THE INVESTMENT ASSOCIATION

THE COMPANIES WE KEEP

delivering good returns for savers and society

September 2018

ABOUT THE IA

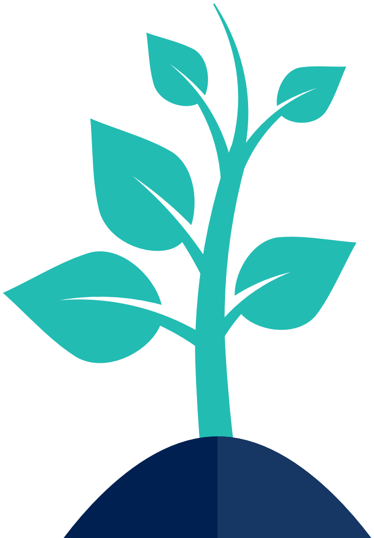
The Investment Association (IA) champions the interests of the UK-based asset management industry, helping savers access investment services, businesses secure the capital they need to grow, and infrastructure and social housing projects obtain the finance they need right across Europe.

Our 250 members range from small, boutique UK firms, to large global players with pan-European footprints. The industry supports nearly 100,000 jobs, and IA members collectively manage £7.7 trillion, £3.1 trillion of which is for overseas clients.

Our members have £920 billion invested in shares, accounting for over one third of the UK market capitalisation. They hold £540 billion in corporate bonds and £40 billion in significant infrastructure.

THE FIRST PRIORITY OF ASSET MANAGERS IS TO DELIVER GOOD RETURNS FOR SAVERS

And we make business better while we do it



It is the responsibility of company boards and management to run the business.

Asset managers are shareholders on behalf of clients, and asset managers in the UK own roughly one third of the value of shares in UK PLCs[1]. This money is often managed on behalf of pension savers and insurance companies.

Businesses are rightly accountable to their owners. The owners have a right to ask questions about the way the companies are run and whether management are considering the material risks to the long-term health of the company.

This is the role that asset managers play in the UK economy. Investing other people's money and acting as stewards of that investment in order to deliver good returns for savers.

Asset managers are expert investors. They have the knowledge and capacity to analyse and engage with management to ensure that the right people are making the right decisions to protect the long-term value of the business.

[1] The Investment Association, Asset Management in the UK 2017-2018, 2018

Since the introduction by the UK Government of automatic enrolment in to workplace pensions in 2012, more than 9.5 million people have automatically joined pension schemes. Today, three quarters of UK employees now have an active workplace pension (an increase from 47% in 2012).[2]

The drive behind automatic enrolment was to ensure that more people were making provision for their own retirement. The role of an investment fund is to take the money that people put into their pensions and savings and make it grow. The money is invested to ensure that people can have a comfortable retirement or savings for a rainy day.

This increase in participation is creating a greater pool of money to be invested through pension funds and means that more and more working people own stakes in global businesses and infrastructure projects (as well as government debt) through their pension funds.

In 2016, 61% of people in the UK gave money to charity, with donations totalling £9.7 billion.[3] Almost three quarters of the eligible population turned out at the 2017 General Election to have their say on the way the Government runs schools, housing and hospitals.[4] Though some people choose not to, we know that many use the tools available to them to have some impact on society.

Increased pension participation presents another opportunity to involve people in an important decision making process: how their decisions on savings and investments can be used to get the best possible financial and social returns. Research suggests that engagement with investment decision-making is likely to

92%

9 in 10 people say that minimising their impact on the environment is important to them

only **a quarter** of people say they would be more likely to invest if they knew their investments were improving the environment

25%

[2] The Pensions Regulator, Automatic Enrolment: Declaration of Compliance Report, 2018
[3] Charities Aid Foundation, UK Giving 2017, 2017
[4] Electoral Commission, Voting in 2017, 2017

32%

Nearly **a third** of people think they can't afford to minimise their impact on the environment

1 in 6 say they simply don't know enough about how to make a difference

17%

be even lower. A survey of consumers conducted for the Independent Governance Committee of Aviva's workplace pension scheme found that only 1 in 3 people asked thought it was important that their pension money was invested in projects that will help to build a better future while almost half (45%) said they wanted their pension provider to keep them informed of where their money was being invested.[5]

There is a difference, of course, between whether people care about an issue and whether they think their pension pot is an appropriate tool with which to do something about it.

