FCLTGLOBAL
IDEA EXCHANGE

We Need to Talk:
Driving Long-term Value Through the Investor/Corporate Dialogue

FCLTGLOBAL
FOCUSING CAPITAL ON THE LONG TERM

FCLTGLOBAL

FCLTGlobal is dedicated to rebalancing investment and business decision-making towards the long-term objectives of funding economic growth and creating future savings.

FCLTGlobal is a not-for-profit organization that works to encourage a longer-term focus in business and investment decision-making by developing practical tools and approaches to support long-term behaviors across the investment value chain. We take an active approach to achieving our goals by:

- Conducting research and developing practical ideas based on solid evidence
- Engaging the world's top asset owners, asset managers, and corporations to problem-solve and test capital allocation approaches that create long-term value
- Developing educational resources and actionable approaches that are available and applicable globally
- Generating measurable change in capital markets behavior among savers, investors, corporations and other stakeholders

Focusing Capital on the Long Term began in 2013 as an initiative of the Canada Pension Plan Investment Board and McKinsey & Company, which together with BlackRock, The Dow Chemical Company, and Tata Sons founded FCLTGlobal in July 2016. In addition to our Founders, our Member organizations from across the investment value chain, including asset owners, asset managers and corporations, are committed to accomplish long-term tangible actions to lengthen the timeframe of capital allocation decisions.

FOUNDERS

BlackRock
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Corporate CEOs and their long-term shareholders benefit from a frank exchange of views about long-term strategy. But, such strategic engagement can be challenging to establish in most publicly traded markets. Corporate boards and management teams often hear the perspective of the "noisy" short-term players—whether shareholders or non-shareholders—in the investment community. On the other hand, long-term investors are typically quiet publicly, and many do not share their perspectives with the company privately either, creating an imbalance of pressure to focus on the short-term, even at the expense of long-term value creation. Corporate leaders and long-term investors participating in Focusing Capital on the Long Term working sessions have pushed the thinking on this issue to create this menu of tools for corporations seeking to better "hear" their long-term investors and for long-term shareholders seeking to be "heard."

In our discussions about focusing capital on the long term, a commonly heard complaint from corporate CEOs is that they don't hear from their long-term shareholders about strategic issues related to long-term value creation; these investors tend to be quiet. In contrast, corporate CEOs—and their boards—hear a great deal from short-term investors or those representing them. Companies hear about hitting or missing consensus earnings targets, read what the sell-side analysts write in their reports, and fear or experience the impact of attention from activists who my have short-term interests.

Corporations, asset owners, and asset managers participating in FCLTGlobal working groups and summits highlight the importance of deep, ongoing dialogue about the drivers of long-term value creation: business strategy, capital allocation, management development, and risk management. By ensuring both that shareholders understand these drivers and that corporations understand their long-term shareholders' views and preferences, this strategic dialogue can create a common foundation that may be able to withstand short-term, more vocal influences.

A great deal has been written about the benefits of such strategic dialogue, including *Straight Talk for the Long Term* from Focusing Capital on the Long Term. (Please see *Further Reading*). Implementing such dialogue is challenging, given the dispersed ownership of companies by a wide varety of asset owners and asset managers globally. In the spirit of providing a menu of ideas for asset owners, asset managers, and corporations who seek to create value over the long-term, the following toolkit provides them with practical suggestions to incorporate into their engagement practices.

PRACTICAL CONSIDERATIONS FOR ASSET OWNERS AND ASSET MANAGERS

Many investors see their role as collecting information on companies, analyzing that information, and ultimately deciding to buy or sell a security in a portfolio. This is the one-way street of traditional investor communications: the company makes its case, and the investor makes an investment decision. Without any feedback to the company, the management team may not know why, or even if, a buy/sell decision was made.

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Engaged investors, on the other hand, actively share their views with the company. It is only natural that the company will listen to and consider these engaged investors' views even if they are short-term in nature. And, in the absence of any alternative views, these short-term shareholders may be seen as speaking for the entire investment community, even if they have different views, timeframes, or incentives from the quiet shareholders. Thus, long-term investors who do not engage with the companies they own risk letting the noisy investors set the agenda—which may not be in the long-term investors' best interest.

