Should Engagement Be Constructive?

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This is taken from my 22/2/19 response to the Financial Reporting Council's consultation on the Stewardship Code. The full response is at http://bit.ly/AlexSCode.

Q13. Do you support the Code's use of 'collaborative engagement' rather than the term 'collective engagement'? If not, please explain your reasons.

This question, and the accompanying text, mentions *two* alternatives to collective engagement": "collaborative engagement" and "constructive engagement". I support neither alternative.

Constructive Engagement

It is important for the Code to have (to the extent possible) clear terms, because one can objectively evaluate whether the Code is being followed. It is reasonably clear what "collective" refers to, but "constructive" is highly ambiguous. In my opinion, the correct definition of "constructive" is an engagement which improves the long-term value a company creates for society. Note that such engagements may sometimes be confrontational, if dealing with entrenched or intransigent management. (For example, the Government's report on Carillion highlighted how it was insufficiently responsive to the concerns of its major investors). They may even recommend closure, which could be beneficial for society as discussed.

However, others may define "constructive" differently. A CEO may argue that investors are not being constructive if they are proposing changes that she disagrees with. For example, selling a division is often accused as being "asset stripping" or "breaking up the firm", even though the evidence suggests that asset sales typically create value.[1] The Kraft takeover attempt of Unilever was widely criticised as being destructive because it was opposed by management, yet led to Unilever undertaking a strategic review that unlocked significant value.

Sometimes an investor may engage deeply with a company, to understand its long-term strategy and purpose. Despite doing so, it may ultimately "agree to disagree" and have a different opinion of the strategy from management. This may lead to it escalating its engagement, or selling its shares and reallocating its scarce capital to another company whose strategy it believes in more.

I have serious concerns that the use of the term "constructive engagement" will deter investors from holding companies to account. Given corporate governance failures such as Carillion, Sports Direct, and the financial crisis, we want to encourage more challenge, rather than less. Using this term could encourage entrenched management to oppose a value-creating suggestion from an investor as being non-constructive, and accuse the investor of not complying with the Code.

Paragraph 98 also states that "there is frequent criticism from companies that investors often engage with them on a limited range of issues, only when they have concerns, or not at all."

[1] See Brav, Jiang, and Kim (2015) for sales due to hedge fund activism, and the evidence cited in Edmans and Mann (2019) for asset sales in general. Brav, Alon, Wei Jiang and Hyunseob Kim (2015): "The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes." *Review of Financial Studies* 28, 2723–2769. Edmans, Alex and William Mann (2019): "Financing Through Asset Sales." *Management Science*, forthcoming.

Certainly, investors for which engagement is a key part of their stewardship strategy should engage routinely, as a matter of course, rather than only in intensive care situations. However, such a statement could be interpreted as suggesting that more engagement is always better, and that investors should engage on all issues that a company wishes to engage with it about. Neither implication is true. First, the evidence suggests that mere engagement activity does not create value, but only targeted, intentional engagement. See Section 3 of "Thoughts for Change from the Steering Group of The Purposeful Company". Second, as mentioned earlier, investors' ultimate responsibility is to savers – their clients. They fulfil this responsibility by engaging on issues where they have the greatest expertise and believe they can make a material difference. They do not have a responsibility to engage with companies on every issue the company wishes to engage with them about – the company is not their client. Such a requirement could lead to the investor being spread too thinly across multiple issues or "box-ticking" stewardship where an investor engages in multiple issues simply to disclose the number of issues it has engaged across. As an analogy, I have chosen to focus on answering specific questions in this consultation in detail, rather than every question perfunctorily.

In addition, it is important for a company's stewardship policy to be focused. A stewardship policy that promises to be all things to all people – to engage on issues relating to customers, employees, the environment, suppliers, communities, and tax policy, and to monitor these issues and base trading decisions on them – may sound attractive but is unlikely to be put into practice. It fails to recognise the reality of limited time and resources. Some investors may intend to undertake stewardship through monitoring rather than engagement. Others may intend to engage on the specific issues on which they have greatest expertise, or their savers are particularly concerned about (e.g. climate change). Thus, if investors engage "on a limited range of issues", this may be fully consistent with the stewardship policy.

Collaborative Engagement

The term "collaborative" may imply an engagement that is supported not only by other investors and stakeholders, but also the company itself. An investor suggesting a change of direction that the company disagrees with may be accused of being not collaborative. The term "collective" is much less ambiguous.

Indeed, the well-known study on engagement by the Hermes Focus Fund uses "collaborative" to define engagements which the firm agrees with.[2] In the authors' words, "In collaborative engagements, the target agreed with the changes sought by the fund and implemented them in cooperation with Hermes. In confrontational engagements, there was disagreement about the Fund's objective from the outset and it was often necessary to remove the CEO and/or the chairman to implement the Fund's objectives." The study finds that value creation was higher for confrontational rather than collaborative engagements. Similarly, the influential evidence on the value created from hedge fund activism (which, contrary to popular myth, creates long-term as well as short-term value), finds that value creation is higher when the hedge fund employs hostile tactics (even though most engagements start off non-confrontational).[3]

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[2] Becht, Marco, Julian Franks, Colin Mayer and Stefano Rossi (2008): "Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes U.K. Focus Fund." *Review of Financial Studies* 22, 3093-3129.
[3] Brav, Alon, Wei Jiang, Frank Partnoy and Randall Thomas (2008) "Hedge Fund Activism, Corporate Governance, and Firm Performance." *Journal of Finance* 63, 1729-1775.