STUDIEN DES
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ESG FROM THE PERSPECTIVE OF INSTITUTIONAL INVESTORS

What listed companies should know

Rothschild & Co

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Studien des Deutschen Aktieninstituts

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Preface

There is a significant shift taking place in the investment world, which is changing the allocation of capital and the relationship between companies and their investors[1]. Capital markets evolve to adapt more and more to global challenges such as climate change and the corresponding risks and opportunities. Due to this development, a new paradigm is emerging which raises the importance of sustainable returns, culture and conduct in investment decision making.

Investors are moving from a focus on pure financial returns to a system where environmental, social and governance (ESG) aspects are increasingly integrated into the assessment of business and strategy of portfolio companies. This is founded in the assumption that better governed companies deliver better returns. The shift from the view that returns must be sacrificed in order to invest responsibly and sustainably, to the assumption that long-term returns may even be higher for sustainable and responsible investments, is one of the most remarkable developments in the present investment landscape.

Larry Fink, CEO of Blackrock, gave a strong signal to the market with his letter to chief executives in December 2017, stating that "to prosper over time, every company must not only deliver financial performance, but must also show how it makes a positive contribution to society". In the competition to retain and attract capital, companies are entering into partly unknown and uncertain territory, requiring a broader assessment beyond short-term financial metrics. In addition, political pressure on institutional investors and underlying pressure from their clients[2] is pushing them to be more responsible owners. The momentum behind these trends is powerful and appears irreversible.

These trends are changing the relationship between companies and their investors. The risks of failing to acknowledge this are clear and range from the rise of activism, growth in shareholder revolts, regulatory fines and increasingly to being excluded from institutional funds due to perceived deficits in environmental, social and governance criteria.

Whilst the direction of travel may be obvious, the challenge this shift poses for companies is both complex and specific. It requires dynamic assessment, the creation of an investor engagement strategy explicitly integrating ESG considerations and an open ongoing dialogue with investors. Institutional investors are also adapting to these changes and the way in which they integrate and apply ESG factors is developing and expanding from specialist funds across to mainstream funds. A broad spectrum of models exists and it can be difficult to ascertain how these are being applied in practice and will develop in the future.

In order to better understand some of these challenges and to help companies react to them, we have undertaken a study with a focus on investments in German companies. During the second half of 2018, we interviewed 18 institutional investors, managing a total of €14.4trn assets. These investors include the largest passive global funds as well as active UK, US, German, Nordic, Dutch and French long-term investors. Ten of the top 20 DAX and MDAX investors have participated and given views across environmental topics, social issues, corporate governance, activism, investor engagement and communication issues.

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[1] With "investors" and "institutions", we refer to institutional investors.

[2] With "clients", we refer to the underlying clients of institutional investors, such as private persons or other institutional investors like insurances, churches, pension schemes etc.

The aim of this study is to provide insight into leading institutional investors' views on the challenges which investors are facing, identify areas of best practice which corporates can consider, increase the understanding and awareness and highlight further areas for consideration.

As it is neither possible, nor our intention to provide ultimate answers in an area that is evolving fast and where common understandings, regulatory impetuses or methods change over time, we have tried to mirror the broad spectrum of investors' views. By reproducing a high number of original quotes from different investors, the readers of this study will hopefully be able to get a flavour of what is changing behind the scenes to form an own opinion and to react appropriately.

Dr. Christine Bortenlänger
Chief Executive
Deutsches Aktieninstitut e.V.

Dr. Martin Reitz
Chairman of the Board
Rothschild & Co Deutschland GmbH

1. Executive summary

1. THE INFLUENCE OF ESG FACTORS IN CAPITAL ALLOCATION IS WIDESPREAD ACROSS THE LARGEST GLOBAL INSTITUTIONS.

A key finding of this study is that ESG factors increasingly influence the allocation and monitoring of assets at major institutions, which include some of the largest investors in German equities. Whilst returns and profitability are still the most significant factors for investment decisions, the majority of respondents is either fully or partially integrating ESG into their investment process. It is also striking that this is happening across most of the institutions and not just for those funds with an explicit sustainable mandate, although it is also clear that these are a growth area.

The integration of quantitative and qualitative ESG factors is applied in very different ways: There are investors who are very focused on the measurement of specific targets and data or have an agenda. There are others, for whom the quality of overall governance is a primary factor, which is influencing the weight and allocation of investment and there are those, for whom ESG criteria are a secondary factor, amongst a range of other considerations.

”

> Consideration of the risk and opportunity set around ESG is really quite crucial. (Institution 2)

”

> Our goal at the firm is to understand any factor that could have a financially material impact on the companies that we own. In many circumstances, we find that ESG factors do, or appear to us to be likely to, have a financial impact on the companies, we own. (Institution 5)

”

> If you do not have good corporate governance, I will tell you E&S will also be problematic because it is a management issue. (Institution 14)

2. WHILST INSTITUTIONS ARE USING DATA PROVIDERS TO MEASURE ESG FACTORS, COMPANY WEB SITES AND REPORTS ARE THE KEY SOURCES OF INFORMATION.

MSCI and Sustainalytics appear to be the main external providers of ESG information. However, company websites and annual reports remain the key sources of input, so that data providers are typically used as a first flag to highlight issues and further work is then done on those topics.

Investors highlight a “boiler plate mentality” with regards to companies providing information, versus a situation where they would like to see Companies providing a leadership stance and insight into KPI's and key issues. From the investors' perspective, the disclosure of ESG information has significantly improved in terms of quantity, but a number of investors call for a better connection to value creation, financial and non-financial figures, "getting ESG issues on the balance sheet and into the P&L".

”

> German companies are probably about average, not particularly bad, but not leading edge. (Institution 2)

”

> Take the lead and to take that confident position, of here is what we believe is most material to our business. … Give us good quantitative data that is audited and good qualitative information around that data to support their progress and management of that risk or opportunity. (Institution 5)

”

> Let's move away from photographs of laughing children in Africa, holding company products, instead tell us what the accident rates are versus the industry standard. (Institution 11)

”

> Connection, getting ESG issues on the balance sheet and into the P&L, is missing, that is why sell side analysts are not accepting of it. (Institution 14)

3. PRESSURE FROM UNDERLYING CLIENTS IS GROWING REGARDING ENVIRONMENTAL AND SOCIAL ISSUES.

Investors have experienced an increased level of interest in ESG topics from their underlying and prospective clients over the last couple of years and the pressure on investment decisions to comply with certain standards has increased. In general, clients of investors seem to be satisfied with the way investors handle governance issues, but ask increasingly about environmental and social topics.

The topics that underlying clients ask about most frequently are climate change and environmental impacts of investments. In addition, weapons and tobacco were named. In parts, investors were also asked about social issues such as child labour. However, the clients' interests tend also to depend on current issues and their media coverage.

”

> There are less pressures on the governance side. Clients have very much left the voting to us and they are pretty happy with what we are doing. On the ESG side, it is very topical. (Institution 1)

”

Climate change, … Our clients are very much expressing their expectations on this towards us, as the asset manager. Also, there are other topics that are more NGO or media driven … which come up occasionally. (Institution 13)

”

If we do not take into account carbon emissions or controversial businesses, it can be a no go for the client to invest … Today, it is only on environmental and controversial aspects, but it will evolve over the next years. (Institution 15)

4. EXPERIENCES WITH GERMAN CORPORATE GOVERNANCE: MORE ENGAGEMENT ON KEY TOPICS AND BOARD PROCESSES EXPECTED.

There is a mixed picture around the evaluation of the current state of engagement with German companies. Investors highlight some very positive interactions and examples of companies working collaboratively and constructively, but there are also instances mentioned of companies refusing the dialogue. Investors would like to see companies engage more and to have more insight and commentary around the board's functioning.

”

We did have an issue with a company, in which we have quite a large shareholding, where the chairman did not respond to us. … It might be a one-off. … If they are not able to speak to investors, then that is a red flag for us. (Institution 1)

”

Management teams and boards need to develop a relationship with investors so that they understand where we are coming from, that we are really and truly thinking long-term. (Institution 5)

”

If you have got employee reps, how open is the discussion? Are discussions held elsewhere? Is it that the supervisory board chair and the CEO can have their own thing going on …? (Institution 7)

”

We would not invest in a company if we do not have a good level of trust in the chairman, that is why it would be helpful, maybe once a year or once every second year, to encourage some kind of interaction, which we currently do not have with German companies, I would say. (Institution 9)

”

The volume of communication with chairs of supervisory boards has really increased over the last two years. (Institution 14)

5. ENGAGEMENT ISSUES ARE DOMINATED BY REMUNERATION AND BOARD FUNCTION/INDEPENDENCE.

Most of the investors we interviewed, highlighted the most important issues they are engaging with companies on, to be board function (competence and culture) and remuneration disclosure.

With regards to board quality, the key interest of investors is to ensure the board's, and in particular the chairperson of the board's, independent scrutiny on managements' strategic decisions. They would also like companies to ensure board's competences are adequate to adapt to the big strategic challenges companies are facing. Demonstrating the strength of independence and skill set is thus critical to investors' assessment of board competence. With this, investors are trying to assess how the composition of the board and the way in which it operates, influences the quality of governance and mitigates future risk.

On remuneration, a number of investors highlighted the complexity of pay structures and unclear remuneration reporting as a particular concern in Germany. Some also find that the level of detail provided obscures rather than provides insight into the areas they want to understand, such as data on targets and pay-outs below performance.

Besides this, a number of topics are raised that reflect the current debates on corporate governance and relate to the annual general meeting, such as capital increases.

> Independence would be top of the list. … We are almost moving away from the term governance and really moving more into understanding how capital allocation decisions, board structure, board leadership, executive compensation decisions, the way a company handles its accounting and tax matters, all of these things coming together and using those to form a picture of a board's culture and risk tolerance. (Institution 1)

> I just feel in Germany, it is still a bit more of a tick box exercise against a code. (Institution 6)

> Supervisory board members have a very long duration of term, it is generally five years, which is allowed by law. (Institution 8)

> One of the subjects that we have been trying to enhance this year was to ask companies to publish a competencies matrix of the directors. (Institution 8)

99

Disclosure from German companies on remuneration is not very helpful and difficult to understand. (Institution 13)

99

One of the things we are consistently voting against is equity issuance and the dilution of shares without pre-emptive rights. (Institution 16)

6. ACTIVISM IS GROWING AND MOST INVESTORS ARE ENGAGING DIRECTLY WITH ACTIVISTS.

The majority of investors interviewed will engage directly with activists mainly with the objective to understand arguments in order to form an own opinion. This holds true for both active and passive investors and happens on a case-by-case basis.

Consequently, voting with the proposals with activist is quite common. This holds true for both active and passive investors. Given the rise of index funds in the market and the lack of relationships many companies have with these, this is an area which needs careful assessment to identify gaps in investor coverage and address them.

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It is very important that the company actively reaches out to its shareholder base to explain their view (Institution 4)

99

I can think of some German companies in recent times where activists have made a positive contribution and helped drive change. There is a lot of bureaucracy with German Companies. Activists are good at finding a way through this. (Institution 17)

99

Put a target on their back by not having all the right governance provisions in place. (Institution 18)

99

It is a dangerous assumption to think passive or index investors will not do anything, given how much we own of their stock. (Institution 18)

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Half of activist fights which go to a vote, we support the activist. (Institution 18)

7. ENGAGEMENT CAN COUNTER PROXY ADVISER RECOMMENDATIONS.

Although ISS are very clearly emerging as the dominant proxy research provider from the interviews followed by Glass Lewis, most institutions highlight they use services of proxy advisors and their research purely as a flag or filter to then make their own decisions on voting. In general, the services are regarded as a supplement, but not as capable of substituting own/in-house corporate governance analysis.

The clear inference is that engaging with large holders can over-turn votes. Therefore, companies need to focus on targeting major holders rather than assume a recommendation from ISS and Glass Lewis is automatically followed.

”

> We use ISS, but it is a flag. It is a guide. That is the opportunity from the client's perspective, to be able to establish a line of communication which enables you to make your case, rather than a call two days before a voting deadline to appraise people of what you are trying to do. (Institution 7)

Key recommendations

1. ESTABLISH A CLEAR ESG FOOTPRINT FOR THE EXISTING BUSINESS.

It is now mainstream practice for investors to consider ESG factors as part of the investment process. Therefore, companies need to assess and integrate this into their investment case and materials and consider the most appropriate and optimal ways to communicate this.

This should involve on-going quantitative and qualitative assessment and regular review by the supervisory board in dialogue with the executive board and IR function.

At the most basic level, this means ensuring key data and information on specific risks and ESG factors can be found easily and is consistent and verifiable by reputable sources, where appropriate. Websites and annual reports are the most important sources for investors and ESG data providers.

Where companies are not compliant, there is a perceived deficit or they are not able to provide information, it may mean disclosing why, explaining 'the direction of travel' and thinking around why it is not appropriate for the business at this time.

Investors are increasingly looking to companies to take the lead and identify the key ESG risks and establish KPI's they can track for specific businesses and clearly link this to the overall strategic development of the business.