To take the issue of the environment, while 9 in 10 people (92%) say that minimising their impact on the environment is important to them, only a quarter of people say they would be more likely to invest if they knew their investments were improving the environment. There may be a number of ways to explain this gap. Nearly a third of people (32%) think they can't afford to minimise their impact on the environment and 1 in 6 (17%) say they simply don't know enough about how to make a difference.

Automatic enrolment means that people are becoming pension savers as a result of doing nothing. It might be unreasonable to expect those same people to then make active investment decisions.

We know that in defined contribution pensions, which are becoming the most common method of workplace pension saving and where it is the responsibility of the employee to build up their pension pot, as many as 99% of pension savers are signed up to the default investment strategy chosen by their employer.[6]

[5] Aviva Independent Governance Committee, Annual Report, 2018. Research conducted by Ipsos MORI.
[6] Pensions Policy Institute, The Future Book: Unravelling Workplace Pensions, 2017. The proportion of members in the default strategy is 94% for Group Personal Pensions and 99.7% for master trusts.

It's because we know that people are prone to inertia when it comes to managing their money that pension scheme trustees have been given the job of acting on their behalf but pension scheme trustees have a lot of things to think about and responsible investment doesn't seem to be at the top of their list. Just 1 in 4 employers (26%) say that they look for a demonstrated responsible investment approach when choosing a pension scheme for their employees.[7]

The Government and regulators are pushing pension scheme trustees to think more about the views of savers when creating their investment plans and there are signs that savers' attitudes to responsible investment are changing. When asked, the savers contributing to defined contribution pension schemes expressed significant interest in responsible investment issues. This interest increased when they were told that they owned companies through their pension fund.[8] Millennial savers (in this case those aged between 18 and 32) have said they are nearly twice as likely to invest in companies or funds that target specific social or environmental outcomes.[9]

As public attitudes develop, asset managers are responding. They will increasingly offer savings products designed to meet the needs and interests of a new generation of savers and they will consider how changing social and environmental attitudes among consumers will mean that all companies will need to adapt in order to survive.

Millennial savers have said they are nearly **twice as likely** to invest in companies or funds that target specific social or environmental outcomes.

[7] Pensions Insight & NEST, Pension Scheme Governance, 2018
[8] DCIF, Navigating ESG: a practical guide, 2018
[9] Morgan Stanley Institute for Sustainable Investing, Sustainable Signals: the Individual Investor Perspective, 2015

ASSET MANAGERS KNOW THAT...

...some people want their money invested to improve all sorts of businesses.

In which case asset managers select a range of investments designed purely to get the best possible returns. When they do this asset managers will still ask the companies questions about how they manage environmental, governance and social issues which could affect the long-term success of the company.

..some people only want their money invested in certain sorts of companies.

So asset managers create funds which favour or exclude certain companies. This is often done for ethical reasons and might exclude companies such as tobacco manufacturers or the arms industry or mean companies attract more investment if they have a good record on social factors.

...some people want to invest their money in ways that are focused on achieving a specific social impact.

Asset managers will put together investment portfolios which are drawn from a narrower range of companies and projects designed to have a specific social outcome. This might mean investing in organisations that aim to improve public health or provide sustainable energy.

Some people want their money invested to improve all sorts of businesses

If we want to create a diverse economy which supports traditional industries, creates manufacturing jobs and invests in innovative new companies then it's necessary to invest in a diverse mix of companies. But that doesn't mean we can't hold those companies to high standards.

In the UK, there is a trend towards integration of environmental, social and governance factors being part and parcel of managing other people's money. The societal pressure to consider matters of environmental sustainability, diversity, and just being good neighbours, means that asset managers increasingly see any company that rejects these principles as a questionable source of good long-term returns.

