

The Kay Review
Department for Business Innovation and Skills
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18 November 2011

CHURCH OF ENGLAND ETHICAL INVESTMENT ADVISORY GROUP AND NATIONAL INVESTING BODIES SUBMISSION TO THE KAY REVIEW

About this submission

This submission represents the joint views of the Church of England Ethical Investment Advisory Group (EIAG)¹ and the Church of England national investing bodies.² The submission should be regarded as an asset owner response. Any follow-up by the review team should be directed to the EIAG Secretary, Edward Mason, on edward.mason@churchofengland.org.

Introductory comments

The EIAG very much welcomes the commissioning of the Kay Review. The national investing bodies of the Church of England are long term investors whose purpose is to maintain the real value of their endowments, meet pension liabilities and generate sustainable returns for the work of the Church. Strong

¹ The Church of England Ethical Investment Advisory Group (EIAG) makes recommendations on ethical investment policy to the Church of England's national investing bodies. The EIAG and its Secretariat also conduct engagement and proxy voting activities on behalf of the national investing bodies. Seven of the voting members of the EIAG are nominated by the national investing bodies, the General Synod, the Archbishops' Council and the Council for Mission and Public Affairs. The remaining three voting members are co-opted for their experience of investment and business. Further information can be found at www.churchofengland.org/about-us/structure/eiag.

² There are three Church of England national investing bodies: the Church Commissioners for England, the Church of England Pensions Board and the CBF Church of England Funds. They have combined assets in the order of £8bn.

long term returns from equity investments in UK-based firms are important to the national investing bodies. However, the proportion of assets invested in UK equities has been in decline over the past decade.

There are a number of reasons for the decline in allocations to UK equities. The marked concentration of the UK stock market in specific stocks and sectors is an important factor. There is also a desire for increased international diversification of equity allocations including to emerging markets. UK firms will only be allocated capital to the extent that they offer suitably attractive long term risk-adjusted return prospects. Currency risks can be managed through spreading exposures and hedging. Significant allocations have also been made to alternative investments, the opportunities for which have increased greatly in recent years.

The national investing bodies all have a combination of challenging long term real return objectives ranging from RPI + 2% to RPI + 5% and current liabilities and obligations to meet. Asset allocation decisions are made with these objectives in mind.

Response to consultation questions

Q1. Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and fund managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.

The standard time horizons of companies and external fund managers are undoubtedly shorter than the time horizons of the national investing bodies. The Church Commissioners (one of the Church national investing bodies) for example are most interested in how their investment portfolio has performed and will perform over periods of five, ten, fifteen and twenty years.

This is not a problem *per se*. Companies, fund managers and long term investors all need to attend to both short and long term performance. Short term fund manager performance is monitored by the national investing bodies as part of ongoing assessment of the prudence of investments. It is inevitable that short term performance can generate some confidence in or concern about a manager's investment strategy. But the national investing bodies believe that ordinarily they are able to discriminate between short term performance difficulties that are the result of the prevailing market environment rather than deficiencies in long term strategy. Decisions are not taken about the performance of fund managers on the basis of individual quarterly returns but returns over at least three year rolling periods and typically much longer.

The EIAG welcomes structural measures that support long term decision making at companies, such as disclosure of long term business objectives,

including sustainability targets and KPIs; disclosure of high quality, measurable, comparable and independently verifiable key environmental, social and governance (ESG) data; moves towards more integrated reporting; incorporation of ESG achievements into executive remuneration plans; and proactive and structured engagement by companies with investors on sustainability issues through annual, high level, sustainability presentations or a 'fifth analyst call'³. The EIAG welcomes supportive regulation and guidance such as Section 172 of the Companies Act on the duties of directors that reinforce the fact that, for example, ESG factors are important to the long term success of a company.

These are all important counterbalances to the use of a company's share price as a key measure of performance, which can produce perverse incentives for companies, individual executives and fund managers alike. Measures that raise the profile, and facilitate investor understanding, of the broader factors that support long term value creation are welcome.

The Church of England Pensions Board, one of the national investing bodies, has commented that it still finds it fairly difficult to find fund managers that integrate robustly ESG issues and ESG performance measures into their investment processes and models.