There is no one model of disclosure which works for all. The best models of practice are being established sector and company specific and require companies to think creatively and reflectively about the 'outside-in' view of their business, its risks and impact on society.

2. ENGAGE WITH AND UNDERSTAND THE VIEWS OF INVESTORS.

It is difficult to establish a clear ESG footprint without an understanding of investor views and their alignment to the strategy of a company. Investors are demanding high quality and thoughtful engagement to demonstrate the qualitative aspects and strength of governance.

As of 2017, the German Corporate Governance Code makes a specific provision for the chairperson of the supervisory board to be reasonably available to investors where practical. Companies are interpreting this in many different ways, depending on the culture of their business. However, a key recommendation from this study is that companies should establish ways to open up to communicate the strengths and quality of board governance around a wide variety of issues in order to allow investors to get a flavour of the company's culture.

Engagement with investors involving feedback and input on these issues is the most effective route to achieve this and the best defence against activists. There is commentary from investors in the interviews in this study around how engagement has changed voting intentions to support corporate strategic objectives when the rationale has been explained. Engagement needs to be with both active and passive investors and where possible including both ESG analysts and portfolio managers covering a stock.

Once again, whilst there is no template which works for all, there is a wide variety of ways of successful engagement strategies, e.g. via roadshows, investor forums, events and independent surveys. It is critical in enhancing the effectiveness of engagement from both company and investor perspectives, that agendas, areas of discussion, expectations and feedback are clearly outlined.

3. BUILD A BROAD BASED SUPPORTIVE LONG-TERM INVESTOR BASE.

Investor engagement should target existing shareholders but also new investors interested in the company's investment case, who can be identified on the back of their respective investment strategies and portfolio profiles as well as a broad market dialogue. Companies typically have room to actively target the „right" investors for a specific equity story and to build a convinced and loyal shareholder base taking into consideration the size of the company, its business profile, its specific challenges and opportunities, as well as its characteristics in relation to region, sector and ESG-positioning.

2. The study

METHOD AND SAMPLE OF INVESTORS

During the second half of 2018, we interviewed 18 institutional investors, managing in total €14.4trn assets. These investors include some of the largest passive global funds, active UK, US, German, Nordic, Dutch and French long-term investors. Ten of the top 20 DAX and MDAX largest investors have participated and given views across ESG, corporate governance, activism and investor engagement and issues.

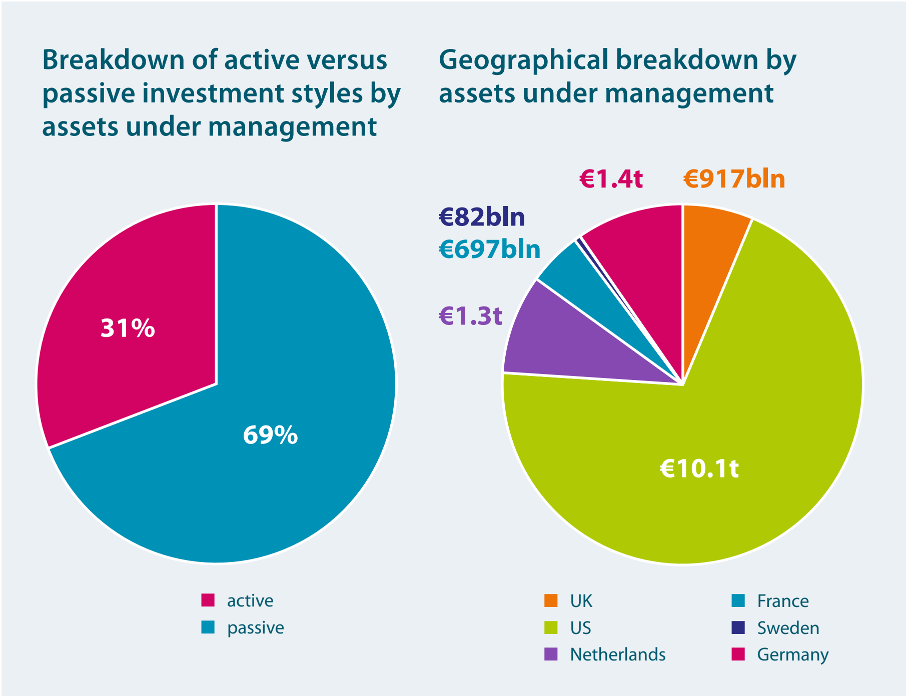

Figure 1

Participants contributed on a non-attributable basis and have been asked a series of questions around governance, integrating ESG in investment practices, activism, role of proxy advisers, what issues they think are important and what they would like to see change.

Different institutions have very different set-ups and we interviewed a cross-section of corporate governance, ESG and German focused specialists as well as portfolio managers, depending on the person with the greatest experience in covering German corporates within an institution or corporate governance/ESG topics.

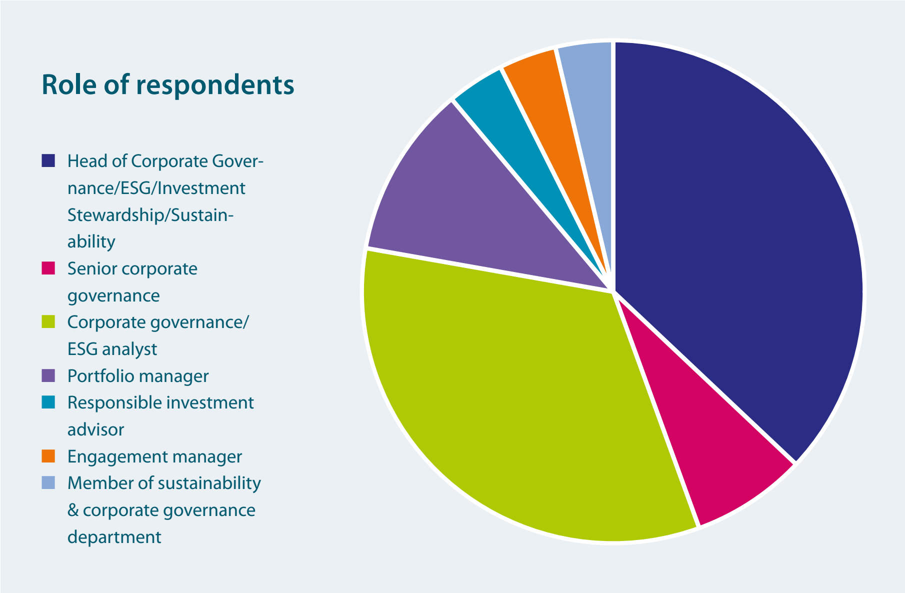

Figure 2

QUESTIONS:

The questions below were used as a general framework to enable a wide ranging and open-ended discussion on issues highlighted.

1. How do ESG factors influence the investment decisions of your firm?
2. How do you evaluate ESG positioning of corporates in your engagement?
3. Which ESG data providers do you use?
4. How well do you think German companies communicate ESG credentials?
5. What pressures are you seeing from underlying clients?
6. What is your experience of how German companies are approaching corporate governance, given their very specific structure?
7. What are the most important governance issues you are focusing on with corporates in your engagement?
8. How do you see the role of the chairperson in German supervisory boards?
9. What are the most important criteria for assessing the chairperson of the board?
10. How do you perceive communication of German supervisory boards? What would you like to see improved in terms of communication and engagement?
11. Do you engage directly with activists? How do you view the impact of interventions from "activist" investors for value generation of the company?
12. How do you incorporate proxy advisers' decisions into your process and who do you use?
13. If you intend to vote against a voting item at the general meeting, do you communicate the reasons with the company and attempt to engage before doing so?
14. What would you do, if you concluded that a company has deficits regarding ESG topics?

3. Main findings

3.1 Influence of ESG factors on investment decisions

QUESTION:

How do ESG factors influence the investment decisions of your firm?

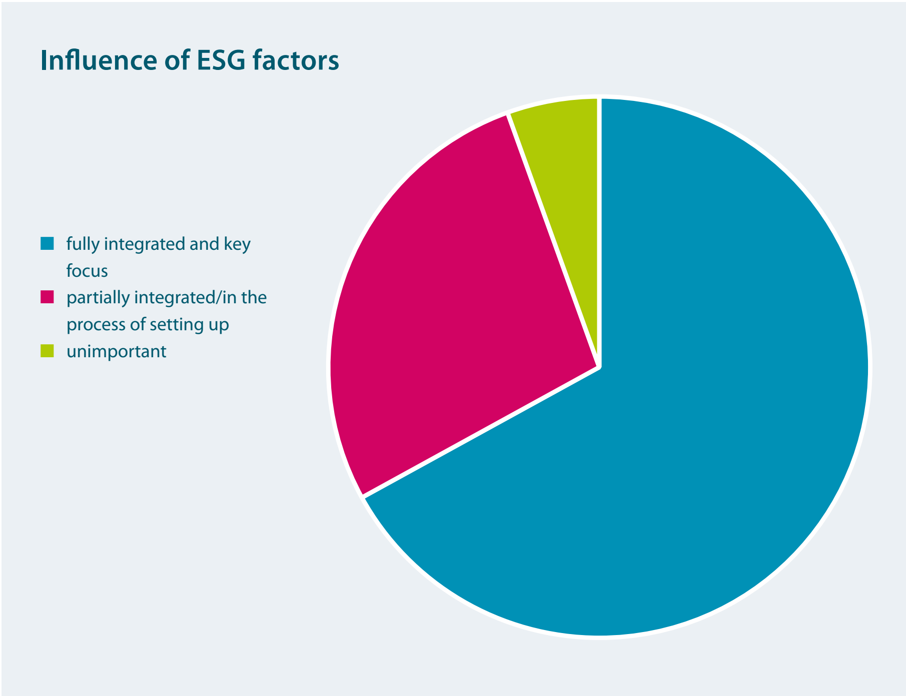

Figure 3

THEMES:

The majority of investors are increasingly influenced by ESG factors in making investment decisions. However, there is a broad spectrum of approaches in this survey. It covers investors with agendas or public campaigns, where they are seeking to achieve defined goals and push for change and those who see engagement as purely investment related.

In sum, the interviews evidence that it is a dynamic process how to navigate through this area and how to cope best with the issue in a qualitative or quantitative assessment. A number of respondents highlighted increasing resources and that they are reviewing and changing the way in which ESG factors are incorporated. This is happening across nearly all funds and not just for those funds with an explicit sustainable mandate, although it is clear these are a growth area.

The motivation behind ESG engagement varies across the investors. However, the majority of investors appear to take ESG into account in order to identify financially relevant factors, to cope with risks, to evaluate additional investment opportunities or to improve portfolio allocation in a risk-reward perspective.

Consequently, the blend of quantitative and qualitative analysis is applied in different ways. There are institutions who are very focused on the measurement of specific targets (e.g. reducing the carbon footprint of a portfolio by 25%) and others, for whom the ESG assessment is an additional factor which is influencing the weight and allocation of investment.

With the notable exemption of climate-related risks, in the range of ESG issues, a number of investors tend to rank the importance of governance aspects higher than environmental or social aspects. This is motivated by the perception that without good governance, it cannot be expected that environmental and other factors will be adequately considered. Regarding good governance, some investors rather take a holistic/informal view to understand the perspective of board members and how corporate processes are able to cope with strategic challenges. Others evaluate governance on the basis of defined criteria and systematically review portfolios on that basis.