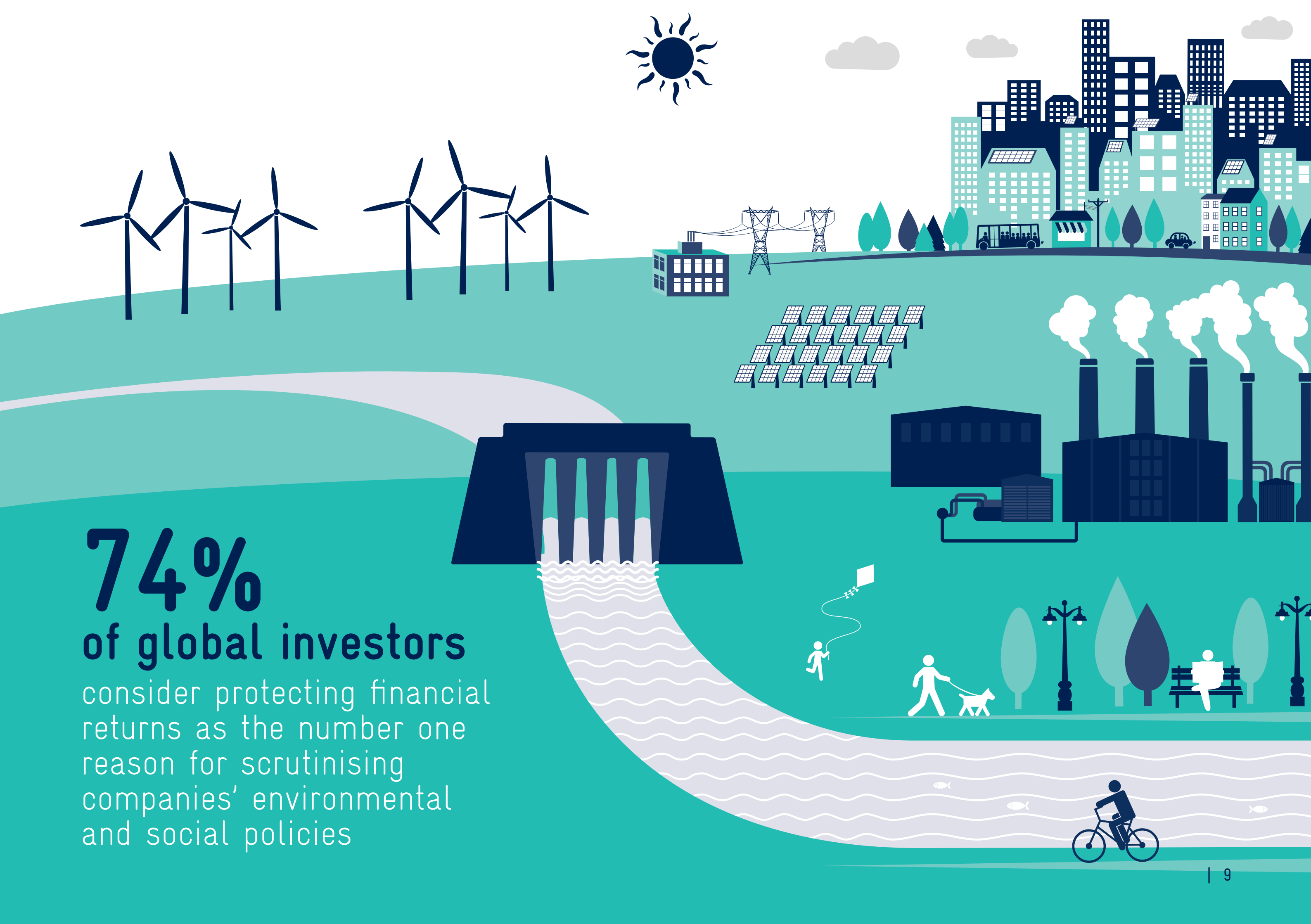
Research for HSBC has found that 74% of global investors consider protecting financial returns as an important motivating factor for scrutinising companies' environmental and social policies.[10]