The national investing bodies are supportive of external fund managers who take a long term approach to performance fees (where performance fees are judged appropriate) and have some investments for example with managers whose performance fees are based on three-year rolling performance relative to a suitable benchmark. The period of performance fees varies according to the timescale over which investment returns are realised and is longer for illiquid assets than for listed equities.

It is worth pointing out that passive investment mandates offer an attractive, low-cost vehicle for long term, large cap equity investment in certain markets, notably the UK, and play an increasingly important part in the portfolios of two of the investing bodies as core equity holdings, supplemented by active satellite mandates typically covering small cap or emerging market companies or specific strategies including long term value investing. Active management is not the only long term equity investment strategy, especially when passive management is supplemented by engagement on long term ethical and ESG issues (as conducted by the EIAG and some responsible investors), or by index customisation on ethical grounds (as conducted by the national investing bodies) or ESG grounds (as conducted by some responsible investors).

³ See www.efinancialnews.com/story/2011-04-07/occidental-fifth-call

Q2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.

Given the comments in relation to Question 1, the EIAG believes that it is important that government should continue to help to foster a climate in which company and investor attention to long term business planning, ESG considerations, high quality disclosure from companies, and transparency from fund managers on their approach, are all encouraged. The government can help to create 'permission' for companies and investors to act in a long term way within a supportive climate of thought. It is important for example that the government is supportive of active participation by funded public sector pension schemes in the UN Principles for Responsible Investment.

The EIAG is concerned that cultural and behavioural issues, including ethics, are insufficiently recognised in companies and markets as an essential component of corporate identity and strategy, drivers of long term value, and protection against corporate disaster. Corporate values, and ways in which they are embedded including through codes of ethics, leadership, training, remuneration, diversity and other HR policies, should be a more important feature of annual and/or sustainability reports.

The EIAG is concerned about the effect of some innovative trading strategies on markets. The EIAG favours investment based on fundamental valuation. The national investing bodies generally avoid active investment strategies based predominantly or substantially on short term market trends. At the same time both the EIAG and national investing bodies recognise the value of the freedom of market participants and the value of there being a broad range of investment strategies especially in challenging times for equity markets as exist at present.

The EIAG and national investing bodies are supportive of government-sponsored research into the effects of new trading strategies and automated trading such as high frequency trading. It is possible that the interests of exchanges and a minority of investors are not aligned with the interests of companies and the majority of investors.

Q3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.

Corporate disclosure requirements should support more focus on long-term corporate strength, e.g. high quality measurable, comparable and independently verifiable sustainability disclosure, compulsory key ESG disclosures (such as greenhouse gas emissions) and moves towards more integrated reporting

The EIAG has long-standing concerns about the model of executive remuneration advanced by the market, in particular an excessive emphasis on variable rather than fixed remuneration, on short rather than long term corporate performance, and on linkage to share price rather than drivers of long term performance.

National investing body voting is principally determined by the relationship between fixed and variable remuneration. In our view salary rewards executives for performing in line with the standards expected of them when appointed. Variable remuneration should reward the achievement of particular goals, with the emphasis on long term achievements. In our view potential variable remuneration in excess of 300% of fixed remuneration drives excessive returns to executives. The three national investing bodies support only about a quarter of UK remuneration reports because of concerns about excessive bonuses and 'long term' incentives⁴.

There are rarely sufficient claw-back mechanisms for occasions where variable remuneration has been achieved through ill-judged or unethical conduct that damages the business in the longer term.

The EIAG would welcome innovative thinking by government and companies on ways in which they might encourage long term equity investment perhaps through enhanced voting rights or loyalty shares for long-term investors.

Q4. Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their business.

The EIAG and national investing bodies are concerned that government policy does not sufficiently encourage boards to focus on the long term development of their business with regard to climate change⁵. The national investing bodies are active members of the Institutional Investors Group on Climate Change and signatories to the 2011 Global Investor Statement on Climate Change⁶.

⁴ Further information on national investing body voting on executive remuneration can be provided on request. The corporate governance policy which is followed can be found at www.churchofengland.org/media/1289056/corporate%20governance%202010.pdf. The EIAG is currently reviewing its recommendations on voting on executive remuneration.

