Stewardship: At the Heart of Active Management

Mention the word *stewardship* and chances are you will get a myriad of responses. The spiritually inclined may contemplate theology, the MBA graduate will likely start to pontificate on shareholder value and/or stakeholder theory, while the avid DC Comics fan may recall Alfred Pennyworth, Bruce Wayne's trusted butler and steward in the Batman comic series. Regardless, all three perspectives of stewardship share the common thread of responsibly managing that which has been entrusted to one's care.

According to the Merriam-Webster[1] dictionary, the word *stewardship* "first appeared in English during the Middle Ages" and served traditionally as a job description, denoting the office of a manager or supervisor of a household. The application of the word has since expanded to include the oversight of associations, institutions and organisations, among others.

With the "management" sense of *stewardship* gradually evolving to convey a positive connotation and taking on greater significance in the word, this sense is commonly applied these days in matters pertaining to society, the environment, family assets and the like.

Closer to home, the Stewardship Asia Centre (SAC) here in Singapore describes stewardship as being "about ensuring that a business can thrive and sustain growth while enhancing the wealth of its stakeholders and the well-being of the societies in which it operates over the long term"[2].

The Code

Demands for stricter corporate governance standards have been increasing in a post-GFC world. This has in turn led to a proliferation of stewardship codes, principles and guidelines in the financial industry. A 2017 report from Ernst & Young[3] reveals that the UK was the first jurisdiction to adopt a stewardship code in 2010. To date, a number of other jurisdictions have reportedly adopted this practice, including Denmark, Hong Kong, Japan, Malaysia and Thailand, among others. Here, it is worth noting that the call for a stewardship code for Europe, over and above the European Commission's Action Plan for Sustainable Finance, continues to grow as proponents see the increasing need for action, not just the recognition and awareness of issues.

Elsewhere, investor-led best practice guidance exists in markets like Australia, the Netherlands and Singapore. Launched in November 2016 by a working group led by the SAC, the Singapore Stewardship Principles for Responsible Investors aims to enable investors to be active and responsible investor[4]. The seven principles herein serve as guiding posts for investors as they seek to foster good stewardship when discharging their responsibilities, so as to create sustainable long-term value for all stakeholders.

Asset Managers and Stewardship: Strange Bedfellows?

The debate about asset managers and their function as investment stewards has been a long standing one. Does the concept of stewardship for an asset manager simply stop at the generation of financial returns? Is it sufficient for an asset manager to merely target "value not values"? Can an asset manager claim to be a good steward of its client assets when it does not bother about exercising good stewardship with the companies it is invested in?

Jahnke (2019) [5] makes the case that attempts at neutrality, i.e., the separation of the concepts of 'value'

[1] See www.merriam-webster.com/dictionary/stewardship
[2] See www.stewardshipasia.com.sg
[3] Ernst & Young, *Q&A on stewardship codes*, August 2017

[4] The SSP is a collaborative effort by members of a working group led by Stewardship Asia Centre. Members of the working group comprise entities such as the Association of Charted Certified Accountants, CFA Singapore, the Investment Management Association of Singapore (IMAS) and the Singapore Venture Capital Association. The SSP is supported by the Monetary Authority of Singapore and the Singapore Exchange. See http://www.imas.org.sg/Articles/267-singapore-stewardship-principles-ssp-.html for the full list of IMAS members supporting the SSP.
[5] Jahnke, Patrick, *Asset Manager Stewardship And The Tension Between Fidcuiary Duty and Social License*, January 2019

and 'values' is likely to be an endeavour that will fall short.

As the chain of relationships joining ultimate asset owners to investee companies becomes more complex, observers see an increasing trend in fragmented ownership, especially in the public markets, with many shareholders holding a small proportion of company shares. While this perspective may apply to end shareholders, the issue takes on a different nuance when viewed from the perspective of those managing the assets of these shareholders.

According to the *G20/OECD Principles of Corporate Governance 2015*, the share of equity investments held by institutional investors such as mutual/hedge funds, pension funds and insurance companies, has increased significantly across time. With the growing influence wielded by the asset management industry, this suggests that there is room for long-term institutional investor engagement to take on an even more effective role in optimising company performance and fostering economic growth. As such, Fenwick and Vermeulen (2018) suggest that stewardship codes *do* matter and they assert that institutional investors must therefore be viewed – and view themselves – as "stewards" of a company[6].