QUOTES:

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We are all one integrated ESG team and we are a resource for the rest of the business. Each team [managing portfolios] varies as to how well they are integrated, so it varies fund by fund. (Institution 1)

”

We are working very hard on ESG integration this year and I think that will lead on to next year as well. (Institution 1)

”

When we are making investment decisions, we do fully consider ESG factors within that. … At the research templates that fund managers use when they are initiating coverage on a company, there is specific mention of ESG issues, which the fund managers are expected to research and to comment on. (Institution 2)

”

Consideration of the risk and opportunity set around ESG is really quite crucial. (Institution 2)

”

We are in the process of changing basically the ESG score that we get by developing our own proprietary rating, which will involve, on a sector by sector basis, looking at material factors and also adding the qualitative overlay from our own analyst by looking at specific KPIs basically for specific sectors. (Institution 3)

”

A company gets a score and the analysts are asked to comment on it, if it's a low rate. Now it is going to be more focused on specific areas. (Institution 3)

”

We started an internal methodology based on different ESG indicators by which we could divide our equities portfolio into leaders and laggards. By 2020, we ideally would like to finalise this process of selecting or categorising our companies and to see how that affects our equities portfolio. We expect that our equities portfolio will decrease as a result of our inclusion policy. (Institution 4)

”

If a company comes out as a laggard and the company is still interesting for our investment teams, from a risk return point of view, then they can decide to engage with that company. If progress is made, it may become a leader again. (Institution 4)

”

What we would normally do, if we find a risk, is we will talk to the management team about that risk, try to understand it better. If we really cannot get comfort and we think it is highly material, then we may choose not to own the security, as in those examples that I have shared. However, we may just feel, as we look at this ESG risk alongside the other risks and opportunities and valuation presented by this company, it is still appropriate to make an investment. We may model the company differently or value it differently in our own work, but still choose to purchase it. There have been several times where we have taken that approach. (Institution 5)

”

Our goal at the firm is to understand any factor that could have a financially material impact on the companies that we own. In many circumstances, we find that ESG factors do, or appear to us to be likely to, have a financial impact on the companies we own. (Institution 5)

”

Myself and others on my team working with the broader investment team, with the other analysts and the portfolio managers at our firm, to understand for specific companies or a group of up to four or five companies in the same industry, which ESG topics are financially material. (Institution 5)

”

Governance is certainly the most important topic because it matters for every company that we look at. (Institution 5)

”

We have not got any tilted portfolios towards any particular ESG issue. It is trying to use the ESG lens as another way of reviewing quality of management or mitigating risks. (Institution 6)

”

For new investments, part of the investment case rationale does look at governance and E&S issues, but in terms of how material it is to the actual investment decision, it is part of the overall viewpoint of risks and understanding of that company. (Institution 6)

”

The ESG integration concerns all asset classes excluding ETF, which are governed by the normal sector exclusions. (Institution 8)

”

We screen portfolios twice a year for any known violations. You cannot invest in a new company without having to go through process of ESG practice. (Institution 9)

”

We look at the issues at the outset and after the trade. The G in ESG is a very important factor. (Institution 10)

”

What we realised is what we are trying to do with all of these things, whether you are looking at the governance, whether you are looking at environmental management, you are really trying to get a flavour for what the culture is for a company. (Institution 10)

”

There are two ways in which ESG has an effect. One is the risk component, in that we are, of course, better able to come to grips with reputational and regulatory risk, as well as control downside risks. On the other hand,

… we identify companies which are characterised by particularly strong ESG drivers and how these companies have opportunities because of these drivers. (Institution 11)

”

If a company like X is doing poorly on governance, then an underweight signal can be announced which is binding across the entire group. (Institution 11)

”

We expect the entire issue of ESG integration, that is to say how sustainability affects the broader portfolio management of mandates … to markedly increase in importance. At the same time, we are seeing strong asset growth, particularly in the specialised funds areas, for explicitly sustainable mandates (Institution 11)

”

We have included analysts and portfolio managers in our corporate governance process. That means an analyst who is covering a stock will also be able to provide input on the issue of corporate governance and they are part of the process. As you can see, the issue of corporate governance or ESG, as such, absolutely plays a role when it comes to investment decisions. The extent of this role and what decision will be made, as to what level of risk you see in that, is of course up to the portfolio manager. (Institution 12)

”

With investment decisions, we are now thinking about how we can link our findings and engagement with the investment decisions. That is a process that has been started. (Institution 13)

”

We differentiate pure ESG funds, which work with exclusion criteria, etc. If you take those, then of course it has a big influence and it is being taken into account directly when shares are selected and when portfolio management decisions are made as well. For the broader spectrum, it is more of a soft approach. (Institution 14)

”

As I said, for the most part, it is just information that is used for the fair value assumption. It is one of several aspects. That does not mean, for example, that we must not buy X anymore. (Institution 14)

”

This can be interesting for the business, but, of course, the precondition is that the business is also developing on a positive path economically. What good is it to me if as business is doing well in terms of ESG but is reporting abysmal figures? (Institution 14)

”

A well-positioned business theoretically would be reflected in a lower cost of capital and a higher valuation because there are fewer risks. (Institution 14)

”

If you do not have good corporate governance, I will tell you that E&S will also be problematic because it is a management issue. (Institution 14)

”

Over the past two years, investors have been reporting more on ESG factors, and much more than they have done before. This does not mean that they have taken account of this issue only for these two years, but that there is a real focus today on positioning investors as responsible. (Institution 15)

”

For us, ESG is integrated in the investment process, which is probably what everyone says, so what does that mean? For us, it means that we think about those issues and we will take them into account to the extent that they are material for that business. That is the key thing for us. (Institution 16)

”

We are not making investment decisions specifically because of ESG factors, but it is more that we incorporate them into the way that we are valuing the business. … if the company is ignoring a risk or not properly addressing a risk, that obviously could impact our view of what the company's cash flows could be on a long-term basis. On the other side, however, it could be that a company might be doing things that negatively impact their long-term cash flow or economic position in order to satisfy certain ESG critics, so we try to take it into account on both sides. (Institution 17)

”

The most significant issue is the G portion, that's where we spend the most time. (Institution 17)

3.2 Environmental and social issues, data providers, ESG reporting

QUESTIONS:

- How do you evaluate ESG positioning of corporates in your engagement?
- Which ESG data providers do you use?
- How well do you think German companies communicate ESG credentials?

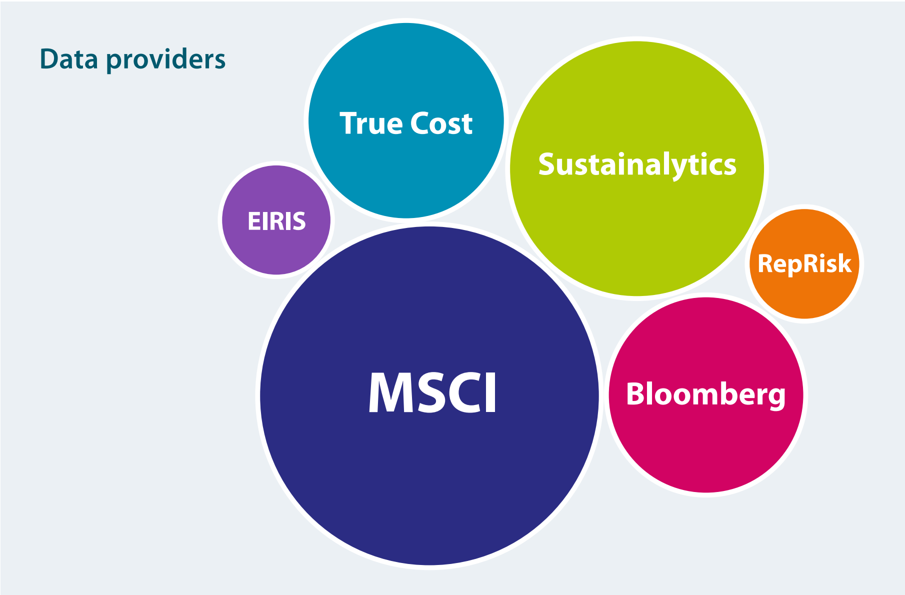

Figure 4

THEMES:

Parallel to client demands (see chapter 3.3), environmental and social aspects gain increased importance in investment analysis. The motivation behind that appears to be mainly to make sure that risks and opportunities for business models resulting from broad societal trends, as well as upcoming regulation will be adequately considered in companies' strategies.

MSCI and Sustainalytics are the main providers being used by investors mostly as a first point of information on ESG topics, but the company website and annual report is seen as more essential. Data providers are typically used for obtaining raw data and as a filter for further work. Investors will typically use the raw data and implement it into their own methodology and their specific selection process of important indicators. They recognize there is pressure on issuers to provide information to data providers and indices, which are not necessarily being used by investors.

From the investors' perspective, the disclosure of ESG information has significantly improved in terms of quantity, whereas a number of investors call for a higher quality of information. They would like companies to outline and identify the ESG risks that are material and relevant for them. Some are also calling for a better connection to value creation, financial and non-financial figures, "getting ESG issues into the P&L and onto the balance sheet". An example of how it can be made explicit provided by one investor is "what impact does it have on the balance sheet/profit and loss if company X saves x% CO2 or monitors the supply chain more closely?" Investors criticised a 'boiler plate mentality' versus leadership stance in providing insight into KPI's and important issues.

QUOTES:

EVALUATION OF ESG ISSUES

"

Regulation around plastic, that might be coming, so what way are we going to go with that. (Institution 2)

"

I think it really depends on the sector. Increasingly, that is what we are working to improve, sector by sector, looking at what is fundamentally important because it really differs. … Some fundamental things in terms of governance are important across sectors. In terms of how we judge a company, … the quality of management and the board and just whether they are up to it, just their confidence and their ability to execute the business plan and so forth, that is number one. (Institution 3)

"

Our inclusion policy is a policy we started developing based on our clients' wish to make more conscious investment decisions, so that we really know the companies we are invested in. We started an internal methodology based on different ESG indicators by which we could divide our equities portfolio into leaders and laggards, if you will. (Institution 4)

"

The concrete objectives are ones which we set together with our clients in 2015, so those are concrete objectives that we want to achieve by 2020 and they are also mentioned in our Responsible Investment Report. For example, we want to reduce the CO_2 emission of our portfolio by 25% We have also set ourselves a goal for investment in sustainable development investment based on the UN Social Development Goals. (Institution 4)

"

We have an exclusion list which is based on UN Global Compact principles on all open-ended funds. (Institution 8)

"

One thing that is new, that was introduced late last year, was our target for the equity portfolio to be aligned with the Paris Agreement targets. (Institution 9)

"

We are not looking for every company in the world to have a strategy on climate change; we care about companies for whom these issues are material and relevant for their business. (Institution 18)

"

A key for us approaching this topic, just like any other topic, is we want to understand how the board is involved in the oversight on this topic. How are they thinking about this, looking out to the long term, which again aligns to our long-term approach. (Institution 18)

DATA PROVIDERS

”

We use MSCI and some third data parties but as user inputs… we form our own view. … Ultimately our message would be to have great disclosure on the company website. At the end of the day that is the main source of information we use and we do not need them to have a CDP or GRI disclosure necessarily, if we can find all the information ourselves on their company website. (Institution 1)

”

The key ones we use are MSCI and Sustainalytics, but we are also using Bloomberg who take their information directly from what the company has reported. (Institution 2)

”

We cannot stress enough that these providers act as a flag for us… it is a useful flag but from there my first port of call would be the annual report and accounts and also a company's own sustainability report. (Institution 2)

”

Sustainalytics. They are part of a picture. A very low rating or some red flag that came up would be part of the discussion, but it would not necessarily override it. (Institution 3)

”

We use raw data of Sustainalytics for our inclusion policy, but we have really only used this raw data to implement that into our own methodology and our selection process of indicators that we think are important. (Institution 4)

”

We used to use MSCI, no longer do. … Use Sustainalytics and RepRisk. (Institution 7)

”

Data providers act as a primary filter and after that there is qualitative analysis provided by ESG analysts. (Institution 8)

”

We use MSCI. It is a base case and we sometimes view their reports with a little bit of scepticism, but they might flag something to us, which we then investigate. (Institution 10)

”

MSCI is more important to our decision…. They have really evolved in the last few years. For exclusion data we rely on EIRIS data high quality…. For CO_2 Trucost (Institution 11)

”

MSCI and also other databases. For our ESG funds, all of this informs the scores as well. (Institution 14)

”

We do have access to some of these providers, but we use them more for answering client questions rather than for investment purposes. (Institution 16)

”

We use MSCI. … It highlights potential areas of concern and then it is the analyst's responsibility to address those concerns, whether or not we as a firm should be concerned and how we are incorporating them, if necessary, into our view of valuation. (Institution 17)

COMMUNICATION OF ESG CREDENTIALS

”

Out of all the different inputs, the most important is what the company is saying about itself on a website or in an annual report. (Institution 1)

”

I think reporting can come across as a bit boiler plate. If we look at some of the disclosures in the annual reports, they can appear to be giving you quite a lot of information and they are quite lengthy, but in terms of the actual content, I am not sure it is always that useful. (Institution 2)

”

German companies are probably about average, not particularly bad, but not leading edge. (Institution 2)

”

Reporting fatigue … what is happening is that disclosure is just becoming a labour to meet all these demands from research providers and indices which people just don't use. (Institution 2)

”

One thing that I feel I have generally appreciated and aligns well with our goals in terms of our formal ESG integration effort is that it seems to me that German companies are very focused on understanding materiality and responding to the ESG topics that they believe to be most financially material. For us, that is perfect alignment. (Institution 5)

”

Really, when we speak with individual companies, … we are encouraging companies to decide for themselves what are the two or three topics that they believe are most financially material from an ESG standpoint. Just as they would develop their own strategy for the broader business, we ask them to determine on their own what they think those two or three topics are and then determine a strategy to deal with those. In general, I would say I feel German corporates are working to address that. (Institution 5)

”

Take the lead and to take that confident position of, here is what we believe is most material to our business. … Give us data, good quantitative data that is audited and good qualitative information around that data to support their progress and management of that risk or opportunity. … Help us see what is important, driving dialogue in the community, but just as importantly, providing us with good data and information on which to assess companies via their peers. That would be very helpful to us as the manager, in managing our own clients and helping them to see the sustainability of the businesses we own. (Institution 5)

”

The topics that matter for any given company or industry do vary. We have an entire set of what we call sector maps. It is broken down into individual industries of what we think is most material for those industries on average, but that can occasionally change even by company. … It does not mean that we are focusing on those topics and it does not mean other companies should focus on those topics. We would really hope that companies would instead, again, just look to what they see based on their industry and the unique aspects of their company. (Institution 5)

