Engaging with institutional investors

LEAD DIRECTOR NETWORK
September 2018

King & Spalding

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The dramatic shifts in the investment landscape—from individual to institutional shareholders and from actively managed funds to indices—have put pressure on boards to strengthen governance and oversight practices. On July 19, Lead Director Network (LDN) members met in New York to discuss their firms' relationship with institutional investors. The meeting included a session with Michelle Edkins, global head of the investment stewardship team at BlackRock, followed by a separate, executive-session discussion about related issues over a working dinner. This *ViewPoints* synthesizes those conversations, which focused on BlackRock's place in the institutional-investor landscape and its approach to creating long-term value through its investment stewardship activities. A companion *ViewPoints* synthesizes another discussion held at the meeting related to oversight of workplace conduct in the context of the #metoo movement.

The institutional-investor landscape

Institutional investors have become increasingly prominent in capital markets over the last few decades. Institutional investors—which include mutual funds, asset managers, pension funds, insurance companies, and others—pool assets and deploy them with the aim of achieving high financial returns. In 1950, institutional investors held 7%–8% of all US equities.[1] As of last year, institutions owned 78% of the market value of Russell 3000 companies.[2] Many of these institutions have become more active, engaging directly with their portfolio companies. Additionally, in the United States, institutions are three times more likely to vote their shares than are individual investors.[3]

Importantly, today passive investors—funds that track an index or formula rather than making active investment decisions—represent a significant and growing portion of US stock ownership.[4] Constituting approximately 30% of the mutual and exchange-traded fund market, their market share is eight times what it was two decades ago.[5] Because passive investors cannot sell a company's stock if they are unhappy with its performance, they have become increasingly interested in the governance practices of their portfolio companies. Although many passive investors maintain similar priorities, they too cannot be viewed as a monolith, as most of the largest passive investors have bespoke governance and voting policies.

In recent years, the institutional investors that have gotten the most attention are the shareholder activists. In the first quarter of 2018, activists deployed $25 billion in capital, launched a record-breaking 73 new campaigns, and won 65 board seats.[6]

BlackRock's approach to investment stewardship

BlackRock is the world's largest institutional investor, with nearly $6.3 trillion in assets under management.[7] Established in 1988 by current CEO Laurence (Larry) Fink and seven partners, BlackRock's "primary objective is to secure better financial futures for our clients and the people they serve," with a focus on long-term financial sustainability.[8] Each year its investment stewardship team, led by Michelle Edkins, votes at more than 17,000 shareholder meetings globally on over 160,000 proxy proposals.[9] Of its $6.3 trillion assets under management, approximately $3.4 trillion is invested in equities, of which over 90% is in passively managed funds.[10] Roughly two-thirds of BlackRock's clients are investing for retirement or other long-term goals, according to Ms. Edkins.

A fiduciary investor

BlackRock's investment mix influences its approach to investment stewardship and engagement with portfolio companies. Ms. Edkins stressed that BlackRock is committed to creating sustainable long-term value for its clients: *"All the money we invest belongs to our clients, so we are a fiduciary investor."* Although BlackRock typically votes on behalf of its clients, roughly 9% of the equity assets it manages are voted directly by clients.[11]

Principles-based, flexible, and pragmatic

Ms. Edkins noted that principles and guidelines, rather than strict rules, guide BlackRock's approach to governance and stewardship. Her team focuses on whether companies have the governance structures and practices in place that enable them to create long-term value. *"One important source of insight for flexing voting policies is the feedback we get from companies through engagement, particularly if our guidelines are not clear enough,"* Ms. Edkins reported.

An "engagement-first approach"

While much attention is paid to the voting records of institutional investors, direct engagement with portfolio companies is critical to BlackRock's investment stewardship philosophy. Indeed, BlackRock describes its model of investment stewardship as an "engagement-first approach." Ms. Edkins noted that if there is an issue where, for instance, a proxy advisory firm such as Institutional Shareholder Services (ISS) has recommended voting against management, *"we will talk with the company first. Assuming it is not an issue that will affect shareholder return urgently, we will give the company time to come back to us with a response. We are much less likely to vote against management as immediately as ISS would recommend—we rely more on engagement."*

Proxy voting

BlackRock typically expresses its concerns through proxy voting only when engagement efforts have failed to bear fruit. Ms. Edkins said, *"When we vote against management, we are saying our engagement hasn't had the effect we thought it would or that we think the* *company needs to take action more urgently."* But undergirding all votes, Ms. Edkins said, is BlackRock's *"judgment of what is consistent with long-term value creation."*

BlackRock votes with management on the vast majority of shareholder proposals. In the year ending June 30, 2017, BlackRock voted with management's recommendation on 91% of all proposals and supported only 16% of shareholder proposals.[12] Ms. Edkins noted that there is less uniformity in the voting patterns of the larger asset managers amongst themselves and compared to the recommendations of the proxy advisory firms than is commonly assumed. The inclusion of routine management proposals, on which there is almost universal agreement, in voting data creates the illusion of uniformity. Ms. Edkins insisted, however, that *"on the more contentious proposals, the voting is much more dispersed."*