So how does a long-term investor engage with companies to ensure that their interests are considered? They can:

- Clarify conditions for strategic engagement rather than trying to engage similarly with all portfolio holdings
- Decide who will engage with which companies
- Select tactics for strategic engagement
- Consider broader changes within the investing ecosystem

SEE TOOLS ON PAGE 9-10

CLARIFY CONDITIONS FOR STRATEGIC ENGAGEMENT

It's daunting for investors to consider engaging with all their holdings, but they need to start somewhere. It's likely impracticable and inefficient for an asset owner to engage with the range of companies it owns in a uniform way, so segmenting and prioritizing strategic engagement efforts are critical. Asset owners may wish to prioritize their largest positions, the companies with upcoming or challenging issues, the highest and lowest performing companies, or simply those in the asset owner's home country or region. Some funds have decided to engage only on issues of specific importance to them and engage broadly across companies but narrowly on a particular issue; others engage deeply with a few companies on the major strategic issues relevant to that asset owner instead. Focusing on where the most impact is possible can prevent efforts from being spread too thin.

DECIDE WHO WILL ENGAGE WITH WHICH COMPANIES

Asset owners must determine the best party to represent their interests in each situation. Should the asset owner engage with its internal staff or through external parties such as asset managers, stewardship advisors, or proxy advisors? Some firms prefer to devote the resources to engage with internal staff, while others prefer to leverage an external party to engage on their behalf and shield themselves from political considerations around engagement. Proxy advisors provide the benefit of consistent engagement, but the breadth of their efforts can dilute their ability to drive long-term intrinsic value. If asset owners expect their managers to engage, clarifying these expectations for engagement and monitoring progress are critical.

Some funds have created informal cooperatives, whereby one fund engages with companies in its own country and shares its thoughts and analysis with another fund that reciprocates in a different country.

STRATEGIC ENGAGEMENT

Long-term value, rather than values

FCLTGlobal defines strategic engagement as interaction between shareholders and corporations about the issues that are most critical to generating long-term intrinsic value that will accrue to shareholders over time. These strategic issues may relate to key elements of the business strategy, competing demands for capital allocation, the hiring/firing/compensation of the management team, or risk management as the company strives to generate value in an uncertain future.

Others create consortiums such as the Investor Forum in the UK, seeking to increase their weight through collective engagement.

In each of these cases, asset owner representatives must understand the business of the company being engaged, its long-term strategy, competitive environment, and potential threats. Additionally, coordinating this engagement among equity, fixed income, and environmental, social and governance (ESG) analysts within an organization is vital to sending a uniform message to corporate management teams.

SELECT TACTICS FOR STRATEGIC ENGAGEMENT

Strategic engagement goes well beyond voting proxies and is best viewed as a year-round activity. Strategic engagement can be as simple as a conversation between a knowledgeable investor and a company's senior management, or it can involve a range of tools in private and public.

Some asset owners host meetings with company executives or directors specifically to create an opportunity to provide feedback. Other investors write private letters to boards with specific feedback on the company's governance or strategy. Still others join investor meetings that are dedicated to long-term issues, distinct from more typical company meetings—such as CECP's Strategic Investor Initiative.

Another tactic is for long-term shareholders to provide their investment thesis and analysis to the corporation. Most corporations typically see sell side or activist analysis but seldom benefit from the analysis of long-term shareholders.

The specific questions that long-term shareholders ask in interactions with companies affect management's thinking. One thought-provoking question suggested by working group participants is: "if you were a privately-held company, what would you be doing differently?" Ensuring that all members of an investment organization maintain a long-term focus in company interactions is critical to effective strategic engagement. We've heard too many stories about inexperienced analysts asking short-term questions just so that they can fill in the appropriate cell on their spreadsheets.

Long-term shareholders often ask questions in private meetings with the company, rather than on public investor calls. While it is understandable that a long-term shareholder who has a deep strategic question may prefer not to share it with their competitors or publicly telegraph their trading intentions during investor calls, having a long-term shareholder anchor the discussion to strategy can refocus these conversations on long-term opportunities.