Watchful Guardians

More recently, Willis Tower Watson (WTW) conducted research on six large asset managers which collectively manage assets in excess of US$17 trillion, and argues that good stewardship is the most useful function the asset management industry performs[7]. When done well, WTW believes that stewardship can result in improved outcomes including better returns for investors, better managed companies, and better controlled societal and environmental footprints, all while being cost-effective. WTW sees its research being a call to action for the investment community to redouble its stewardship efforts.

With shareholding tenures getting shorter, it is hardly surprising to see the implicit erosion of the ownership mentality, as this gets replaced by a short-term flip-flop attitude in investment management. And such investor behaviour in turn then transmits over to company management, for whom the challenge of discerning what is *urgent* versus what is *important* just keeps getting harder.

The industry's renewed emphasis on stewardship is therefore relevant and timely. Stewardship is important for the wider business and investment ecosystem, including investors and investee companies.

Stewardship Alive: Responsible Investing

Responsible investing, a discipline that incorporates environmental, social and governance (ESG) factors into investment decisions, in a bid to better manage risk and generate sustainable returns over the long term, continues to attract growing attention.

According to the *2018 Global Sustainable Investment Review*[8], global sustainable investment assets stood at US$30.7 trillion at the start of 2018, a 34% increase from 2016. A few other interesting highlights from the review include:

- By geography, Europe accounts for the largest pool of sustainable investment assets with US$14.1 trillion in assets under management, followed by the US with US$12 trillion;
- Responsible investment commands a sizable share of professionally managed assets across the globe, ranging from 18% in Japan to 63% in Australia and New Zealand; and
- From 2016 to 2018, Japan has experienced the fastest growth in responsible investment assets, followed by Australia/New Zealand and Canada.

And what has driven such growth? MSCI ESG Research[9] offers the following three primary drivers:

- A changing world faced with increasing global sustainability challenges;

[6] Fenwick, Mark, Vermeulen, Erik P.M., *Institutional Investor Engagement: How to Create a "Stewardship Culture"*, Tilburg Law and Economics Center Discussion Paper, February 2018

[7] Willis Towers Watson, I*nvestor stewardship: one hand on the wheel?*, April 219

[8] Released in April 2019, this biennial report was written by The Global Sustainable Investment Alliance (GSIA), an international collaboration of membership-based sustainable investment organizations. This report brings together the results from regional market studies by the sustainable investment forums of the US, Europe, Japan, Canada, and Australia and New Zealand. It also includes data on the African sustainable investing market in cooperation with the African Investing for Impact Barometer and highlights from several countries in North, Central and South America provided by the Principles for Responsible Investment. Note that GSIA defines sustainable investment as activities/strategies which encompass the following: negative/exclusionary screening; positive/best-in-class screening; norms-based screening; ESG integration; sustainability themed investing; impact/community investing; and corporate engagement and shareholder action.

[9] See www.msci.com/www/blog-posts/esg-investing-is-here-to-stay/01251377498

- The emergence of a new generation of investors, i.e., the millennial generation who are asking more about their investments and how their investments are being put to work; and
- Evolving data availability and analytics.

Elsewhere, BNP Paribas' *ESG Global Survey 2019* finds 'improved long-term returns', 'brand image and reputation' and 'decreased investment risk'[10] as the top three motivators for investors to incorporate ESG into their investment decision making. It is worth noting that these findings corroborate those found in a 2017 ESG survey conducted by the CFA Institute[11], in which 'investment risk management' and 'reputational benefit' were also listed as reasons for considering ESG issues in the investment analysis/decision process. Some 40% of respondents saw doing so as their fiduciary duty while also sharing the view that ESG performance was a proxy for management quality.

To Be, Or Not To Be

This tremendous growth seen in the field of responsible investing has however raised questions about what a responsible investment is and how to meaningfully measure both social and financial returns.

A recent research paper by MSCI[12] reveals that more than 2,000 research articles written by both academics and practitioners have sought to analyse the link between ESG related factors and their contribution to financial risk and performance. Such volume of research notwithstanding, there appears to be no consensus on whether ESG has improved returns on a risk-adjusted basis. The authors of the paper suggest one reason for this could be that many of the ESG investing methodologies used in previous studies were designed to meet social or ethical values and not financial objectives.

What is interesting though, is that the MSCI paper also shares that there is little research concluding that ESG criteria has impaired investment performance. Question is: could this inclusion of ESG criteria in an investment process have been a contributing factor for the 'non-impairment' of investment performance? To this end, the authors also go on to observe that ESG considerations[13] do indeed help to reduce systematic and stock-specific tail risks in investment portfolios.

