<u>What is Stewardship?</u>

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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.

Stewardship is often thought of as an investor's responsibility to the companies it invest in, and to ensure that they do not go bankrupt. For example, society has blamed corporate failures, such as the 2007 financial crisis, on investors failing to supervise companies closely enough.[1] However, this is not what stewardship should be. The Merriam Dictionary definition of stewardship is "the careful and responsible management of something entrusted to one's care." What is entrusted to an investor's care is savers' money. Investors' primary responsibilities are to savers – their clients – not to companies.

This is not just a semantic point, nor one which is simply an unfortunate consequence of using the term "stewardship" that could be addressed by using a different term. Instead, it fundamentally results from investors' fiduciary duty, which is towards their savers. Investors have no more a responsibility to companies than do customers or workers. Certainly, members of society should often do far more than their legal responsibilities, and in many cases investors do fulfil their responsibilities to savers by engaging with companies and, by doing so, improving long-term returns to savers – just as customers may provide feedback to companies on their products, and workers may make suggestions to management. However, when a customer or worker decides whether to make suggestions, they balance the benefit of doing so with the cost of their own time. If the customer or worker chooses not to do so – and indeed decides that the best option is to switch to another company – they are not being irresponsible. Similarly, an investor must balance the time and resources used to engage with a company with other ways it can serve its savers – including potentially divesting the holding.

Thus, company failures are not the responsibility of investors, just as they are not the responsibility of customers or workers (even when they have ownership rights). Customers were not to blame for the near-collapse of the Co-operative Bank, nor were workers to blame for John Lewis's 99% fall in profits in the first half of 2018. *Company failures are the responsibility of the board and senior management, and any "stewardship responsibility" is that of the board*. It is convenient for regulators to blame corporate failures on investors' failure to steward – and potentially for divesting (as investors did from Carillion, saving their clients millions of pounds) – but this is unwarranted.

A second, related, misunderstanding is the view that good "stewardship" involves ensuring the company's longevity. This may well be what management and regulators want, but it is not always what society wants. Within large companies, it is well accepted that the responsibility of

[1] The 2009 Walker Review into the UK financial crisis concluded that "The atmosphere of at least acquiescence in high leverage on the part of shareholders will have exacerbated critical problems encountered in some instances. … [E]ven major fund managers appear to have been slow to act where issues of concern were identified in banks in which they were investors, and of limited effectiveness in seeking to address them either individually or collaboratively."

management is to close down underperforming divisions and open new ones. Keeping an underperforming division alive has a substantial opportunity cost – it prevents a company's financial, human, and physical resources being reallocated to new, faster-growing divisions. Similarly, keeping alive a company that is no longer serving the current needs of society has a substantial opportunity cost – it prevents society's financial, human, and physical resources being relocated to new companies that are better placed to address society's challenges and needs.

Society should have no problem with the decline of tobacco companies, coal companies, and even high-street retailers of books and music. Coal companies used to serve a social purpose, before greener sources of energy were found; high-street retail used to be the best way to sell books and music, before online platforms were established. Nowadays, society is best served with greener sources of energy, and using scarce high-street space to sell products that customers wish to try out first, or non-retail purposes (e.g. restaurants). By continuing past their sell-by-date, companies can destroy substantial value. Kodak wasted $5 billion buying Sterling Drug, a pharmaceuticals company, attempting to stay alive by moving into an unrelated industry, after it started to fall behind in digital cameras.

Indeed, the emotive word "failure" is unhelpful as it suggests that it is something to be avoided. "Closure" is more accurate, just as a headquarters opens and closes new divisions or branches. (Of course, those making closure decisions should minimise the resulting losses, to the extent possible – for example, by reallocating workers to a different division or via outplacement and retraining.) Consider the following quote:

"The ruthlessness of venture capitalists in killing bad ideas … is far more important to their success than the ability to identify diamonds in the rough. The arm's length system plants a thousand flowers, uproots hundreds when they do not thrive, and nurtures only a few to bloom. New opportunities abound, while old, tired ways of doing business are ruthlessly eliminated. The system's strength, then, is that it is not heavily biased towards preserving the privileges of incumbent firms and workers."[2]

This quote may seem to be that of a ruthless capitalist, but is from Raghu Rajan, the former Governor of the Central Bank of India, in his book *Fault Lines*. This book finds fault in many aspects of the capitalist system – but allowing the closure of companies that no longer serve their purpose is not one. Another excellent treatment of the distinction between long-term survival and long-term value maximisation is legal scholar and practitioner J. B. Heaton's "The Long-Term in Corporate Law."[3]

Coming back to what this means for stewardship, investors are responsible neither to savers nor to society for preventing companies from closing. Divesting from companies that no longer serve their purpose, itself serves both savers and society. It is critical for regulators to recognise this and not argue that investors have the responsibility to ensure the long-term survival of companies, nor label every corporate closure as a failure of stewardship. This point also highlights the error in arguments that workers should have control of a company since they have interest in preserving its long-term future. This may be true, but such preservation is not always in society's interest.

[2] Rajan, Raghuram G. (2011): "Fault Lines: How Hidden Fractures Still Threaten the World Economy." Princeton University Press.
[3] Heaton, J.B. (2017): "The Long-Term in Corporate Law." *The Business Lawyer* 72, 353-366.

Regulators must thus be wary of terms such as “stewardship responsibilities”. Investors’ stewardship responsibilities are to their clients, so more engagement and monitoring need not be better. Indeed, an investor that engages in neither engagement nor monitoring could still be said to be exercising good stewardship, if it has expertise in neither and its purpose is to provide savers with low-cost access to equity markets (without which, they might put their money in bank accounts and not share in the wealth created by rising stock markets).