Finally, some large investors are changing their investment structures, investing through private investments in public equity (PIPES) or other locked-up structures to deepen strategic engagement within the appropriate legal constraints.

CONSIDER BROADER CHANGES WITHIN THE INVESTING ECOSYSTEM

Beyond the straightforward solutions discussed above, some asset owners and managers are considering more hands-on ways to improve the environment for strategic engagement.

First, in most private and family-held companies, the largest owners of the company serve as its board members. In publicly listed companies, major institutional shareholders typically hold the majority of the shares but do not serve on the board due to concerns around inside information. Activist investors, however, regularly propose directors for companies, gaining a voice for their priorities. Although long-term shareholders may not be able to serve on boards, there are opportunities for these shareholders to take an active role in nominating, training, or evaluating board directors on their long-term orientation. For example, in practical terms, investors might establish a consortium to assist with long-term director training, supplementing existing training platforms with an orientation toward building long-term intrinsic value, developing a roster of board candidates, or conducting independent due diligence on board directors.

Second, companies often do not know who the ultimate owner of their shares is, depending on the type of account or fund managing those shares. Long-term shareholders can ensure that the companies they own know their total positions across all of their portfolios as a basis for a strategic engagement.

Third, long-term shareholders who have not already done so can evaluate how they spend their research budget and ensure that they are not inadvertently funding short-term sell-side research that counteracts effective long-term strategic engagement. Instead, they can encourage and reward those sell-side analysts who broaden their analysis beyond short-term financials to the critical issues that drive long-term value creation. Similarly, investors can align their sell-side analyst ranking and voting in annual polls to better reward long-term analysts.

Finally, asset owners can consider how their activities in one part of the portfolio may be affecting their strategic engagement with companies in a different part of the portfolio. Two examples are share lending and investing with short-term activist funds. Such activities may be profitable on their own but may reduce aggregate portfolio returns by increasing downward pressure on long-term holdings or encouraging management teams to be more short-term.

PRACTICAL CONSIDERATIONS FOR CORPORATIONS

Companies tell us consistently that they would like to hear more from the quiet long-term shareholders. They are especially keen to build engagement when they are not in the midst of a crisis or activist intervention. So why do management teams find it difficult to have frank discussions with their key long-term shareholders? There can be legal and competitive reasons not to over-disclose, and short-term activity is often in the best interest of market participants such as the media, the sell side, and the exchanges. Some management teams are concerned about being boxed in by sharing their long-term plans, but the overwhelming sentiment of management teams who have successfully engaged with long-term shareholders is that investors understand that market conditions change and that companies may need to pivot. Investors clearly prefer understanding a long-term plan and changes to it over time rather than guessing in the face of opaque communications.

Companies that want to build these relationships focus on long-term strategy and long-term shareholders and avoid getting distracted by short-term market participants. Specifically, they:

- Emphasize the long-term strategy in all investor communications
- Focus investor relations activities on long-term shareholders
- Consider broadening their levers for strategic engagement beyond senior management

EMPHASIZE THE LONG-TERM STRATEGY IN ALL INVESTOR COMMUNICATIONS

Starting every interaction with a review of the company's long-term strategic roadmap and tying the discussion of how the company has performed against back to that roadmap provides the basis for a strategic, long-term-oriented conversation. Key milestones serve as the inputs to a successful outcome; the financials over time reflect the outputs. Similarly, if the company needs to adjust its strategy because of changes in the marketplace, being able to discuss those changes in the context of a well-understood roadmap will make for a more productive conversation.

Companies that want to attract and retain long-term shareholders—and not attract short-term shareholders—might start communications with a review of the long-term strategy, provide an update on recent performance, then recognize long-term risks or uncertainties to frame the conversation around key long-term issues.

As discussed in the FCLTGlobal publication "Quarterly Guidance: A Relic of the Past," most companies no longer provide quarterly guidance; the evidence is clear that providing short-term metrics attracts short-term investors.

Finally, academic studies show that many companies' management statements contain even more short-term language than their investor Q&A sessions. Companies may want to analyze their own language in these statements and in their other publications to ensure that they are framing the discussions with long-term language to encourage a strategic dialogue and attract long-term shareholders.