There is a growing body of research, for example, which shows that more diverse company boards make better long-term decisions because they move away from 'group think'. Independent research undertaken by the Credit Suisse Research Institute has suggested that companies with a higher proportion of female board members tend to generate higher returns.[11]

From the end of 2013 to the end of 2016, companies with 25% senior women outperformed others with an annual growth rate of 2.8%. For companies with 33% senior women the outperformance was 4.7% and for those over 50% outperformance was 10.3%.

Engagement with shareholders is an essential activity for all listed companies. It informs the decisions that the company takes, whether about the products or services it provides, about its strategic direction, its long-term health, and its relationship with its workforce or the society in which it operates. If taken seriously, shareholder engagement will strengthen the business and promote its long-term success to the benefit of everybody.

[10] HSBC, Sustainable Financing and ESG Investing report, 2018
[11] Credit Suisse Research Institute, The CS Gender 3000: The Reward for Change, 2016



74%

of global investors

consider protecting financial returns as the number one reason for scrutinising companies’ environmental and social policies

Challenging the status quo in boardrooms

In April 2018, the Investment Association and the Hampton-Alexander Review wrote to 35 FTSE 350 companies with low female representation at senior leadership level, calling for change. The body of research is clear: firms with a diverse management team make better decisions and drive innovation.

Some of the responses we received surprised us. While some of these firms recognised the value of diversity many others were unrepentant. They claimed the nature of their industry meant that women just weren't interested or experienced enough to join the executive team of a company whose workforce was traditionally male-dominated.

Others made the reasonable point that they only ever hire the best people for a job but didn't explain why the figures show that they always thought the best person was a man.

A company's long-term interests are likely to be served by a board that has the variety of skills and expertise needed to understand the business environment in which it operates. A manufacturing firm will of course benefit from having people in the boardroom who know what it's like to work on the shop floor. Asset managers argue that long-term success also requires diversity of experience and different ways of thinking from the people around the boardroom table. Sometimes this will mean hiring people from outside the company.

WE WROTE TO 35 FTSE 350 COMPANIES WITH LOW FEMALE REPRESENTATION AT SENIOR LEADERSHIP LEVEL. THESE TIRED EXCUSES WERE INCLUDED AMONG THE REPLIES WE RECEIVED.

Our workforce reflects the nature of our business, the industry in which we operate and the markets we serve.

We are within our rights to manage and operate our business as we see fit.

We would genuinely like to have a female director.

We do not have any Board vacancies to consider and, as you may have noticed, have not made an executive appointment for some 30 years.

We operate in the construction industry.

The lack of female participation in our leadership finds its primary origin in the type of industry we are working in, manufacturing.

In the past, many manufacturing sites had 100% male employees.

Shining a light on shareholder rebellions

In 2017, the Investment Association established a Public Register of UK listed companies which have experienced significant shareholder rebellions. The Public Register shines a light on companies which are out of tune with their major shareholders on issues like pay and the appointment of board directors.

Analysis of AGM votes in 2018 has shown that shareholder rebellions are on the rise. Out of more than 600 companies on the London Stock Exchange's main markets 1 in 5 (120) have experienced significant dissent.