While proxy voting is an important aspect of BlackRock's investment stewardship, the firm has never submitted a shareholder proposal, started a proxy battle, or led an activist effort against management. BlackRock has also never sought a seat on a public company board as part of its investor stewardship activities.[13]

Focused engagement

An LDN member expressed desire for more engagement with institutional investors such as BlackRock: *"Engagement is easier said than done—we would like more, but it's difficult to generate interest or to get time with them."* Ms. Edkins explained that BlackRock regards the majority of companies as well run and well governed and typically prioritizes engagement with the subset of companies whose governance or performance give it cause for concern. *"If you offer us a meeting, particularly around proxy season, and we say we have no concerns—that is positive feedback from us,"* she said. She added, "*If a company where we have no issues proposes a substantive agenda on longer term themes, we are likely to take the meeting in the off-season.*" LDN members suggested that there is value in engagement even in the absence of specific issues. One member described a desire *"to have a relationship and dialogue so if we need a call in a moment of contention or crisis, we have that relationship."*

"Social purpose"

In his 2018 letter to CEOs, BlackRock's Larry Fink encouraged companies to articulate their purpose and strategy for long-term growth. Mr. Fink wrote, "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society." [14] Failing to articulate a purpose, he argued, leads to undue influence from short-term pressures, exposes a firm to activist interventions, generates subpar returns, and ultimately threatens a company's "license to operate."[15]

Ms. Edkins noted that the concept of "social purpose" in Mr. Fink's letter had drawn a lot of attention and suggested that the meaning of the letter had been misconstrued in some quarters. She added that public companies depend on an array of parties to be successful and, to ensure their continued support, need to demonstrate that they are mindful of those dependencies. *"A clearly articulated purpose helps inform a company's long-term strategy, contributes to stakeholders' support of the company's goals and shapes corporate culture – all factors in a company's long-term financial success,"* she said.

An "arm's-length" relationship with activist investors

Noting that activist investors have often sought to enlist the support of large institutional investors like BlackRock, LDN members were curious about BlackRock's relationship with shareholder activists. Ms. Edkins said that BlackRock never reaches out to activists to suggest companies to target or to make suggestions about what changes they should propose. Despite the perception that activists have a close relationship with institutional investors because they reach out to them frequently, Ms. Edkins said BlackRock maintains *"arm's-length relationships"* with activists, focused on specific situations and forthcoming shareholder meetings. She also noted that because the investment stewardship team is structured by sector, an activist with multiple engagements would often meet with different members of the team.

Ms. Edkins added that even when activists have identified a performance, operational, or governance issue or shortcoming, BlackRock's starting point is to support the company as long as management has a credible plan to respond. *"If there is an issue but management comes through with a plan and the board is credible and committed to ensuring the issue is addressed, we will support management and the incumbents."* said Ms. Edkins.

Current areas of focus

BlackRock's current areas of emphasis include board composition and diversity, human capital, corporate culture, and capital allocation.

- **Board diversity**. For BlackRock, "board composition, effectiveness, and accountability remain a top priority."[16] Diversity, especially on gender, is a particular point of focus. Ms. Edkins noted BlackRock's first priority is *"diversity in thought, expertise, and experience."* She went on to say, *"Some of that diversity comes from different life experiences and from people who are different to those of the dominant culture. Boards are ultimately decision-making bodies, and diverse groups take better decisions."*

- **Human capital**. BlackRock's investment stewardship team, noting that companies often assert that employees are critical to their success and that they are operating in "a talent constrained environment," has identified human capital management (HCM) as an important investment issue.[17] In particular, it has indicated that it will engage boards on their oversight of policies designed to protect employees, how HCM strategies and policies promote healthy corporate culture and prevent harmful behaviors, integration of HCM risks into overall risk management, employee diversity, and linking HCM performance to executive compensation.[18] Ms. Edkins noted that BlackRock had been *"engaging companies on their* *human capital management practices to encourage them to report in more detail about how they are ensuring they are an employer of choice for key talent."*

Human capital issues are related to the issue of leadership diversity as well. As Ms. Edkins pointed out, "Today's workforce and top graduates are not homogenous. If people who are not part of the dominant culture join a company and don't see people in leadership who are diverse, they will go elsewhere. Companies need to attract, retain, and develop the best people—that's a competitive advantage."