In a more recent study of more than 600 global asset owner respondents[14], Dennis Fritsch, PhD, of RI Research, looked at the financial impact of ESG 'doers' and their ESG strategies, and found that only a small minority of 'doers' experienced negative financial outcome. Of 332 respondents, almost a third experienced a positive impact of ESG on the financial performance of their funds (versus one percent who experienced a negative outcome).

The above appears to contrast with the still rather commonly held view that integrating ESG factors into one's investment process typically comes at the expense of financial performance. Here, Fritsch offers the view that such a belief most likely stems from associating ESG integration with exclusionary screening based on ESG factors, i.e., negative screening, which can result in the exclusion of certain companies or sectors from an investment portfolio, thereby reducing portfolio diversification, increasing risk and negatively impacting portfolio returns.

Fritsch however goes on to also share that when asked what 'positive financial impact' meant, survey participants listed "improved risk profile of investments" and "focus of investment strategy on the longer term" as two key definitions. Although respondents perceived governance and systemic factors as being most likely to be return-generating, there was wide recognition that ESG served a key function in mitigating risk and enhancing performance.

It is worth noting how both of the aforementioned studies arrived at the same finding that including ESG factors in an investment process contributes to the improving risk profile of an investment. To this end, financial history reminds us that risk profiles (and the ignorance of) can indeed have a pivotal influence on the outcome of long term investment performance.

[10] Note that 'investment risk' is taken in the context of risks associated with ESG and being able to identify such risks and making fully informed investment decisions.

[11] In May 2017, CFA Institute invited 47,208 members who were portfolio managers and/or research analysts to participate in a survey to better understand the perceptions of CFA Institute membership concerning ESG issues and ESG data, and the use of such information in their investing processes.

[12] Giese, Guido, Lee, Linda-Eling, MSCI, *Weighing the Evidence: ESG and Equity Returns*, April 2019

[13] Note that for purposes of this paper, ESG considerations were made via the application of MSCI ESG Ratings.

[14] Fritsch, Dennis, *ESG: Do you or Don't you*, June 2019. Responsible Investor, in association with UBS Asset Management, studied more than 600 asset owners across 46 countries, representing more than EUR19 trillion in AUM. Participants included AP1, AP4, Caisse des Depots, First State Super, Lansforsakringar, Nordea Bank, PFA Pension, RPMI Railpen and Skandia Group.

Our Stand

Regardless of the data sets and studies that try to prove or disprove the link between financial performance and responsible investing, we believe that a company must be well-managed to deliver sustainable earnings growth and create long-term shareholder value.

As an active fundamentally driven investor, Fullerton holds that evaluating a company's management structure and assessing its ability to manage ESG risks, in addition to analysing its financial performance, provides a more complete understanding of the companies we seek to invest in. A company that ignores ESG factors not only puts its brand and reputation at risk, but also raises questions in our minds about the sustainability of its business model and durability of its earnings stream.

Hence, engagement with companies is a fundamental part of our investment process. We believe that positive engagement and open dialogue with company management allow us to develop a more informed view on the companies and on the way they operate. It also provides us with the opportunity to encourage good corporate citizenship, particularly where improvements in policies and practices can be expected to enhance and protect shareholder value. As such, we make it a point to meet regularly with various levels of company management and conduct channel checks with the suppliers, customers and competitors of the companies we invest in.

Fullerton embraces active stewardship and its role in preserving long-term shareholder value. To this end, we are proud to support the Singapore Stewardship Principles.

The Heart of the Matter

In an early poignant scene in the 2005 movie "Batman Begins", a somewhat disillusioned Bruce Wayne asks his butler Alfred Pennyworth why he still cares about the Wayne household (following the death of Bruce's parents[15]), to which Pennyworth replies, "because a good man once made me responsible for what was most precious to him in the whole world"[16] (with obvious reference to the young Master Bruce).

Similarly, in the course of managing client assets, we hold share ownership rights on behalf of our clients. We believe that the efficient exercise of these rights, when authorised to do so, is at the heart of what it means to be an active manager and trusted steward of client assets. For where one's treasure is, there also will one's heart be.

[15] Since arguably Pennyworth would no longer have had any obligations to the Waynes, given the death of his employer.
[16] See www.imdb.com/title/tt0372784/characters/nm0000323