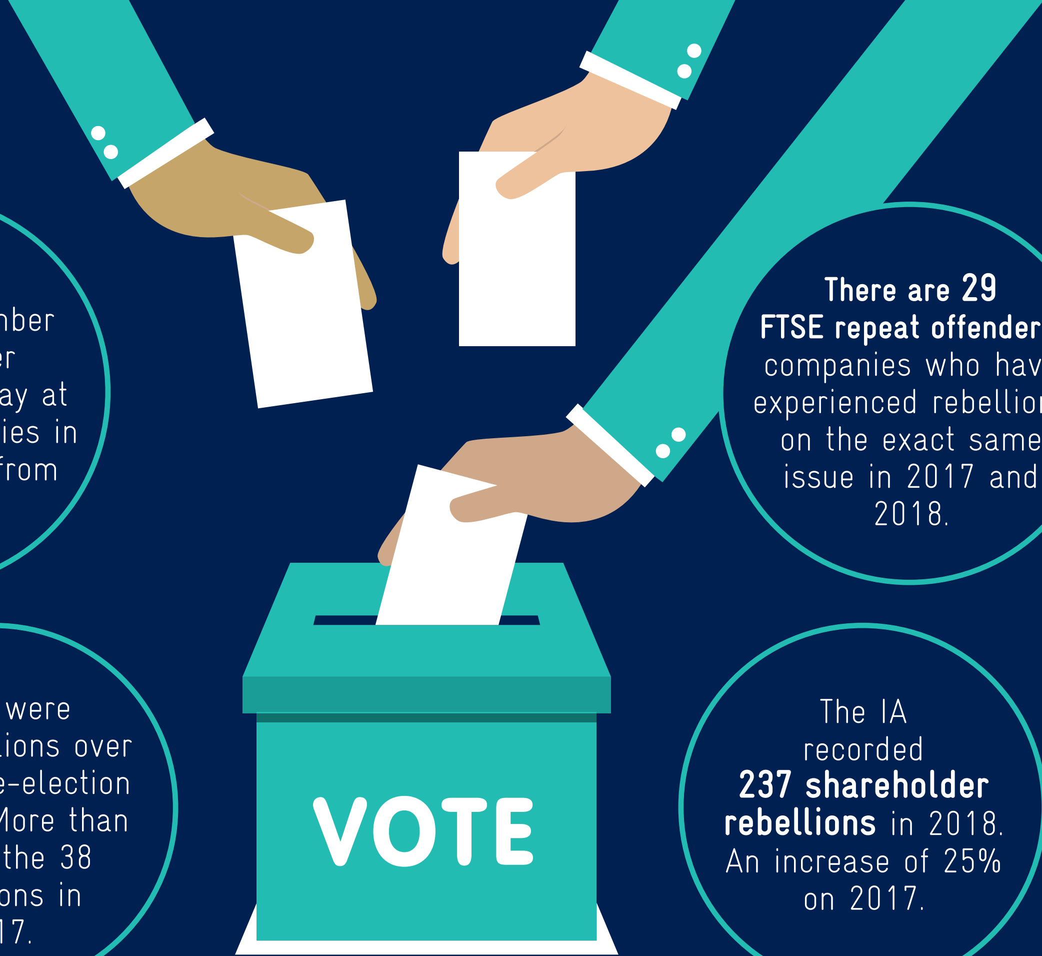
Launched in December 2017, the IA's Public Register is a new way to hold companies to account and the evidence shows it is working. This year, nearly two thirds (65%) of companies on the Public Register made a public statement at the time of their AGM, acknowledging the significant shareholder dissent and outlining how they plan to engage with shareholders. In 2017, before the Public Register was created, only half (51%) made a public statement.

Shareholders remain unimpressed with the approach to pay in FTSE boardrooms, and are frustrated the message is not getting through. While executive pay declined overall as an issue, with the total number of rebellions on pay dropping 10% from 68 in 2017 to 61 in 2018, there was a sharp rise in objections to FTSE 100 pay this year. Shareholders now need to see companies acting on their pledges to deal with investor concerns or risk facing another backlash next year.

If more than **20%** of votes cast on an issue at an AGM are against the company then we class that as a rebellion and add the company to the Public Register.

There were **double** the number of shareholder rebellions over pay at FTSE 100 companies in 2018. Up to 18 from 9 in 2017.

There are 29 FTSE repeat offenders: companies who have experienced rebellions on the exact same issue in 2017 and 2018.



There were **80** rebellions over director re-election in 2018. More than double the 38 rebellions in 2017.