”

CSR guideline has helped up to a point. However, that was more quantitatively. We are now concerned with qualitative implementation. (Institution 10)

”

Compared to France, Germany has some catching up to do. … Compared to the US, broadly speaking, I would say we are a little bit further along. (Institution 11)

”

Let's move away from photographs of laughing children in Africa, holding company products. … Instead tell us what the accident rates are versus the industry standard. (Institution 11)

”

I would like to see companies integrate sustainability issues more firmly in their communications with investors. (Institution 11)

”

We would like to see clear KPIs for sustainability aspects to be part of the status report, which are actually tangible and which would be represented in sectoral comparisons, as well as in terms of a historical development. (Institution 11)

”

The problem we saw with CSR again this year is companies will report in different ways. (Institution 14)

”

What is always missing is the connection between financial figures and non-financial figures. Company X, for example, is pretty good at this in its reporting. They will say, the change implemented by employee such and such, or some sort of training, has resulted in such and such an advantage in terms of personnel costs or something similar. That connection, getting ESG issues on the balance sheet and into the P&L, is missing. That is why the analysts on the sell side are not as accepting of it. (Institution 14)

”

It would be advantageous for investors to read in an annual report, what sort of impact does it have if I save this much CO2 and on which items in the P&L? It is not only that I save paper, save energy, but, rather, in order to meet ESG goals, I am also saving money. That is also important for a shareholder… It is not just a case of window dressing to improve reputation. (Institution 14)

”

It is our job to work out how does a certain issue impact our view of value. It might get a lot of news flow. It might get a lot of negative press attention, but it also might have very little impact on the long-term value of a business. If that is the case, then we can encourage the company to engage around the topic better or to improve their disclosure, but really what we want them to be doing is maximising that long-term value. (Institution 17)

”

What we are doing is comparing company disclosures in similar industries. … built an internal matrix that looks at how say energy company A, B and C are disclosing … what is the quality, who do we think is doing the best, who is a laggard and how are we going to provide that feedback to them? (Institution 18)

3.3 Increasing pressures from underlying clients on environmental and social issues

QUESTION:

What pressures are you seeing from underlying clients?

Figure 5

THEMES:

Generally, institutions have noticed a higher level of interest in ESG topics over the last couple of years, especially from Northern European clients. Therefore, the pressure on investment decisions to be aligned with certain ESG standards has increased. Whilst the treatment of governance issues by the institutions appears to be widely approved and in line with what their clients expect, clients ask increasingly about environmental and social topics.

The topics mentioned most often are climate change and environmental impact of investments. However, the clients' interests also appear to be driven by recent issues and their media coverage.

This results in an increasing demand from clients to exclude certain sectors of companies from their portfolios. Particularly the exclusion of companies producing guns, weapons and munition is of high importance. Tobacco and coal were also named by a few participants. Other topics mentioned were plastics, sugar, cyber security and alcohol. Social issues, including that of the supply chain, such as the potential use of child labour, were also sometimes highlighted.

However, long exclusion lists based on environmental or social criteria are not common for traditional investors, whereas a different situation tends to appear for specific SRI portfolios. Indeed, the growing interest from clients has led institutions to set up a growing number of ESG funds. Though they still have a relatively small market share, they are expected to continue to grow.

QUOTES:

”

There are less pressures on the governance side. Clients have very much left the voting to us and they are pretty happy with what we are doing. On the ESG side, it is very topical. When there was the recent shooting in the US, we had a lot of client demand around our policy on guns and weapons. (Institution 1)

”

Firstly, we do try to engage on behalf of all of our clients and their views can be quite varied. If they are in specific funds, for example for ethical reasons, certain sectors may be excluded or we have a tilt in the portfolio towards companies that have strong management of ESG issues, so they are probably more interested in how companies are addressing ESG risk and opportunity. (Institution 2)

”

Climate, generally for most clients, is probably a bigger issue now than it was a couple of years ago. Cyber security is also a big issue that clients are interested in hearing about. (Institution 2)

”

A general theme we get a lot, from especially E&S oriented clients or prospects, is a wanting to be more hard line in terms of exclusions, which we, at this point, are not maybe as much as some of the smaller boutique E&S focused funds. Certainly, that is fair to say, … that is just not the way we operate as a more traditional investment house. …Our approach at this point is basically that if you have a segregated mandate, then we can be flexible in terms of exclusion policies and so forth, but for our general offerings … the challenge for the investment managers is to decide, well, how can I actually get a good return if I exclude all of these and where do you draw the line for exclusions too? (Institution 3)

”

Our inclusion policy is a policy we started developing, based on our clients’ wish to make more conscious investment decisions, so to really know the companies that we are invested in. (Institution 4)

”

Clients find the integration of ESG into our investment processes so important; it is a real determining factor. (Institution 4)

”

On the environmental side, climate related topics and water related topics are probably our key area of focus. (Institution 5)

”

What that is causing is clients to come to us with many more reporting requirements and with requirements of really just trying to understand exactly how we are handling ESG-related topics. (Institution 5)

”

The pressures we get, yes, they are social, they are political and doing the right thing and being great investors, but you cannot hide from the fact that there is also a commercial pressure from the next step in the chain. (Institution 7)

”

The Nordic clients, as you can imagine, they are very hot on more the sustainability, E&S issues, so they will be asking questions around those for all funds, even the mainstream funds. (Institution 7)

”

The thing we have been struggling with over the last few months is more clients asking for investments to be screened out. Tobacco is the obvious one, but we have had a lot on nuclear weapons, coal. That has really been something that we have been struggling with and trying to get a consistent process around that, if we are going to do it. Then, also, not wanting to exclude too much of the universe, really. (Institution 10)

”

It depends on the customers. Of course, the more ecological customers ask a lot about environmental aspects. If you look at the charity sector or also the public area, they often ask about social aspects. We definitely notice that because of the EU Action Plan, which is slowly being launched at the moment, the customers are increasingly focused on environmental issues. (Institution 11)

”

Our focus right now, this is really just a snapshot, is on supply chains and human rights. (Institution 11)

”

Climate change, … Our clients are very much expressing their expectations on this towards us, as the asset manager. Also, there are other topics that are more NGO or media driven, like palm oil or others, which come up occasionally. …, but most of them come down to the E of ESG and climate change. (Institution 13)

”

Which are the two most important topics? This year, we very much addressed climate strategy, CO2 and the environment. (Institution 14)

”

The social aspects are very important from the customer side. There is also CO2 footprint, using more carbon neutral energy or compensating for it, things like that, of course. (Institution 14)

”

Today, clients are very focussed on climate issues. If we do not take into account carbon emissions or controversial businesses, it can be a no go for the clients to invest. Today, it is only on environmental and controversial aspects, but it will evolve over the next years. (Institution 15)

”

There is certainly more interest in ESG. The questions are more and more frequent and more detailed. That is a good thing and I am pleased to see that come through. There is probably still a large number of people who feel obliged to ask what we are doing and do not really know what to do with that information. They are kind of checking the box, but at least there is awareness that they should be doing something. There are very few who try and actually direct us into how we should be doing our job, as far as how we need to engage with companies. (Institution 16)

”

I would not say pressure, but I would say, versus five plus years ago, definitely more questions. People asking some of the questions ..., how you incorporate it, things like that, whereas before it really was not a focus. We, for a long, long time, have talked about the importance of management and governance, so that part is not new, but I do think more people are engaging around especially the environmental and social aspects of ESG. (Institution 17)

3.4 Governance – perception of the status quo in Germany

QUESTION:

What is your experience of how German companies are approaching corporate governance, given their very specific structure?

THEMES:

The specific structures of the two-tier German board system are regarded positively and the clear separation of roles is regarded as providing good 'checks and balances'.

However, a number of investors are interested in better understanding operational aspects of the two-tier board system. In addition to the general governance aspects (like independence) (see chapter 3.5.), the size of German boards is mentioned as a cause of concern by some investors and there is a desire to understand more about how they work in practice and the role and impact of employee participation. Length of tenure, skill and background and attendance at board meetings also feature as issues, which some investors would like more detailed insight into.

Finally, a few investors perceive the overall German approach as being more check-list oriented and investors would like to see a more open approach and attempt at communicating the culture and thought process involved in decision making at board level.

QUOTES:

GENERAL PERCEPTION

We only voted against 8.4% of resolutions in Germany this year which is relatively low compared to our European markets. We had 14 engagements and 7 replies which is a fairly high success rate compared to other European markets. (Institution 1)

We still see issues with independence of boards. I know they have got this different structure to other markets and therefore we have to view it differently in terms of the actual independence level that we are looking for, but I am still seeing boards with 0% independence. They are just made up of employee representatives and controlling shareholder representatives, so they are big red flags for us and we will continue to vote against those until we see change. (Institution 1)

We do not have a very strong preference for one-tier or two-tier, as long as it is clear how the roles and responsibilities are divided and it is exactly that which is not always clear with some German companies, how the power balance is organised.

That is potentially an area where German corporates could improve on, also in terms of their communication. (Institution 4)

”

Board independence is a very important aspect of the composition. We always expect the supervisory board, with two governing bodies, to comprise majority of independent members and that can also become a challenge if, of course, employee representatives cannot be deemed as independent. (Institution 4)

”

There is a trickiness of how effective the supervisory board can be when they are so large and part of the reason they are so large is because of all the employee representatives. Do you really need ten employees or eight? Would two suffice, which would help pull the boards together, which might help in terms of effectiveness? (Institution 6)

”

I just feel in Germany it is still a bit more a tick box exercise against a code. There is less of a, culturally, what are we trying to achieve here, how does this work for our company? A more risk embedded look at things. (Institution 6)

”

There is a sentiment, if you have got employee reps, how open is the discussion? Are discussions held elsewhere? Is it that the supervisory board chair and the CEO can have their own thing going on? The reason is we are not cynical or having some conspiracy theories, it is because they do not engage and we are left with nothing. (Institution 7)

”

The two-tier board structure is a positive point. As with most investors, we are in favour of separating the functions of chairman and CEO and in Germany that is automatically the case. There is also the impact of the legal environment requiring a certain percentage of employee representatives, which could have an impact on corporate governance in Germany. That could have, for us, a direct consequence, as we have a minimum level of independence required in our voting policy. (Institution 8)

”

In the context of this two-tiered structure, we imagine that board meetings should take place without the presence of the CEO, or other key executives, at least once a year. (Institution 8)

”

Investors in Germany, in general, only have limited influence on companies due to the two-tier structure because they have an additional defence layer in the form of the supervisory board. As an investor, you cannot remove an executive unless you make sure the supervisory board is with you beforehand and that is just very difficult. (Institution 11)

”

Fundamentally, we think the two-tier board system is much better. We compare it across countries and we think it is markedly better because, from an investor’s point of view, it is very transparent who is actually managing the business and who is supervising it. This separation of power is clearly structured. (Institution 12)

”

German companies will follow along with regulation. That is for sure. If there is regulation, then they will comply. (Institution 13)

”

The German system may be a little slower, has a little more co-determination…. More checks and balances, but it has to be balanced for it to work and both sides have to implement it. (Institution 14)

”

My feeling is that the German system is better than the other one, but there are pros and cons. There is not one right system. You can get to a decision more quickly in the single board system because everyone is together, all the information flows well and then a decision is made. The non-executive members are also all involved in this. The German System, of course, has also to work seamlessly between executive board and supervisory board. That is where the interface is and that is also a corporate governance issue because if it does not work then you have a problem ... That is the crux of the matter. It is a good system if it is correctly implemented. The interfaces have to work seamlessly and that is why we pay attention to corporate governance – diversity and good communication. (Institution 14)

”

The two-tier board system is a really good thing. (Institution 15)

”

Co-determination, in theory, it is a very good idea. In practice, it tends to significantly slow decision-making and has led to a number of adverse outcomes. You can look at other markets that have employee representatives on the board that, for whatever reason, have not led to the same kind of, I would say, slowdown in decision-making or obstruction. I think of places in the Nordics, as an example, where that co-determination model seems to work better. (Institution 17)

”

I want to understand what role everyone is really playing in the room and what role can they really play to oversee. A sceptic might say, how effectively could an employee weigh in on very tough resourcing capital allocation decisions if it has a potential negative impact on them and their colleagues? (Institution 18)

”

Certainly, given that German companies have a very global shareholder base now, they probably should be thinking outside of the norm. These are huge companies. They actually, generally, perform pretty effectively. They are competing with global competitors. If we had to think about what is our job in one sentence, at the end of the day it is, how do we make sure that corporate governance is adding value to our investment? German boards should think about, how does their corporate governance add value to this company. (Institution 18)

SPECIFIC ISSUES

”

I do think there is a set instruction in the code about tenures, but we see tenures that exceed 12 years as non-independent. I think some companies do not recognise that and are classing their board directors as independent and therefore we are disagreeing with the level of independence they think they have. (Institution 1)

”

Some German companies also have supervisory boards with very long tenured members. They lack a policy on board refreshment sometimes and that can also raise some concerns. If there is not a healthy balance between long tenured and short tenured board members, there is a risk that board culture may become less effective and less beneficial for the company as a whole. (Institution 4)

