to only 25% of our sales and is covered forward for periods of up to five years on a prudent and consistent basis. Nevertheless, we are often lumped together by investors with a group of less fortunate companies and our share price movement tends to reflect this.

There are, I think, two other topics with which I would like to deal. The first has to do with the quality of research analysts. Although we are well served in both Rolls-Royce and T&N by a group of well informed analysts, we also have to contend from time to time with recommendations issued on the basis of inaccurate and unverified assertions. There can be no excuse for such sloppy work when it is intended to influence investment decisions, and the fact that it is an exception does not make it easy to accept.

But there is also, in my view, inadequate attention given to a company’s investment strategy, and the way in which it is attempting to safeguard its future competitive position. I would like to see analysts and investors taking a more constructive and critical interest in expenditure on research and development, training, marketing and capital plant. I do not mean by suggesting this to deflect analysts from the important questions of short-term profit and earnings per share, but I do believe that investors are entitled to expect more in the way of professional analysis of the company’s longer-term strengths and weaknesses than they usually get, and certainly in my experience, American analysts are less open to criticism in this respect.

A great deal is spoken about the short-term perspective of British investors. Its existence and influence are beyond doubt inimical to the long-term prosperity of individual companies, and indeed
of the UK economy, and it may be that a more suitable involvement could be encouraged by companies carefully explaining their investments for the future and by analysts and investors demanding such information and evaluating it by comparison with the activities of other companies.

Summarising, I believe that company managements must spend a great deal of time in communicating with the various groups of analysts, investors and the financial press. Familiarity with a company’s problems and ambitions is a necessary requirement for informed comment and analysis, and will not come about without determined and continuous efforts. The occasional spectacle of companies faced with a hostile bid, seeking to remedy the years of neglect of investor relations in a few hectic weeks, is not an edifying one.

Nor in my view is the use of public relations consultants adequate by itself. Investors in a company and those who influence them are entitled to contact with management at the highest level, and to continuous interpretation of the company’s performance and ambitions. This is because there is really no substitute for the trust of each party in the other, the familiarity of analysts, investors and the press with a company and its objectives, and the resulting confidence which makes good relations a matter of course.

I cannot close without referring to Annual General Meetings, often regarded by company chairmen as an essential but regrettable waste of time. This is because they are too often regarded by individual shareholders as opportunities for ego trips or by pressure groups as opportunities for pursuing their particular fetish. Just occasionally, and I have had this welcome experience, a meeting can be distinguished by sensible, well-informed questions directed to the welfare of the company. That this is so rarely the case owes much, in my opinion, to the indifference of investing institutions to the AGMs of the companies of which they are shareholders. I believe that institutions have a duty to the company and to small shareholders to attend AGMs and to take part in them, first to make them the sort of annual review and accounting that they should be and secondly to help the small investors present to obtain full value from their attendance.
The indifference of the institutions to which I have referred is even more regrettable in the fairly wide-spread practice, happily not universal, of failing to complete proxy forms. If institutional investors are not to attend the Annual General Meeting, then the least they can do is to express their views by proxy votes of the resolutions put to shareholders. To take no action at all is, in my view, an unforgivable abdication of responsibility. In my own companies, when I have put this view strongly to institutions, it has often been well-received and acted upon. I hope that it will be more widely taken up.

In summary therefore, companies have to work harder at communication with investors, analysts and the press. This is not a one-way street and reciprocal interest activity is required, enhanced by a hopefully developing appreciation of the importance of institutional shareholders in the conduct and accountability of companies.

January 1990
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Creative Tension? 25 years on

A collection of essays on the relationship between the management of public companies and institutional investors