The IA recorded **237 shareholder rebellions** in 2018. An increase of 25% on 2017.

Some people only want their money invested in certain sorts of companies

Asset managers allow savers to invest in specific strategies based on their values. These strategies focus on investing in companies which are creating positive change in particular areas, such as tackling climate change or improving diversity.

For example, this year Legal & General Investment Management launched a gender diversity fund which ranks companies according to criteria such as the number of women in management and favours companies who meet a defined benchmark.

Negative or exclusionary screening is the largest sustainable investment strategy used, with more than £10 trillion invested across the globe in such funds.[12] Exclusionary or negative screening is when a particular type of company is blocked from being included in an investment portfolio, usually because of environmental, social or ethical criteria.

Anti-smoking campaigners have long argued that local authorities should not invest in tobacco companies and some local authority pension funds, including the UK's largest, the Greater Manchester Pension Fund, have taken the decision not to invest in tobacco for ethical and social reasons.

[12] Global Sustainable Investment Alliance, Global Sustainable Investment Review, 2016

Negative or **exclusionary** screening is the largest sustainable investment strategy used, with more than **£10 trillion** invested

In March this year, BNP Paribas Asset Management announced that it would no longer invest in tobacco across funds where it had discretion over the investment decision, applying to funds totalling more than £275 billion. In the same month, BlackRock announced that it had written to its clients to help them understand their exposure to civilian firearms companies, and help them explore their options for altering or eliminating their firearms exposures from their investment portfolios if they wish to do so.

Asset managers may also exclude companies from investment portfolios for other reasons. Deep green investment policies screen in or out specific companies and infrastructure projects according to a strictly defined set of environmental criteria. Other investments that have been subject to the exclusionary approach include those which had exposure to Apartheid-era South Africa, those producing or selling alcohol or pornography, those dealing in conflict minerals, those producing nuclear energy, and companies dealing in cluster bombs and landmines.

The social and ethical values leading to the exclusion of some of these investments will in many cases be close to universally held but in others, such as alcohol and nuclear energy, social attitudes will be more varied.

Some people want to invest their money in ways that are focused on achieving a specific social impact

Investing to achieve a specific social impact is known as 'impact investing'. The UK National Advisory Board on Impact Investing, the body created to represent the UK in global discussions about impact investing, has calculated that £150 billion is currently put towards impact investing in the UK. This includes £79 billion towards environmental investments, £60 billion in social housing, £12 billion in broader private investing such as loans or bonds issued by large charities, and £2 billion in 'mission-locked' organisations (for-profit companies that make a commitment to achieve a social impact).[13]

£150 billion may seem like a lot of money but it is a fraction of the total that individual savers and pension funds have put aside to invest. The Investment Association has calculated that £9.1 trillion is managed in the UK by asset managers, hedge funds and private equity firms.[14]

A survey for Barclays found that more than half of people in the UK (56%) had at least a moderate interest in exploring impact investing but only 9% of respondents had so far invested in the impact-investing sector.[15] In 2016, the UK Government formed an advisory group to look at how to

64%

two thirds of savers said that they did not know enough to get involved in social impact investing

[13] UK National Advisory Board on Impact Investing, The Rise of Impact: Five Steps Towards an Inclusive and Sustainable Economy, 2017
[14] The Investment Association, Asset Management in the UK 2017-2018, 2018
[15] Barclays Wealth and Investment Management, The Value of Being Human: A Behavioural Framework for Impact Investing and Philanthropy, 2015

close this deficit between interest and action. It found that reasons for non-participation included a lack of available products, a belief that social impact investing would sacrifice financial returns, low levels of understanding among savers, and a lack of knowledge among financial advisers and pension trustees.[16]

The advisory group highlighted research which found that two thirds of savers (64%) said that they did not know enough to get involved and that one fifth thought that the concept was still too new for them to consider social impact investing.[17]

One obstacle to asset managers dedicating more money towards social impact is the relative lack of suitable investments. Deloitte found that 'mission-led' businesses account for 4.3% of turnover in the UK private sector, roughly equivalent to the size of the SME market in the transportation and storage sector.[18]