”

Same names seem to turn up an awful lot … which makes me wonder how diverse the nominations are. (Institution 6)

”

Board members attendance has come up as an issue in Germany, where it is not disclosed or quite often you end up with a supervisory board attendance rate was 83% or something but it does not disclose individually. (Institution 6)

”

These boards seem to be massive and unwieldy, what material decisions are being made by the supervisory board. (Institution 6)

”

Another point that is quite sensitive for us is the duration of the mandate. In Germany, in comparison to other European companies, and mostly UK companies, supervisory board members have a very long duration of term. It is generally five years, which is allowed by the law. We are in favour of more regular board renewal and, if possible, even annual renewal. (Institution 8)

”

When it comes to board structures, apart from independence, the number of external mandates is still an issue. This applies to the executive board level, i.e. the CEO, as well as the advisory board level. We continue to be the ones who are really tough on this. … We simply believe supervisory boards will have to dive much deeper into the companies in the future. (Institution 12)

”

Attendance at boards, we cannot be happy with 80% or 90%, expectation has to be for 100% and more. (Institution 12)

”

Meetings need to be communicated transparently, when the meetings took place and what the attendance was like and … . Also, how each member took part. … At the end of the day someone who attends 100% of the meetings, but never says anything is no good to us either. (Institution 12)

”

We talked to a German supervisory chair yesterday. He said in his company, the whole diversity issue was all about gender and the argument was always there are so few women available. … Then perhaps you have to look outside (Germany) and then you will find female candidates. (Institution 12)

”

For me it is not about male or female, but rather the complex questions of male, female, nationality, age and more importantly history and their competencies. These factors are important in a globalised world. (Institution 12)

”

The supervisory boards tend to be, in my opinion, far too large, way too big. Coming back to why decision-making is slow, when you have a 20-member supervisory board, getting a group of 20 people to agree on anything is very difficult and I think it is just too much. They do not move fast enough. (Institution 17)

”

A well composed board, with more attention to diversity, with more attention to a range of tenure and experience, particularly since German companies are competing on a global scale. We would expect to see them be more proactive about the composition of that group over time. (Institution 18)

3.5. Governance – motivation and key issues

QUESTION:

What are the most important governance issues you are focusing on with Corporates in your engagement?

Importance of governance issues

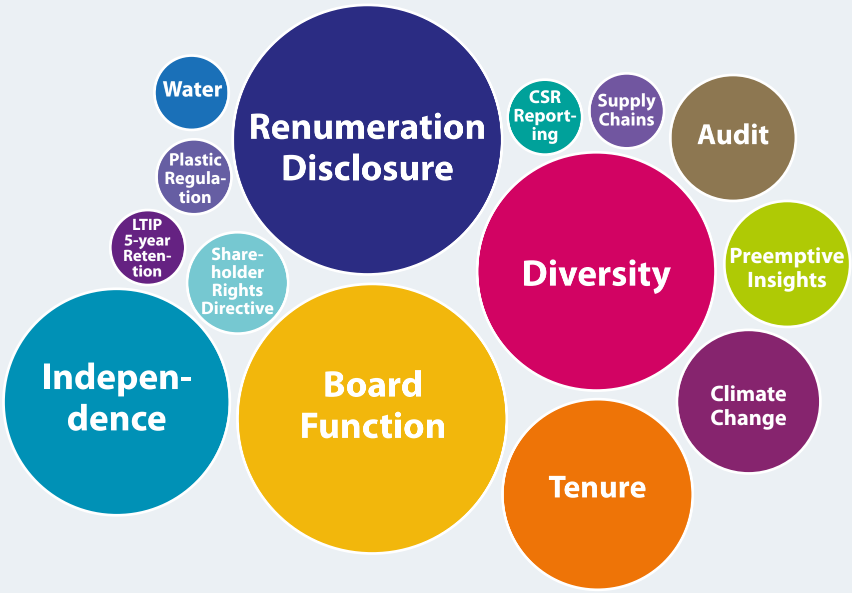

Figure 6

THEMES:

Long-term investors raise governance issues in order to make sure that both the management and supervisory board work in their best interests. Investors, however, do differ in terms of whether they perform their assessment according to clearly defined criteria or whether they take a rather holistic view of getting a flavour of a company's culture.

The most frequently mentioned topics that investors focus on during their engagement, were remuneration and its disclosure, as well as board competence, culture and the role of the chairperson.

Pay is seen as a topic which takes up much time, but this is viewed as inevitable. Investors highlighted the complexity of pay structures in Germany. Some find the level of detail provided obscures rather than provides insight into the areas they want to understand. Lack of data on targets and pay-outs for below performance TSR are also issues which were cited as areas of concern.

Board competence and culture cover a wide range of issues, but in essence, investors are trying to assess how the composition of the board and the way in which it operates, influence the quality of governance and therefore the company's ability to adapt to challenges and risks. Whilst there are specific measures and quotas which are applied, investors also consider qualitative factors such openness, responsiveness and willingness to engage.

A number of investors commented on indicators for board competence and culture. In addition, a couple of investors raise the idea of companies looking to provide a matrix of competencies to make assessing the skill set of the board more accurate. Points raised reflect prominent aspects of current debates in the field of corporate governance. Engagement is therefore focused on diversity, length of tenure, board size and "overboarding". However, at least some of these points rather appear to serve as proxies for evaluating the independence and adequate mix of competences.

There are some issues around capital authorisation that are perceived as specific German features and cited as an issue on which investors require explanation. Investors highlighted examples of companies who engaged and were able to provide credible explanations which led to them changing their votes, so the over-riding message was that engagement and explanation can lead to support, if there is a strong rationale.

QUOTES:

GENERAL AND BOARD RELATED ISSUES

”

I would mention a couple of the obvious ones. Diversity is obviously a big topic globally, and not just for us, of course. (Institution 2)

”

In terms of when we are looking at corporate governance from our side, it is really the independent scrutiny. We recognise independence is only one metric, but, if we are doing deep dives, it is trying to understand how the supervisory board, in this instance, is overseeing the management board and what is the accountability and the challenge that is there. Do the structures lend themselves to good scrutiny and accountability or less so? (Institution 6)

”

In Germany, as well as in other markets, we are looking at the experience and qualities of directors, especially when there is a new chairman come on board. I know we have abstained on new chairmen in European markets because we were unsure of their experience and why they were chosen. (Institution 7)

”

There is no overarching trend coming through, apart from independence of the board. (Institution 8)

”

One of the subjects that we have been trying to enhance this year was to ask companies to publish a competencies matrix of the directors. … We would like a yearly update of the matrix of competencies of a board. That would be a good thing. (Institution 8)

”

We are looking for boards to have 40% representation of women. That is actually one of the targets that we ask of our national holdings, where we actually are represented in the nomination committee and can have an influence on the composition of the board. That is a hard target. We really encourage equal boards. (Institution 9)

”

Remuneration, independence and board composition. (Institution 11)

”

In terms of supervisory board competencies, they should draw up a detailed competency map, which also clearly states where there are gaps. This document should be shared externally, which very few companies do… The companies should also definitely communicate how supervisory board meetings proceed and who is taking part. They need to provide more granular reporting on what happened there, in my opinion, in order to have more transparency. (Institution 11)

”

Our core governance expectations have to do with how boards are structured. Also, on the remuneration plans. (Institution 12)

”

Remuneration and independence. (Institution 13)

”

Which are the two most important topics? This year, we very much addressed climate strategy, CO_2 and the environment. That is one issue with which we tortured the companies with. The second one, in my opinion, continues to be remuneration. (Institution 14)

”

We also pay particular attention to the board members being independent. In our view, board members are no longer really independent after ten years, but rather dependent. Our demand is that the supervisory board is staffed with at least 50% independent members. (Institution 14)

”

We also pay attention to terms, so that the terms are not too long. We have our voting guidelines, 12 years or three terms. If the term is five years then it adds up to 15 years. Age, as well. The supervisory board members should not be older than a certain age. That is 75 for the supervisory board. So far, we have been strict about it during voting. (Institution 14)

”

Some subjects are recurrent. First, the composition of the board. We focus on the independence of the board members, skills of members and gender balance of the chairman/chairwoman. Remuneration is also a big part of our engagement meetings. (Institution 15)

”

If there were a deviation from German Code, then that would be an indicator, but we would probably apply more of a global standard rather than just thinking about what the German rule is. We can take that into account, but if it is something like board independence or chairman/chief executive, we have a global approach to those situations. (Institution 16)

”

We have a wide range of topics that we like to discuss in that capacity, which ranges from maybe the independence to accountability on various topics, if there are maybe governance issues at the company. We also want to hear how the board is thinking about strategy and risk oversight, as well as how they are thinking about the makeup of the board and any sort of refreshment or changes and how they evaluate that. For example, if there is an evaluation every year and also a skills matrix, where they review and see which skills may be becoming more additive to the board as the strategy changes for the future. (Institution 18)

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The board is just one pillar. We also have some more traditional pillars when you think of governance, which include governance structures, executive compensation, where that is applicable, and then our fourth pillar is just overall risk and strategy. Again, when we think about how we talk to companies about risk and strategy, it has to do with the board's oversight of the material risks of the company and their oversight of managements' strategy. (Institution 18)

REMUNERATION

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In Germany, it is mainly around disclosure and on REM related issues. There are a couple of engagements we have had with companies where we recognise that it is an industry problem and we are trying to get some companies to lead the way in terms of disclosure. (Institution 1)

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Remuneration and compensation take up a lot of time, probably too much; but it is an important issue and companies want to discuss that with us. On remuneration, it is fair to say that in Europe companies are not always so good on their disclosures. … Also, the target metrics are not always as demanding as we would like. … LTIP pays out on TSR for below medium performance, something we are not comfortable with. (Institution 2)

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Thematically, the main [issue] that we have had for many years now is on executive remuneration, in particular long-term incentive awards or long-term equity awards where we have been trying to push investee companies towards a five-year restriction period (LTIP/equity awards). … It has been successful in the UK and less so in continental Europe including Germany. … Other than that, it is more case by case and sometimes it is reactive, sometimes it is around the meeting. (Institution 3)

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Some of the rules in the market around executive pay and the requirement for caps, investing period and something, you have got some really, really convoluted plans that if you look at the disclosures, you spend several pages describing how the plan actually works, the mechanism. … do not know what it is based on. We do not know what is being measured. We do not know how that ties into the company strategy. Why do they pick these performance measures? We would like to see more of the deliberations or the rationale behind particular metrics. (Institution 4)

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I think the judgment of whether a material change is being made to a remuneration scheme; the trigger seems to be much higher for Germany. There will be what we would consider changes of metrics or changes of structure that do not necessarily come to a shareholder to vote, yet we would have assumed that was material enough change to come back to shareholders. (Institution 6)

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We have been consulted in a number or remuneration consultations and even just trying to understand those when they are actually coming to us, it is very hard. (Institution 6)

Overall view of remuneration disclosure in Germany is, it could be better… disclosure of KPI variables applied to variable pay are not as comprehensive as you find in the UK. They are complex because they are opaque, rather than the underlying structure. The funny thing is, actually, most of the German companies we look at, there is hardly anything particularly contentious going on and yet there is this caginess, which actually complicates things. They are good performing companies as well. (Institution 7)

If you have a 3 or 5-year LTIP then you should be able to tell investors what you are targeting … director tenure is also a bug bear, five or six years in some cases for a vote. (Institution 7)

If we look overall, the issue that takes most of our time is compensation discussions. (Institution 9)

I think Germany has changed rather radically and compensation is much higher. (Institution 9)

In terms of the individual aspects, I see room for improvement when it comes to remuneration and how that is communicated. Complexity should be reduced; the remuneration programmes should become simpler and they should be tied to stock prices more closely. It should also take sustainability issues into account. (Institution 11)

In 2016 we rejected almost 90% proposed remuneration schemes in Germany. That was all for one simple reason that they were far too complex and there is this little sentence that says, it is up to the supervisory board's discretion anyway to decide on the amounts, or whichever way the board is remunerated, or how the bonus is paid out. (Institution 12)

Disclosure from German corporates on remuneration is not very helpful and can be difficult to understand. (Institution 13)

PRE-EMPTIVE RIGHTS

We have seen a lot this season where companies have been looking to issue capital without pre-emptive rights up to a limit of 20% and we take quite a strong hard view that this should not be more than 10%, other than in exceptional circumstances. One of my engagement focuses for the next few months will be to engage with all of our German holdings. (Institution 1)

The other area that we struggle on a little bit more … is around capital management and the actual capital authorities. … In Germany, we get less visibility because you have only got these five-year authorities, whereas, obviously, in the UK we have it as an annual authority and we get an annual disapplication of pre-emption rights. I know it … is standard market practice, but [it] … is just too long a stretch. … You can hold a stock for nine years and only have one vote on it. (Institution 6)

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We have engaged with CFO’s who could not explain why they were doing this [dis-application of rights]. The ultimate answer seemed to be we just do it because we have been doing it every year and it is not needed. (Institution 7)

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One of the things we are consistently voting against is equity issuance and the dilution of shares without pre-emptive rights or rights issues. We are quite strict about that. We do talk with some companies who try to explain ahead what they are doing. Where we are one of the bigger investors, then generally we will have those conversations. (Institution 16)

OTHER ISSUES

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Audit is not something with easy solutions, but we are thinking and speaking to more companies about that. (Institution 2)

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We also look at the auditor and that is something that has changed a great deal these past few years. (Institution 12)

3.6 Governance – the role of and criteria to assess the chairperson of the board

QUESTIONS:

- How do you see the role of chairperson in German supervisory boards?
- What are the most important criteria for assessing the chairperson of the supervisory board?