FOCUS INVESTOR RELATIONS ACTIVITIES ON LONG-TERM SHAREHOLDERS

Distinguishing among the various types of stakeholders who are interested in the performance of a company is a critical step for many management teams. There are fundamental distinctions within the *investment community*—a term that often encompasses long-term shareholders, short-term shareholders, prospective investors, sell-side analysts, and the financial media—in terms of duties owed, incentives, and timeframes. Even among long-term shareholders, investment strategies can vary dramatically among indexed holders, value-oriented investors, and growth-oriented investors.

Understanding who holds their stock—in what size, in which type of investment strategy, and for what holding period—forms a basis for beginning strategic engagement. Furthermore, analyzing the trading patterns of the short-term shareholders, high-frequency traders, insiders, retail shareholders, and long-term institutional shareholders can help management parse stock price fluctuations that are technically, rather than fundamentally, driven. This parsing helps both investors and the company disregard temporary technical fluctuations and remain focused on the long term.

Senior management's time is one of a company's most valuable resources. Armed with a clear understanding of their shareholder composition, senior management can focus their time on those shareholders it would like to keep or attract. One suggestion from our working groups is to have the CEO engage directly with the top 20 long-term shareholders, rather than participate in quarterly calls, with the clear expectation that the investor will be represented by decision-makers who understand the company, such as senior portfolio managers or analysts.

Another approach is to release the full quarterly report and detailed discussion (the commentary typically contained in the prepared remarks) in advance of the quarterly call, then simply host a public Q&A session. This session may be moderated to allow for more time to answer long-term strategic questions in a public forum, rather than review short-term metrics. While there may be resistance from short-term or non-shareholders, a company's management team has the discretion to focus on what is best for the company in the long term, instead of responding to the "noise" of the investment community.

Given the changes brought about by MiFID II, companies are reconsidering their historical reliance on the sell side to communicate with shareholders. Some corporations are using annual general meetings or general assemblies of shareholders to explain the company's long-term strategy and approach to stewardship to their shareholders. Others are hosting contiguous meetings with board members or division heads for long-term shareholders to both encourage them to attend the annual general meeting itself and to foster a strategic dialogue with them.

Some companies host annual direct investor days targeted to potential and current shareholders to share long-term strategy and solicit strategic feedback from them. In fact, a number of our members have commented that these forums get away from the "speed-dating" of the typical sell-side-hosted conference. Questions that one company likes to ask their long-term shareholders include, "what do you think we could do better?" and "what is our competition doing that we aren't doing?" There is a range of opinions on how well equipped many investors are to offer feedback, but companies tend to know which investors are insightful.

Other companies are carefully delineating between the buy side and sell side in investor calls or company meetings. On their calls, one company allocates 30 minutes to buy-side questions, and 15 minutes to sell-side questions. Others queue up questions in order of holding period of the stock or engage their CEO and CFO only with the buy side, letting the investor relations professional answer any remaining sell-side or media questions. Similarly, in company meetings, many long-term investors ask the sell-side representatives to wait outside to ensure an open dialogue between shareholders and the company.

Lastly, companies are rewarding investor relations professionals for attracting and retaining the long-term shareholders that the company really wants. Investor relations professionals will then be motivated to guide their management teams to allocate more time to long-term shareholders. A common refrain we hear is that "companies get the shareholders they deserve," and focusing investor relations activities on long-term shareholders can shape that roster.

CONSIDER BROADENING LEVERS FOR STRATEGIC ENGAGEMENT BEYOND SENIOR MANAGEMENT

Some management teams are sharing the responsibility to engage with long-term shareholders by designating a director to lead the investor dialogue from the board level, such as the board chair, lead independent director, or chair of a shareholder relations committee. While some are concerned that a board member could "go off script" or get tripped up on details, others argue that having the board member provide "context rather than content" is valuable for both the shareholder and the company.

Other management teams are ensuring that their board members are well informed on the composition of their shareholder base and understand the importance of strategic dialogue with long-term shareholders. Simply reminding them of the size and importance of these long-term shareholders can counteract short-term pressures. Engaging the board in strategic dialogue with long-term shareholders can have the additional benefit of reminding board members to maintain a longer-term orientation.