Other potential vehicles for social impact investment are sometimes less accustomed to the steps they need to take to access funding from the capital markets. In 2016, the Investment Association issued guidance to housing associations to help them understand the disclosure and transparency standards that asset managers require from potential investments in order to make sure they are properly looking after the money they have been trusted to invest.[19]

A recent survey of corporate pension fund representatives also highlighted a mix of caution and lack of knowledge that was preventing large pension funds from asking asset managers to consider social impact. Nearly half of those representatives (49%) said they had only limited knowledge on social impact investment, four fifths of those surveyed said that potential social impact investments lacked the necessary data on risk to make them sound investments. More than half said they would be

[16] Department for Digital, Culture, Media and Sport, Growing a Culture of Social Impact Investing in the UK, 2017
[17] Centapse, Social Impact Investment Attitudinal and Behavioural Research, 2017
[18] Deloitte, In Pursuit of Impact: Mission-led Businesses, 2016
[19] Investment Association, Governance and Disclosure Guidelines for Housing Associations Seeking Funding From Capital Markets, 2016

in favour of allocating funds to social impact investment if a greater range of scalable investment targets was available.

Financial return is a pension trustee's predominant concern but changes to the law by the DWP will permit trustees to consider non-financial views, including ethical concerns and social and environmental matters. If pension scheme members do want their savings invested in line with these non-financial views it is clear that there is some way to go to encourage a greater dialogue between the pension savers and the pension scheme trustees. At present more than half (54%) of pension scheme trustees say that they feel no need at all to actively seek the views of members.[20]

[20] Allenbridge, Social Impact Investment and Pensions Survey, 2017

...this includes

£79 billion towards environmental investments,

£60 billion in social housing,

£12 billion in broader private investing... and

£2 billion in 'mission-locked' organisations

WHAT NEXT?

How asset managers and savers can speak up to make business better

The accountability chain

A whole range of people from company directors to pension fund trustees are responsible for making sure that people's savings are soundly invested in well-run companies. This is the accountability chain.

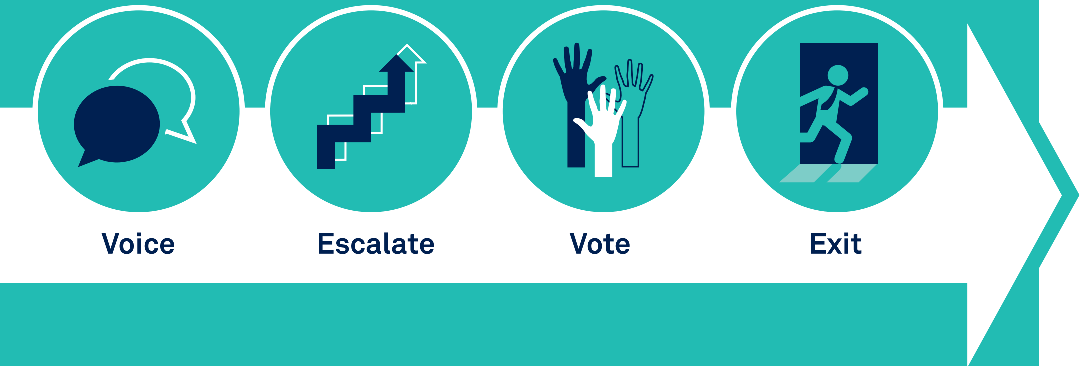
Asset owners	Asset owners are the pension funds and insurance funds which have a duty to act in the best interests of the scheme beneficiaries
Asset managers	Asset managers are appointed by asset owners for their professional expertise in meeting investment and stewardship objectives
Non-Executive Directors	Non-Executive Directors support and challenge the decision making process on the board and ultimately the formulation and execution of the Company's strategy
Executive Directors	Executive Directors run the business on a day-to-day basis, develop the strategy and managing the operation of the business
Company	

How asset managers hold companies to account

Asset managers want companies to deliver long-term returns for their clients. The activities which asset managers conduct to promote that long-term success are known as 'stewardship'.