THEMES:

The role and attitude of the chairperson of the supervisory board plays a crucial part within issues covering the area of board competence. Some investors underline that they regard the supervisory board's chairperson as their representative and, thus, as their natural communication channel if they wish to address general issues or concerns.

Engagement with supervisory chairperson is seen as important, but there seems to be a wide range of experiences in terms of access in Germany.

When it comes to the assessment of the chairperson, independence is viewed as the most important factor. The more general comments received relate especially to the perception of how the chairperson is embedded in the German governance "ecosystem", his/her accessibility and communication skills, whereas the most important competence criterion referred to is independence.

QUOTES:

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We did have an issue with a company, in which we have quite a large shareholding, where the chairman did not respond to us. It might just be a one-off specific instance, but the chairman should be our main point of contact on the supervisory board. If they are not able to speak to investors, then that is a red flag for us. (Institution 1)

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It is important that they do engage with shareholders, both to explain how they fulfil those responsibilities, but also to hear shareholder views, which is something that they perhaps do not realise the value of if they have not been doing that kind of engagement. I do appreciate also that the chairman actually has quite a key role within the works councils as well, so that is quite interesting. From our perspective, perhaps, that can give us some flavour of how employee relations work and their approach to managing the employee base, which could also be quite helpful in our understanding of how the company is managed. (Institution 2)

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Especially if we are a larger investor in a German company, we would appreciate to see the chairman once a year and to catch up on developments on the topics within his or her remit. (Institution 4)

We would not invest in a company if we do not have a good level of trust in the chairman. That is why it would be helpful, maybe once a year or once every second year, to encourage some kind of interaction, which we currently do not have with German companies I would say. We have very few exceptions. (Institution 9)

Most German companies, particularly the ones that we have dealt with, have had pretty good, heavyweight chairmen, so we are not worried about experience and that kind of stuff. (Institution 10)

It very much depends on the personality of the individual person, of the chairman. It depends on whether the CEO is more visible in the outside world, not only with employees, but also in the media and with the investors, or if he is not. … It does not matter what kind of corporate it is, I have not seen them talking too much. If they talk, and you can see this with X, they can be very powerful. (Institution 13)

The volume of communication with chairs of supervisory boards has really increased over the last two years. (Institution 14)

I have always had the impression, although I could have been completely misled, but I have always had the impression that investors cannot talk to the supervisory board. (Institution 16)

Can think of some cases in Germany where I think chairmen became a little too powerful, a little too involved in the operation of the business. That is not unique to Germany. That happens in other places as well. It is important for a CEO to know his or her role and for a chairman to know his or her role. (Institution 17)

INDEPENDENCE AND QUALIFICATION ISSUES

For us, independence would be top of the list. (Institution 1)

Obviously, the supervisory board's role is different than management's, so you have to respect that and the independence is important. (Institution 3)

I wish there was more clarity in independence because the code does not have a real definition. I know that is something they are thinking about in terms of the code revision. (Institution 3)

I would say independent leadership, hopefully, would be something that German chairs would be looking to make quite clear and drive in the boardroom and also would be part of recognising that shareholders are going to increasingly want to understand the view, on a one-on-one, more personalised basis, of the independent either chair or directors of the board. (Institution 5)

Independence would be one definite, quite high up there. We do not buy into the cooling off period that they have in Germany, as in if you have previously been on the management board, you have probably been either consulting, receiving a pension, on severance agreement and you probably appointed most of the management board, so to then flip over to being chairman and be considered independent because you have been away for two years, that does not smell right to us. (Institution 6)

Length of tenure comes in under independence for me. (Institution 6)

The most important factor is the ability to hire and fire the CEO. That is effectively what we judge a chairman on, getting in the right CEO because everything else filters on from there. The relationship between the CEO and the chairman. (Institution 7)

We do not have very specific requirements on the person of the chairman. Of course, we are rather in favour of an independent board chairman, but we do not have a principle of opposition to a former executive, as long as the independence requirements are well respected. (Institution 8)

Firstly, it is the independence of the chairman and, secondly, his qualifications in the role. These are qualifications in terms of knowledge of the sector and knowledge of the country where the company is implemented. Thirdly, it is communication skills. (Institution 15)

COMMUNICATION ISSUES

Would it be helpful to have more direct contact? Absolutely, yes, or just to have the opportunity to or for there to be an openness to doing that from the company's side. (Institution 3)

The chairman of the board, the supervisory board, has a very important role to play and we expect them to make themselves available for meaningful dialogues with shareholders. (Institution 4)

Hence, we are calling these chairmen because there is an issue, but have they been accessible? Yes, but that is because of a circumstance. What my colleague and I are focusing on is moving beyond that and in the UK parallel where you have great relationship meetings, when things are not going wrong, that is missing in Germany. (Institution 7)

Strategy. … The initial approach [of the company] was that the supervisory board chairman was available to discuss governance and sustainability issues with the caveat that he would not discuss strategy, which presented a complication for us because our approach is very much the governance team meets alongside the fund management team with boards. … For us, the distinction seemed to be one that we would not necessarily have made and, therefore, my personal view is, if German boards do wish to engage on governance with UK investors in a meaningful way, then they should probably be prepared to address strategic concerns which relate to governance rather than trying to say no comment at that point. (Institution 7)

3.7 Communication of German supervisory boards

QUESTION:

How do you perceive communication of German supervisory boards and what improvements would you like to see?

THEMES:

There are mixed opinions on the current state of engagement. Some investors highlight very positive interactions and examples of companies working collaboratively and constructively. Where companies are engaging, it appears to be at a high level and appreciated. Communication below the board level with IR departments is generally considered as to be working very well. However, there also do appear to be some gaps and investors have highlighted they would like to see more companies' boards and more consistency in communication.

Investors would like engagement to be timely (well ahead of the AGM), thoughtful and aimed at identifying and addressing key areas within the corporate governance and ESG arena. Investors don't necessarily always need to meet the supervisory chair, but the key determining factor appears to be having a credible person with insight into the board process who is able to give investors confidence into the culture and competency of the board.

The issues being raised in communication echo previous responses in focusing on independence, tenure, remuneration but also some rather organisational issues, such as getting an agenda right before the meeting.

QUOTES:

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We would like to see companies approach investors more. I know they have got a lot of work to do as well, but even if it is just an annual check-up or if they are making any large change. (Institution 1)

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We would like to have some more commentary on the board evaluation, which is very boilerplate, if it is done at all. It is really important to understand how the board is thinking about its own performance and making sure that it is doing the best job it can. Details on some of the outcomes of the board evaluation, some of the areas of focus, for example, would be good. Trying to give a bit more flavour in the risk sections on what is actually important and of how risk is changing, would also be good. (Institution 2)

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It would be much more helpful if a company has an agenda ahead of a meeting, to make it a much more effective use of everybody's time. (Institution 3)

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I would say, for Germany, this voting season and thereafter, it [engagement] has mostly been at the IR level, which generally comes under the finance director. Is that good enough? Well, sometimes it is. It depends, it depends. (Institution 3)

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Generally, we encounter some difficulty getting access to the board of the German companies that we are invested in. They tend to be relatively closed and, maybe it is a cultural thing, chairmen of German supervisory boards would seem not to be too interested or willing to talk to shareholders directly. … We have some positive examples as well. The larger our investment in a company is the easier it becomes, of course, to access the company. That is a bit obvious, but I do sense that German companies are increasingly aware of the expectations of their investors. (Institution 4)

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If we are a top ten shareholder, it would be good for the board to be reaching out to us and/or, in the future, we are increasingly going to be reaching out to those companies, especially where we have, let us say, 5% or more ownership. What we have found is that engagement can be tricky and difficult. Management teams and boards need to develop a relationship with investors so that they can understand where we are coming from, that we are really and truly thinking long-term. We have found that our best relationships with companies have been those where, oftentimes, they have proactively reached out to us perhaps four or five years ago and now we have good consistent conversations with them. (Institution 5)

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It certainly feels there is less engagement and accountability. We have certainly got one at the moment, a company where we own over 1% of the issued share capital, we have written to them several times, but I am not aware that we have ever had a conversation with them on broader corporate governance issues. (Institution 6)

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I think being more open and, if the chairman gets a letter, being more open to ensuring that someone in the team is responding to that…One thing I think German companies certainly have done, where we have engaged with them, the IR does pick up on it and we do get proxy materials coming through straight to my email, which is quite good versus some other markets. (Institution 6)

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Positive in the sense that when asked they have delivered, they have come, it has been clear, it has been communicative. I would not say it was always a positive circumstance. (Institution 7)

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The actual calls we have had with German companies are ‘tiptop’. (Institution 7)

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Strategy. If boards do wish to engage in a meaningful way, they should be prepared to address strategic concerns. (Institution 7)

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German companies are on the same trend as other Countries, no significant difference. (Institution 8)

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From our experience of German companies, I would say that they are even a bit more accessible and available than others. (Institution 8)

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We have had several discussions with board chairmen. We are in favour of this, so it is a very positive point for us to have this kind of access to the board. (Institution 8)

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My sense is that direct communication between the board and shareholders are almost non-existent with German companies and it is normally the management and IR department that you are talking to. It would be helpful if there would be some kind of dialogue. In general, my experience is that the whole corporate governance agenda is much more formally and legally driven in Germany …. Normally, the chairman does not approach shareholders. (Institution 9)

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When there have been discussions with German companies where we are involved, in general these have been very good. There is no closed door or nothing like you sometimes can read about in German newspapers. That is not our experience. There are some German companies that we are not invested in because we have made the decision based on the analysis that we do not feel comfortable with the level of transparency etc. (Institution 9)

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If you ask us if anything could be improved, it would be to have dialogue as well with the chairman. (Institution 9)

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The ones that we have met have actually been very good. We have had conference calls. We have had in-person meetings. They always come across as very knowledgeable and very aware of what is happening within their companies, so no complaints when we actually do have an engagement. (Institution 10)

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I would say that in terms of what they say publicly and what is out there, we are pretty comfortable with where it is at the moment. You still get a bit of a north European versus south European divide when it comes to disclosure and that kind of stuff, so we are pretty comfortable with the Germans, the Netherlands and the UK. (Institution 10)

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German companies do a good job on disclosure, less good on face to face meetings, we see a lot more French companies … we have had some instances where we have wanted to talk to a German non-exec and they have said legally they are not allowed to talk to us. (Institution 10)

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Supervisory board has to be actively communicating with investors, in my opinion, so that you get an overview. (Institution 11)

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Communication has improved. At least we are able to get appointments with many DAX companies. There are two or three who still play hard to get ... Otherwise, there is good communication. We are talking and the companies have now understood that. (Institution 11)

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If we had a wish list, our optimal communication with a supervisory board would be that we would get together once or twice per year and talk about the relevant issues. It usually makes sense to do that shortly before the AGM, just to discuss the AGM agenda items. That could be important to the company as well, that they do not have any bombs go off at the meeting. (Institution 11)

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The great fear has always been that an investor might say, what kind of a CEO have you picked? What an idiot! That is not the issue and that was never part of the reason for the investor dialogue. Rather, we want to know, within the framework of the dialogue, what the parameters are when you are looking for someone. What are the fundamental indicators that are necessary for this job? We also want to know how competencies are distributed across the supervisory board. For example, are the right people in place who understand the company, the industry and the purpose? Things like that are decisive, amongst other things. (Institution 12)

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There are still some companies … which do not really alert you to important issues, which are necessary for transparency reasons. Of course, we will approach them if possible and tell them that we want this information. The big difference is that it is no good if the companies just send it directly to us. Rather, we expect that this be sent to all investors at the same time. (Institution 12)

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One important milestone for advisory boards was the guidelines for investor dialogue, at least from my perception. … Since then, the understanding that investors would like to talk to the person whom they elected to the supervisory board, as a representative for investors if you will, and the understanding that there is a need to communicate, has increased. (Institution 12)

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If German corporates were more proactive, I would like to see a combination of more engagement, more events, reports, disclosure, etc, but also more proof. (Institution 13)

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We look at the competency profile and that is always discussed during our interviews. Did the chair think about this? Did they cover all areas or is there still a need to bring in specialists that are not currently there? (Institution 14)

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Once a year is enough, really, within an appropriate timeframe before the AGM … two months before at the latest. It is about very important things like corporate governance, the composition of the supervisory board and strategic questioning. Are the company's internal control mechanisms good enough? How well are risks managed, etc? Other things, like ESG, which is also done by ESG experts from the IR side also come up continuously, which depict the entire company. (Institution 14)

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There are more and more presentations available to watch online. Unfortunately, some companies are still not doing this automatically, putting it up online. You have to request it. It would be nice if all companies had an up-to-date presentation available. (Institution 14)

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If it is investor relations that have knowledge of what is said during the board meetings, that is okay for us. If it is a board member who cannot discuss something, who says they cannot tell us because they are only a board member and they cannot talk on behalf of the company, that is a problem for us. We do not care if it is a board member or if it is investor relations or a legal person, we need to talk to someone who has the most knowledge of the strategy, the company and what is said during the board meetings. (Institution 15)

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Are German companies communicating enough with us? It is a mix. Some companies, yes, others, no. … Shareholder engagement is important. Good disclosure and rationale for executive compensation is something that the board should really focus on. (Institution 17)

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Very board centric approach to engagement. When we do engage … we prefer to engage with independent directors. (Institution 18)

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The engagement behaviour is important. I would describe that as accessibility to their shareholders, being proactive, reaching out, offering the right people. Offering members of the board to those shareholders that want to talk to members of the board and offering members of management to shareholders who want to talk to members of management. Being a little bit more comfortable with what those conversations can look and feel like. (Institution 18)

3.8 Activists

QUESTION:

Do you engage directly with activists? How do you view the impact of interventions from "activist" investors for value generation of the company?