⁵ See the EIAG/national investing bodies policy on climate change at www.churchofengland.org/media/36536/policyclimatechange.pdf

⁶ www.iigcc.org/iigcc-investor-statement

Q5. Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.

The EIAG believes that better regulation and guidance could remove some existing obstacles to effective engagement with companies by investors.

The EIAG's experience is that institutional investors can still be nervous about collaborative engagement out of fear of concert party rules. The EIAG can also still find FTSE350 UK companies who are reluctant to engage on ethical and ESG issues. Clarification of rights and responsibilities on both counts, and a strengthening of investors' hands, would be very helpful to effective institutional investor engagement.

In the EIAG's experience controlled companies are typically the toughest companies to engage with and yet it is often precisely at these companies that attendance to shareholder and wider stakeholder long term concerns is weakest. The EIAG also acknowledges however that family control in particular can facilitate genuine long term strategy and protection against demands from short-termist shareholders.

The EIAG favours amendment of premium listing requirements to require greater than 50% free float, which would greatly support shareholder engagement. Premium listing requirements should specifically take account of the creation of long-term value e.g. through a requirement to put the company's sustainability strategy to a shareholder vote at its AGM.

It is the EIAG's view that shareholder votes on remuneration should be binding, not advisory, and that this would improve company/shareholder engagement on executive remuneration.

Current practical arrangements for proxy voting are highly unsatisfactory as there is no way of investors being sure that their votes have actually been cast and recorded as instructed. It should be mandatory for companies to provide confirmation to investors of how their vote has been recorded. This would tighten the company/shareholder relationship.

Finally, it is the EIAG's view that the borrowing of shares in order to vote at general meetings is wholly inappropriate, contrary to stewardship principles and facilitates short rather than long term decisions about the future of companies.

Q6. Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with asset owners' long term objectives.

There is insufficient guidance on what the fiduciary obligations of charity and pension fund trustees entail and mean. This creates a danger that risk-averse trustees, and their investment consultants, will focus excessively on short-term financial performance, and lack of deviation from the average, as the measure of fiduciary responsibility. Trustees need to be given 'permission' to act with greater regard for long term factors. In particular, it would be helpful if it could be clarified that those with a fiduciary duty would be failing in that duty if they did not take ESG factors into account given their importance for long term value.

Pension fund trustees are particularly hampered by the need to value liabilities based on short-term bond rates, and assets on market values. This causes extreme short-term variability in valuations and is a significant constraint on long term thinking. Current valuations of assets are irrelevant when the assets are part of a long term return-seeking strategy and there is not the slightest prospect of the assets being sold.

There is an agency problem with regard to voting on executive remuneration. External fund managers are typically conflicted on remuneration issues and reluctant to challenge short-term and excessive compensation because their own compensation arrangements are similar. There should be a greater requirement on fund managers to get the assent of asset owners for their proxy voting policies and to facilitate voting in line with the instructions of asset owners.

Q7. Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.

Companies should be required to make deeper disclosure of their main investors (above and beyond normal disclosure requirements) when they publish their annual report, which would indicate clearly and publicly where stewardship responsibility primarily lies for a particular company and encourage active ownership.

The Stewardship Code might be developed to require asset managers to disclose the extent to which they integrate long-term considerations and ESG factors into their investment process, as well as the average length of time stocks are held in portfolios and, if appropriate, focus lists (i.e. 'churn' rates).

Q8. *The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.*

Respect for, and attention to, shareholder engagement by companies varies widely. The responsibilities of Chairmen and Senior Independent Directors with regard to investor engagement should be more clearly stipulated and enforced. There need to be avenues for investors to complain about companies who will not engage, with potential sanctions (e.g. loss of premium listing) for miscreants.

Q9. *The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.*

The EIAG supports stricter governance requirements for premium listings given the number of poorly governed non-UK companies, unresponsive to engagement, who have entered the FTSE100 in recent years, potentially over the heads of better-governed UK companies with long term commitment to value creation in the UK.

Q10. *Likely trends in international investment and in the international regulatory framework, and their possible long term impact on UK equity markets and UK business.*

No comments.

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