Many large companies are asset owners themselves through their corporate pension plans. Companies can ensure that their pension plans are engaging with the companies they own with the same orientation they seek in the company's shareholders, modeling and encouraging long-term thinking in these conversations.

Engagement often begins at home, and some companies are analyzing internal employee engagement metrics as well as ratings on Glass Door and similar platforms. Naturally, there are many short-term market pressures that act as impediments to strategic engagement with long-term shareholders. Companies can analyze their own media strategy, its effect on engagement, and their listing venues or exchanges and encourage the investment community to support long-term thinking.

SUMMARY

Strategic engagement is a powerful way for investors and companies to better understand one another and drive long-term value creation. FCLTGlobal Idea Exchanges encourage long-term asset owners, asset managers, and corporations to consider how these and other tools may provide mechanisms to build long-term strategic engagement.

We welcome your experiences, perspectives, and feedback at research@fcltglobal.org.

ASSET OWNERS AND MANAGERS

Clarify conditions for strategic engagement

Options include:

- Largest holdings
- Time-sensitive or challenging actions
- Home country or region
- Specific issues of importance to the asset owner or asset manager

Decide who will engage with which companies

- Build internal capacity for engagement directly
- Delegate strategic engagement to asset managers and explicitly incorporate responsibility for strategic engagement into manager mandates
- Direct proxy advisors to create long-term voting models and engagement strategies
- Create or join a consortium for collective engagement
- Collaborate with like-minded investors in other regions to cover the globe
- Ensure discussion at company meetings is focused on the long-term strategy and that messages from equity, fixed income and ESG analysts are coordinated

Select tactics for strategic engagement

- Host executive- or board-level meetings specifically to provide feedback to companies
- Share investment thesis and analysis with companies
- Provide feedback to board via private letters
- Build or join consortium for parallel meetings for long-term dialogue outside of investor meetings
- Consider asking long-term questions on open investor calls to encourage management to emphasize long-term issues
- Use non-disclosure agreements or invest through PIPES or other locked-up structures to improve access and dialogue

Consider broader changes within investing ecosystem

- Nominate or propose board directors
- Provide long-term training or certification for board director candidates
- Disclose significant holdings to investee companies to open dialogue
- Compensate sell-side research only for long-term analysis
- Examine share lending practices
- Reconsider investing with or coordinating with short-term or activist funds

CORPORATIONS

Emphasize the long-term strategy in all investor communications

- Clearly articulate long-term strategic roadmap with milestones
- Emphasize long-term metrics in investor calls
- Eliminate quarterly EPS or similar short-term guidance

Focus investor relations activities on long-term shareholders

- Analyze shareholder base by size, investment strategy, and holding period
- Distill short-term fluctuations from longer-term trading patterns
- Within the investment community, reallocate senior management time toward long-term shareholders
- Refocus Annual General Meeting or contiguous meeting on long-term shareholders and strategy
- Host direct investor days instead of participating in short-term oriented sell-side forums
- Delineate buy-side and sell-side discussions
- Reward investor relations professionals for focus on long-term shareholders, rather than for activity more broadly

Consider broadening levers for strategic engagement beyond senior management

- Designate director for strategic dialogue with long-term shareholders
- Ensure that board members understand the composition and role of long-term shareholders
- Consider engagement of corporation's own pension plan
- Analyze internal and external employee engagement metrics
- Assess media strategy's influence on long-term shareholders
- Consider the impact of exchanges on long-term strategic engagement

Further Reading

Our research applies many concepts framed in others' research and expertise, particularly:

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A new series from FCLTGlobal, the Idea Exchange, is a collection of tools and opinions designed to spur discussion on how investors and business leaders can drive greater long-term behaviors.

These Idea Exchange Reports complement our periodic whitepapers and aim to serve as conversation starters around long-term approaches across the global business community.

Our goal is for this series to produce a true exchange: we encourage you to share your perspectives and first-hand experiences to contribute to innovative, practical research. Reach us at research@fcltglobal.org.

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745 Boylston Street, 8th Floor, Boston, MA 02116 USA | +1 617 588 9950 | www.fcltglobal.org