Stewardship of companies involves looking at a range of issues, including:

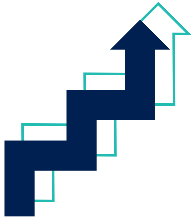
- **Strategy and financial performance**
- **Corporate Governance** – including executive pay, diversity of board and management, succession planning, culture and stakeholder engagement
- **Productivity and capital management**
- **Audit and accounting**
- **Environmental and social issues**



Voice

Asset managers try to exert influence directly over the board and encourage them to consider their approach to issues including strategy, corporate governance and environmental and social issues. Asset managers highlight issues which they think pose a material risk to the company and want to understand how companies are managing that risk.

First, asset managers set out their expectations of companies through guidelines which explain how they would vote at an AGM, and then they speak to people at the companies they invest in, including executive and non-executive directors on the board, to ensure that their expectations are being met.



Escalate

If asset managers don't think that companies are listening to their views then they take their engagement up a level. This might involve getting together with other shareholders or making public statements. Action with other shareholders can be informal or through representative organisations (like the Investment Association). Companies can sometimes be encouraged to change their approach when asset managers start explaining their concerns in the media.

Vote

Investors see voting at the AGM as an important part of their stewardship activities but if companies listen to their shareholders then AGMs can be quiet affairs. Otherwise, asset managers will express a view on the board by voting their shares at AGMs or proposing their own resolutions to be voted on.

For more on how asset managers hold companies to account at AGMs see page 12.

And if all else fails… Exit

Having taken consideration of the previous steps and the best interests of their clients, asset managers may feel that they have no option but to sell their shares. Asset managers have a duty to take decisions which are in the best interests of their clients. Exit is usually seen as the last resort, when all other approaches and engagement has resulted in no change.

There is a consensus among asset managers, government and regulators that considering social and environmental factors is an essential part of holding companies and their management to account.

Considering the views of ordinary savers not only enables investors to ensure that they are attuned to the views of their customers or pension scheme members but also provides a snapshot of the way consumers think about the way companies conduct their business.

A clear signal from savers that they want to see things done differently will inform the way that investors are holding business to account and make sure that companies and their management are thinking about how they do more for the long-term interests of savers, of businesses, and of society.

Over the course of the next year the following activity will take place to boost the way that savers, pension schemes, asset managers and companies talk about how we deliver good returns for savers and society.

Preventing corporate failure	Improving company behaviour	Action from investors	Transparency on Pay
Insolvency and corporate governance BEIS is implementing new measures to **hold reckless directors to account** for company failures. The IA will also investigate whether companies are paying dividends without shareholder approval.	**UK Stewardship Code** The FRC has said it will review the UK Stewardship Code in 2018. The code sets out good practice to **enhance the quality of engagement between investors and companies**.	**Clarifying and strengthening trustees' investment duties** The DWP is updating legislation to clarify **pension scheme trustees' duties to consider financially material risks** and opportunities, including environmental and social factors.	**Shareholders' rights** In 2017, the EU approved regulations (the Shareholders' Rights Directive) to improve transparency and **increase the influence of shareholders**. The regulations, which will enhance reporting on executive pay, will be implemented and adopted in 2018 and 2019.
Independent Review of the Financial Reporting Council The Government has asked Sir John Kingman to review the purpose of the FRC and its potential role in **preventing corporate failure**.	**Corporate governance at private companies** Businessman James Wates is leading a group that will publish **corporate governance principles for large private companies**, bringing them more into line with expectations towards public companies.	**Sustainable finance** The European Commission has proposed new regulations on institutional investors and asset managers to **disclose how they integrate environmental, social and governance factors** in their risk processes.	**Executive pay reporting** New laws require large listed companies to **publish the gap between the average UK employee's salary and the chief executive**. Directors will also have to explain how they are acting in employees' interests.

THE
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