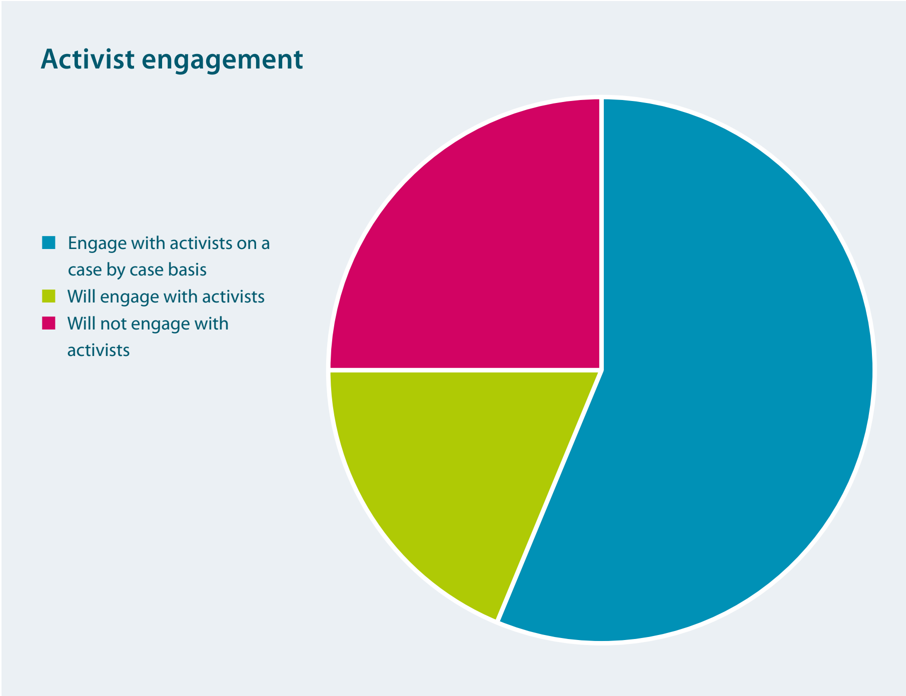

Figure 7

THEMES:

Even though investors normally regard it as natural to speak to the company first, the majority of investors interviewed will engage directly with activists, although almost every investor explicitly indicated they do so on a case by case basis. There is recognition that whilst the investment time horizon is different and activists can create risks, they can also enhance value. Investors thus engage with activists in order to take an informed decision. However, some investors are uncertain if they can talk to activists under the current financial rules and investors are hoping for clarification on this in the short to medium-term.

Investors believe the best defence against activists is to have strong relationships with a broad range of shareholders and engage with them to understand what their views are. Moreover, there is a clear view that companies need to additionally explain their perspective if an activist is taking a position which is contrary to the board's view.

The interviews highlight the need to ensure that this regular engagement is also done with passive and index investors who also can and do engage with activists. For instance, one index investor reported to have an average rate of supporting 50% of activist situations which go to a vote.

QUOTES:

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If we have got an issue with a company, we very much believe that the company should be the first people that we contact and they should hear it from us, rather than anyone else. Although we may agree with the views of an activist in some circumstances, we will approach it in our own way and speak to companies before we take any action, so it will not come as a shock. (Institution 1)

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Activists have a different agenda or time line from ourselves and probably more often than not we wouldn't engage with them. … However, that is not to say that we do not speak to activists. It depends on the activist, … because you do get different flavours of that particular kind of shareholder. Some activists we do know quite well and we respect. (Institution 2)

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It very much depends on the situation. Our general approach in terms of engagement with companies is we try to be collaborative, supportive etc. (Institution 3)

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We definitely see an increase of activist activity in Europe. In those situations, it is very important that the company actively reaches out to its shareholder base to explain their view. … It is a missed opportunity if a company does not take that chance to reach out to their investors. They are invested in the company for a reason. (Institution 4)

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What we will do usually in a situation where a European company or a German company is targeted by an activist is just to make sure that we are fully informed, meaning that we will enter into dialogue with the company in question to get their views, but we will also get the activist's views and see what their point is and what they are aiming to do. (Institution 5)

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Activists are more likely to be pursuing companies where we have generally felt that there is a management or other operational issue that appears to not be being taken seriously as we would hope or expect. However, that is not universally the case and, as a result of that fact, … we aim to form our own opinion on that. (Institution 5)

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Activists contact us and we do not refuse to talk to them, but at the same time, we do not share with them our voting intention. We engage with the company as well and we only let them know our voting intention, not activists. We can take into account activists' reasons, their rationale, but the decision is taken completely on a case by case basis. (Institution 8)

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We engage with activists on a case by case basis. Sometimes these activists seek a dialogue with us. Sometimes we are prepared and sometimes not. … the time horizon of activists is a lot shorter than the whole-time horizon for our investment. Normally, they have a short to mid-term orientation and we clearly have a long-term ambition. What we do not want is that long-term shareholder value destroyed by short-sighted decisions. (Institution 9)

We will try to talk to both sides, at least, to get as much information as possible. There have been times when we have worked with activists, there have been times when we have worked with management, there have been times where we have just thought, this is not an issue of sufficient concern for us to go to either side. It is very, very case by case. (Institution 10)

Our approach is, we say something if we do not like it and the companies should listen to that and decide what to do with the feedback. (Institution 11)

If there is an activist on board, we may exchange ideas here and there, but it is not systematic. In my opinion, that kind of backchannel diplomacy will not lead to success, last of all in Germany, … because shareholders in Germany are not sufficiently involved with the company and the supervisory board is a layer of defence. (Institution 11)

If an activist investor comes on board, we would not seek contact with them. We must not … because we constantly live under the Sword of Damocles, which is 'acting in concert'. … It basically makes it impossible … to form one joint position together with other investors in relation to one company and to publicise that. This coordinated, hidden behaviour is just too much of a legal risk. (Institution 12)

The regulatory authority should really be clearer about what you are allowed to do and what is prohibited. You may be able to talk about certain topics in the run-up, but mostly off the record rather than on. You have to be careful and that is why we actually are not seeking to approach these activists. We can listen to them. It is also okay to have a conversation, but collaboration? (Institution 14)

We are long-term investors and if it aligns with the activist investors, we would, of course, listen to that as well. It is not as if they generate particularly new ideas most of the time, but, if it is only considered as a short-term thing, to leverage something or just create an advantage for themselves, we do not really approve of that. (Institution 14)

We will try to understand why activists asked to move the board member or why they asked to increase the dividend. We try to understand their motivation and we will engage with the company to understand both sides, after which, we will make our choice to follow one or the other side. (Institution 15)

We do not tend to engage with other asset managers very often, almost never in fact. We are large enough that we are fortunate to have good access to company management and IR. (Institution 16)

Generally speaking, activists tend to be very short-sighted. That does not mean that they do not raise good points. I can think of some German companies in recent times where activists have made a positive contribution and have helped drive change. There is a lot of bureaucracy with German companies. Activists are good at pushing through that bureaucracy. (Institution 17)

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Engage to the point that it would be important for us to understand what they are pushing for or trying to achieve because, again, if they are pushing for something that we view as detrimental to the business or counter to our view of value creation, then that potentially is a meaningful risk to our investment. … what it does not mean is we would not try to join up with the activist and push for something, if that makes sense (Institution 17)

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Put a target on their back by not having all the right governance provisions in place. (Institution 18)

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We have to approach activism with an open mind. It is possible that an incoming firm [activist] may have identified issues or brings new ideas which could actually deliver value over the long term and be a positive disruption. …That said, rarely, if ever, does an activist hold the stock as long as our funds will hold it, so we have to be very thoughtful about how much disruption we support, if we think disruption is needed. (Institution 18)

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Half of activist fights which go to a vote, we support the activist. We look at every one, case by case and that is the output. Year on year it is the same. (Institution 18)

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It is going to be important for companies, especially German companies, if they are early in their engagement lifecycle, to be prepared for some pretty transparent and ongoing discussions, in a way that may feel different than the way they have felt with long term investors in the past. (Institution 18)

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It is a dangerous assumption to think that passive or index investors will not do anything, given how much we own of their stock. (Institution 18)

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When an activist shows up to a company and that activist says, I have talked to all your shareholders, they think X, Y, Z about you, they told me they are not going to support you, they told me they do not like your board etc, that is … no way that that has happened. I can assure you, never, … will we have told an activist what we think of a company, if we have not told the company that. We will not even tell the activist what we think about them if we have told the company. (Institution 18)

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One of the major challenges with activism is you just do not see it coming. Boards probably should, in advance, invest in relations with long term holders. Invest in those holders that are going to be there in the good times, that are going to be there through the activist campaign, if there is one, and that are going to be there in the bad times. Arguably, we are almost a more important relationship than the rapid-fire relationship with a new activist in the stock. (Institution 18)

3.9 Proxy advisors

QUESTION:

How do you incorporate proxy advisers' decisions into your process and who do you use?

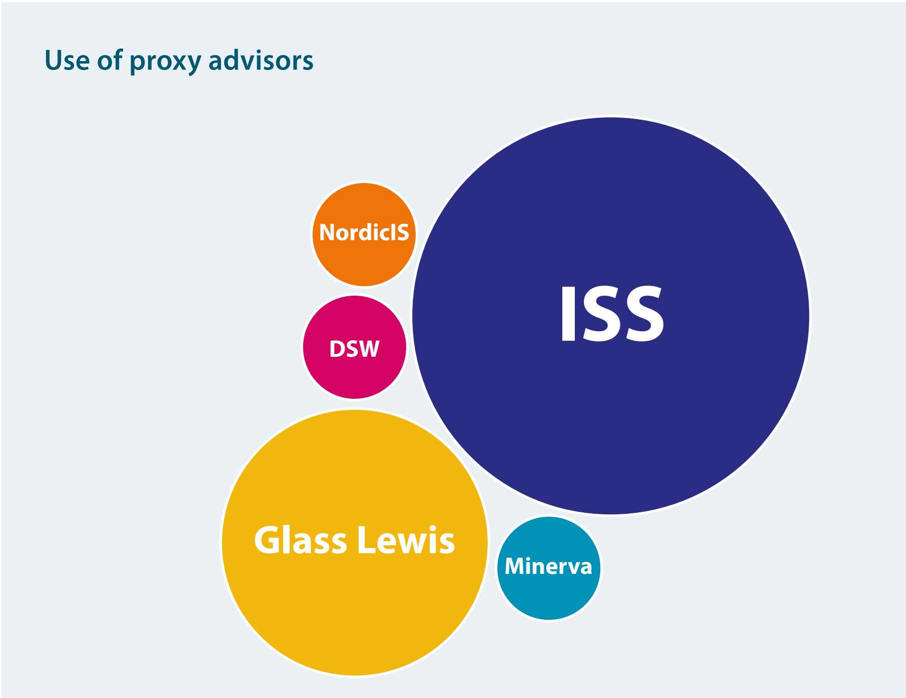

Figure 8

THEMES:

ISS are clearly the dominant proxy research provider used by investors, followed by Glass Lewis. Similar to ESG data providers, most institutions highlight they use proxy advisers purely as a first filter or a supplement to their own research to then make their own decisions on voting.

The clear inference from that is that engaging with large holders can over-turn votes and companies should not assume the recommendation from ISS and Glass Lewis is 'blindly followed'.