- **Culture**. Ms. Edkins noted that corporate culture is an increasingly important topic of her team's engagements: "Purpose, long-term strategy, and culture intertwine. If you don't have a culture that supports your strategy, you won't deliver the strategy."
- **Capital allocation.** Amidst record share buybacks in the United States, where $178 billion in shares were repurchased in the first quarter of 2018 alone, oversight of buybacks has become an important issue for both investors and regulators.[19] Commissioner Robert Jackson Jr. of the Securities and Exchange Commission (SEC) suggested in June that the SEC should revisit its rules governing stock buybacks, citing what he called "clear evidence that a substantial number of corporate executives today use buybacks as a chance to cash out the shares of the company they received as executive pay."[20] Some institutional investors have echoed concerns about share repurchases. In endorsing Jackson's statement, Amy Borrus, the deputy director of the Council for Institutional Investors, said, "We don't want executive incentives to skew decisions about capital allocation that are not in the company's long-term interest."[21] Ms. Edkins noted, *"The reason we've talked a lot about share buybacks is because not enough companies are articulating how they are reinvesting."* As fiduciaries for long-term investors, she continued, *"We need to understand how investments are being made and how they benefit long-term shareholders."*

Conclusion

Because the bulk of BlackRock's equity holdings are invested in index strategies and the majority of its clients are long-term investors, LDN members perceive BlackRock as representing *"patient capital"* that can take a long-term approach to governance issues. Several LDN members expressed optimism that BlackRock and other passive investors could serve as a counterweight to short-term pressures arising from activist investors, social-justice activists making one-off proposals, proxy advisory services that take a shorter-term view, and the need to deliver quarterly results.

The Lead Director Network (LDN) is sponsored by King & Spalding and convened by Tapestry Networks. The LDN is a group of lead independent directors, presiding directors, and non-executive chairmen drawn from America's leading corporations who are committed to improving the performance of their companies and to earning the trust of their shareholders through more effective board leadership. The views expressed in this document do not constitute the advice of network members, their companies, King & Spalding, or Tapestry Networks.

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

Appendix: meeting participants

Bobby Burchfield, Partner, King & Spalding

Loren Carroll, Non-Executive Chair, KBR

Sandy Cloud, Lead Trustee, Eversource Energy

Don Cornwell, Lead Director, Avon

Jim Fogarty, Non-Executive Chair, Depomed

Ann Hackett, Lead Director, Capital One

Glenn Hubbard, Lead Director, MetLife

Johnny Johns, Lead Director, Genuine Parts Company

Dixie Johnson, Partner, King & Spalding

Ellen Marram, Lead Director, Eli Lilly and Ford Motor Company

Mike McCarthy, Lead Director, Union Pacific

Steve Reinemund, Lead Director, Exxon Mobil

Cal Smith, Partner, King & Spalding

Steve Specker, Lead Director, Southern Company

Dick Walker, Partner, King & Spalding

Jim Woolery, Partner, King & Spalding

Endnotes

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[1] Luis A. Aguilar, "Institutional Investors: Power and Responsibility" (speech, Georgia State University, Atlanta, GA, April 19, 2013).

[2] Charles McGrath, "80% of Equity Market Cap Owned by Institutions," *Pensions & Investments,* April 25, 2017.

[3] Richard Fields and Anthony Goodman, "Board-Shareholder Engagement," in *The Handbook of Board Governance: A Comprehensive Guide for Public, Private and Not-for-Profit Board Members, ed. Richard Leblanc* (Hoboken, NJ: John Wiley and Sons, 2016), 407.

[4] Ian Appel, Todd Gormley, and Donald Keim, "Passive Investors, Not Passive Owners," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), January 21, 2015.

[5] Spencer Jakab, "Are Fund Managers Doomed? Making the Case for Passive Investing's Triumph," *Wall Street Journal*, October 18, 2016.

[6] Jim Rossman, "Lazard's 1Q 2018 Activism Review," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), April 20, 2018.

[7] "About BlackRock," BlackRock, accessed June 28, 2018.

[8] "BlackRock Responsibility: Our Philosophy," BlackRock, accessed June 28, 2018.

[9] BlackRock, *The Investment Stewardship Ecosystem,* Viewpoint (New York: BlackRock, 2018), 9.

[10] Ibid., 3, 13

[11] Ibid., 13.

[12] Ibid., 9, 11.

[13] Ibid., 2.

[14] Larry Fink, "A Sense of Purpose," letter to CEOs, accessed July 1, 2018.

[15] Ibid.

[16] BlackRock, *BlackRock Investment Stewardship Engagement Priorities for 2018* (New York: BlackRock, 2018), 1.

[17] Ibid., 5.

[18] BlackRock, *BlackRock Investment Stewardship's Approach to Engagement on Human Capital Management* (New York: BlackRock, 2018), 2.

[19] Hazel Bradford, "SEC Should Revisit Stock Buyback Limits, Commissioner Says," *Pensions & Investments*, June 11, 2018.

[20] Ibid.

[21] Hazel Bradford, "Wary Investors Applauding SEC Call to Examine Stock Buybacks," *Pensions & Investments,* June 25, 2018.