QUOTES:

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We only receive ISS research. We do not have any of our holdings that just get pushed through with ISS recommendations. We review every single resolution, whether that be a small holding or a large holding, so we have our own policy and we will apply that to everything. We use ISS recommendations, but we do not ever just take them as they come. (Institution 1)

”

In Europe, we tend to use ISS. We will, for our larger holdings, certainly do our own detailed analysis. For smaller holdings, we will tend to review cases where there is something that is perhaps controversial or a potential vote against. I would say that ISS applies a custom policy that we have developed, so they take their own research and then overlay it with our particular policies. The recommendations will not be in line with the core ISS, it will be different in some areas. We review the recommendations based on our own policy, just to make sure that that is what we want to cover. (Institution 2)

”

We use ISS for the voting platforms, so their proxy exchange. They take care of a lot of the back-end stuff in terms of getting the votes executed. In terms of research, we subscribe to them and Glass Lewis. We have our own voting policy, which is fully in-house. We review all proposals, we make all voting decisions ourselves on the basis of our own policy. … anything that is M&A, commercial and the usual, in any case, we consult with the investment team on that and they make the call on that. The same goes for any votes against management for our larger shareholdings, so they get to make the final call on that basically. (Institution 3)

”

We get the proxy-advisor research, I think they are useful, certainly for their standardised disclosures of board tables and for highlighting issues. Flagging something and tables, they can be very useful, but we do not follow the recommendations necessarily. (Institution 3)

”

There are a lot of European companies who think investors follow ISS recommendations and that is not necessarily the case. I think it is complicated because there are some investors that have set up a policy with them where it will vote automatically and they might monitor it, especially smaller ones. (Institution 3)

”

We want companies to engage with us first on everything. You can engage with them [ISS] to explain what you are doing and whatever, absolutely, but we want them, if it is like a capital raise or something, to talk to us. (Institution 3)

”

A lot of continental European companies do this governance roadshow where they come around and they explain their board structure. It is all the stuff that you vote on and whatever. I guess it is because maybe they feel investors are totally dependent on proxy advisors and stuff for voting outside of their home market, so they want to show their face, but it has not been particularly helpful, especially if we try to ask questions that are outside of the structure of whatever presentation they have. (Institution 3)

”

We make use of one proxy advisory firm, which is ISS, and we use their reports for information purposes. In the voting platform, we have integrated our own voting policy, so we do not follow the ISS advice, but we use their proxy reports for information purposes. In principle, all our votes will be submitted in line with our own policy, which deviates from the proxy advisory firm's policy. (Institution 4)

We use ISS, but do not actively vote in line with them. We use Glass Lewis as well and we are actively working to even further reduce any kind of linkages to their vote…I would say they [proxy advisors] are helpful to us, but again, increasingly just one of many data points that we are using as we think about how we want to vote. (Institution 5)

We use ISS, but it is a flag. It is a guide. That is the opportunity from the client's perspective, to be able to establish a line of communication which enables you to make your case, rather than a call two days before a voting deadline to appraise people of what you are trying to do. (Institution 7)

We use ISS for most companies, particularly German corporates. … as a kind of filter and a source of information, which can help highlight some sensitive points that we are trying to look at in more detail. (Institution 8)

What is important for us is that we do our analysis ourselves, so they can and do recommend, but we decide how we vote. For example, if there are issues or a recommendation to vote against, we will have a dialogue with the company and sometimes we will change our vote or maybe we will vote against as well. We do not use ISS for that reason because they are more that we should follow their policies and their recommendations and that does not suit us. (Institution 9)

We do use ISS research, but, again, it is base case and we decide for ourselves. (Institution 10)

We use Glass Lewis. How important are their recommendations? Let me give you some data that should make it clear pretty quickly. We vote no on about 30% of agenda items. Glass Lewis does an analysis and says, based on your policy, you should vote against this. That is about 30%. We deviate from Glass Lewis recommendations in low one figure percentages. (Institution 11)

Proxy advisors generally only do the presorting, the groundwork, based on our guidelines. (Institution 12)

I have only come across ISS and their research. We use their research as a flag and then take an internal decision. (Institution 13)

We have our own guidelines, which we publish on our website and we strictly adhere to that. The proxy advisors have their own guidelines as well, which sometimes deviate from ours and are far too lax or something like that. That is why we use our own guidelines. We use ISS to handle our voting rights. You have to enter it on a platform. Their recommendations are integrated, if I can say that, with our guidelines. (Institution 14)

We only use ISS. We use them, firstly, for the operational part of the vote and for the research too. We have for the first time done a certain amount of research and then an analysis of general meetings. (Institution 15)

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We also get research from external proxy providers. Again, we form our own decisions in-house. We have our own policy, we have our own process for making those decisions … but we have access to them. (Institution 16)

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We use ISS. We do not always follow ISS's recommendations. (Institution 17)

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We buy research from a lot of providers. Glass Lewis and ISS are two among the many providers from whom we buy research. We do not follow their recommendation. That said, a common-sense person could see that a lot of things in our corporate governance and proxy policy rhyme with the things that you see in the policies of ISS and Glass Lewis. That is no accident. Those are common sense corporate governance rules. (Institution 18)

3.10 Voting at general meetings

QUESTION:

If you intend to vote against an item at the general meeting do you communicate the reasons with the company and attempt to engage before doing so?

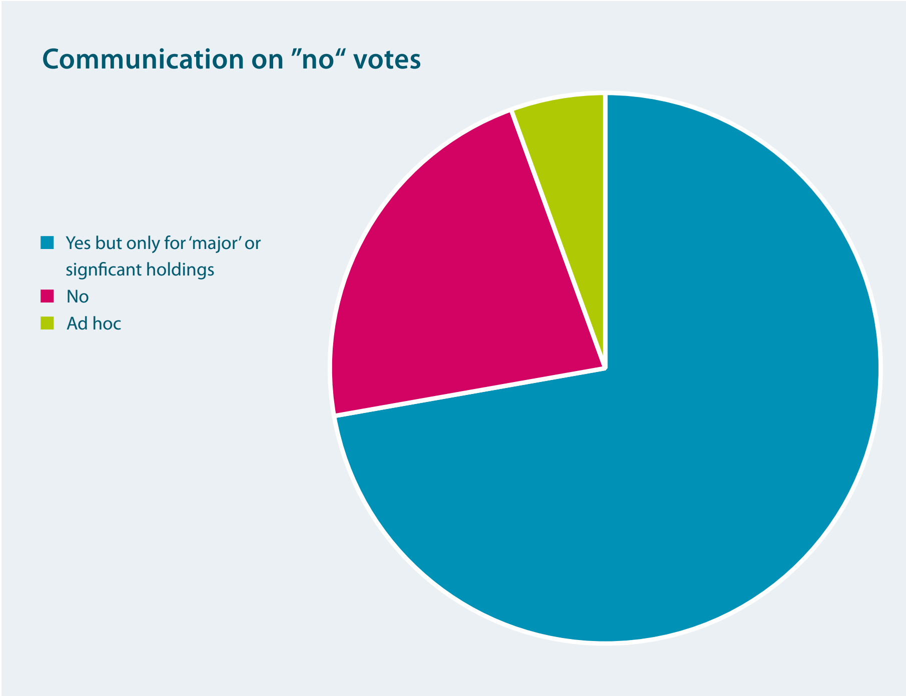

Figure 9

THEMES:

The majority of investors will make the effort to communicate a no vote or abstention ahead of the vote, mainly if they are a large investor in a company. However, a minority believes that companies should ask for this information.

From a practical perspective, it is simply not possible for investors with thousands of holdings to engage and communicate on every no vote and there is a grey area around what constitutes a significant holding for the company and what is significant for the investor. The data and comments indicate companies can expect clear feedback from largest holders and the opportunity to engage, if they wish to take it.

QUOTES:

We contacted X before their AGM as we had three points, we wanted clarification on. … They turned around a very through answer within 3 days and we managed to support all three resolutions. X is an example of where we did actually approve capital issuance without pre-emptive rights which exceeded 10% because X had come to us in advance to explain their situation. (Institution 1)

Unfortunately, we cannot do that for all our 6,000 meetings between three analysts, so it is very much dependent on our holding. … our focus this year has been to communicate with all our companies after the vote against, but for any of our big holdings, we would have contacted them before. (Institution 1)

If we are reasonably significant, we would always make the effort to engage if we were voting against and possibly if we were abstaining as well. In practical terms, I do not think that is always possible. (Institution 2)

Even if it is, in dollar terms, a relatively small exposure for us, above a certain percentage then we would inform the company, no matter what. (Institution 3)

We disclose [our voting] retrospectively on the web site, but not the rationale. (Institution 4)

Especially when we consider to vote against a resolution at an AGM of a company where we have a large holding, we will definitely enter into a dialogue with those companies and request any further information, if anything is unclear, or express our concerns with regard to any of the resolutions at the AGM and try to change things or at least to help the company understand why we expect certain things from them. (Institution 4)

If its small holding, we just vote based on publicly available proxy policy, if it's a larger holding and it's a contentious vote, we will absolutely look to discuss that with management team before the vote occurs. (Institution 5)

Say the holdings are relatively stable, we do not actively go and seek to engage with them ahead of the meeting because mainly it is very, very clear cut. … In the first year, we will be gentler with votes… we always send a letter. … I do not think the German market is as strong as it should be given the size of the companies. (Institution 6)

We would vote against maybe for a director or a proposal because we have had issues with an M&A transaction or performance or strategy, which has been discussed many months in advance with management and it is that chain and then it manifests into a vote. The companies are not alarmed by the decision. They may not want the decision. … We will vote against directors if we feel they are not doing their job. (Institution 7)

For the moment, it is not systematic. It varies. We are trying to engage with companies in which we have significant holdings, of course, and also if there is a specific request from a company itself. (Institution 8)

All voting activities are made in house … we are trying to engage where we have significant holdings. (Institution 8)

It makes no sense to vote no and not to communicate. (Institution 9)

I would say it is not practical in every situation. I think … if we hold more than 1%, we will try to engage and we will most definitely write to them, either just before or just after the AGM, to say why we voted against. (Institution 10)

It is up to companies to get the information; we do not owe it to them. Just to be clear, if the company wants to talk with us beforehand then they are welcome to do so on all levels. (Institution 11)

In terms of remuneration, there have been quite a few changes. If we have frequently voted against, we now communicate with the companies. There is a dialogue. They will engage us early on in the discussions. We are not the ones who come up with the remuneration systems, but we are the ones who they at least try to involve here and there. (Institution 12)

No. This might change during the next few years, but right now I do not have the contacts and I do not have the capacity, time resources mainly, to get in touch with them. (Institution 13)

If we vote on over 300 companies, we cannot call every single one. We look at our most important ones, where we also have the largest company shares. (Institution 14)

We send an email to issuers where we vote against one item. Some answer and we engage in a dialogue, sometimes we change our vote. (Institution 15)

We are a bit ad hoc about it, would like to be more systematic. … It does not come from the governance team. If a portfolio manager felt it would be helpful for the company to know in advance, they would get in contact. (Institution 16)

If asked I would be honest and tell a company my view, some companies do not ask and again I think around AGM items, companies should be proactive with their shareholders and engage. (Institution 17)

In contested activism situations, … we do try and tell companies the way we are going to vote, particularly if we are voting against management. Across the entire portfolio, in every instance where we might vote against management, it is virtually impossible for us to give advance notice. (Institution 18)

There is a correlation between our direct communication on our voting intention and our engagement history, so this will be a reason for public companies to want to engage with us. (Institution 18)

3.11 Reactions to ESG deficits

QUESTION:

What would you do, if you concluded that a company has deficits regarding ESG topics?

THEMES:

Engagement around ESG issues follows a pattern of escalation which typically starts with the issue being raised by letter, email or verbally with IR, followed by communication with an executive board member and then can escalated to the supervisory board, voting against at AGM's, public interviews to the financial press and in some instances legal action. Divestment of stocks is regularly seen as the last resort.

QUOTES:

"

It is definitely on a case by case basis. The step by step process would be that the governance team would identify this issue. It might be a recurring issue or it might be a big alarm bell, and we would flag that to the relevant fund manager. The fund manager will always be integrated. We would never go to a company without going to the fund manager first. The fund manager always knows what is going on. (Institution 1)

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What we would normally do, if we find a risk, is we will talk to the management team about that risk, try to understand it better. If we really cannot get comfort and we think it is highly material, then we may choose not to own the security, as in those examples that I have shared. However, we may just feel, well, as we look at this ESG risk alongside the other risks and opportunities and valuation presented by this company, it is still appropriate to make an investment. We may model the company differently or value it differently in our own work, but still choose to purchase it. There have been several times where we have taken that approach. (Institution 5)

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Selling shares always remains the final sanction. There are less drastic ways that we can express our discontent with something, like at the general meetings on some specific points. (Institution 8)

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If we believe a company has ESG deficits, we talk to the executive board. Now if there is no reaction, we talk to the supervisory board. If the supervisory board does not act, we will go the annual general meeting, or we go public. Those are the basic escalation steps. If nothing happens at all, we will disinvest. We may also think about going to court. (Institution 11)

"

We can sell the shares because we are an active investor. That is a bit of a last resort because we obviously invested for certain reasons, where we thought it was going to be a good investment, but the thesis can change. Our first course of action is always to have a dialogue with the company. (Institution 16)

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