Volume 5, Issue 3

April 2016

ACTIVISM AT MEDIA COMPANIES

INDEX FUNDS AND ACTIVISM

ENGINE CAPITAL

BROKAW ACT

ACTIVISM MONTHLY

Premium

Activist Insight

www.activistinsight.com

Passive investments, not passive governance

Institutional investors have quietly supported a big rise in activist investing, but now appear keen to put their own stamp on how companies are run.

At conferences devoted to explaining the rise of shareholder activism, investors and advisers from both sides of the table usually spend a fair amount of time discussing the role large asset managers have played in facilitating their growing influence.

Ask the activists, and they'll tell you that "RFA's" ("requests for activists"—discreet representations from exasperated portfolio managers keen to have someone else lead a shakeup at one of their underperforming companies) have become a common source of ideas. Others may champion the "increasingly sophisticated" research activists have undertaken and published, but the subtext is usually the same: institutional investors have become increasingly willing to support activists both in private and on the ballot.

“The 2015 proxy contest between Trian Partners and DuPont, led some to believe the tide had turned against activists.”

Growing support for activist investors

Asset managers have assumed both more power and more responsibility since the global financial crisis, most notably with votes on compensation, introduced in the US in 2011. Passive investment managers, which have been among the most successful in accumulating assets during that same period, have proven noticeably diligent in ensuring their governance is as stringent as that practiced by active strategies.

The rise of activist investing seems to have accelerated the adoption of interventionist governance teams.

For some, however, 2015 represented a peak in the support large institutions—index funds in particular—were willing to offer activists. **BlackRock** CEO Larry Fink began the year warning against factors that encouraged short-termist thinking, and May’s proxy contest between **Trian Partners** and **DuPont**, where BlackRock, **Vanguard** and **State Street** sided with management against the activist, led some to believe the tide had turned. Yet even Fink has not wholly abandoned the idea of supporting dissidents, pointing out earlier this year that his firm voted with activists in 39% of the 18 largest proxy contests of 2015. “Without clearly articulated plans, companies risk losing the faith of long-term investors,” he wrote. “Those activists who focus on long-term value creation sometimes *do* offer better strategies than management. In those cases, BlackRock’s corporate governance team will support activist plans”

Taking activism in-house

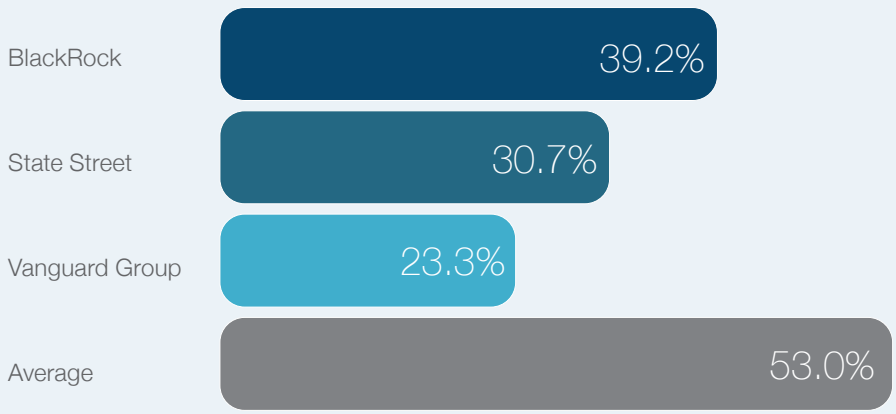
Indeed, if not all asset managers are happy about the rise of activist investing, 2016 might be the year they start to do something about it. Letters sent to executives and boards by major index fund managers at the beginning of the year suggest expectations are higher than ever, but also that the institutions will defend management teams who strive to meet them. In a February 27 letter to his firm’s largest holdings, Vanguard CEO William McNabb warned that boards of directors who engage with investors and show “self-awareness… are less likely to be surprised by activists or proxy votes, and more likely to have stronger support of large long-term shareholders.”

Pension funds have long used the ballot box, shareholder proposals and, more recently, partnerships with activist investors to force change at companies whose shares they own. Those options appeal much less to passive managers, who want to keep

Index funds remain less willing to support activists

Data from our sister company **Proxy Insight** suggests that some of the largest index funds remain more supportive of management than activists, with the chart opposite highlighting the proportion of dissident cards voted on in proxy contests going back to 2012.

Although more and more contests are now settled before a vote, the number voted on by each asset manager is significant: 95 for BlackRock; 75 for State Street and 73 for Vanguard during the period.



Source: Proxy Insight

> "There's a sense among large institutions they'd like to be able to send a message without resorting to a proxy vote."

costs down and stay out of the limelight. Yet they now have an opportunity to use large-scale engagement drives to hold companies to account.

"There's a sense among large institutions they'd like to be able to send a message without resorting to a proxy vote," says James MacGregor, Executive Chairman at Abernathy MacGregor, a communications and investor relations firm. "Ten years ago, there wasn't a channel for that to happen. Now, I think it's widely accepted that there is value to that channel existing, even if it's used infrequently."

As passive investors meet with more and more companies each year, their engagements have become deeper and more sophisticated. They are setting new priorities, integrating strategy and engagement into their governance policies, and reducing their reliance on proxy voting advisers, says Sabastian Niles, a Partner in New York-based law firm **Wachtell, Lipton, Rosen & Katz's** Corporate Practice. As a result, index funds are much less likely to take a back seat. "The assets under management by BlackRock, Vanguard, State Street and other major institutions dwarf those of activist hedge funds," says Niles. "These investors now have a seat at the table too."

Rob Zivnuska, a Principal at shareholder advisory firm CamberView Partners and the former Head of Corporate Governance for the Americas at BlackRock agrees that there is determination to ensure passive managers have a say in how companies are run.

"These asset managers don't want the choice to be activists or nothing," Zivnuska told Activism Monthly Premium in an interview.

New priorities

The warnings matter, especially since the priorities of governance teams at the institutions themselves are changing rapidly.

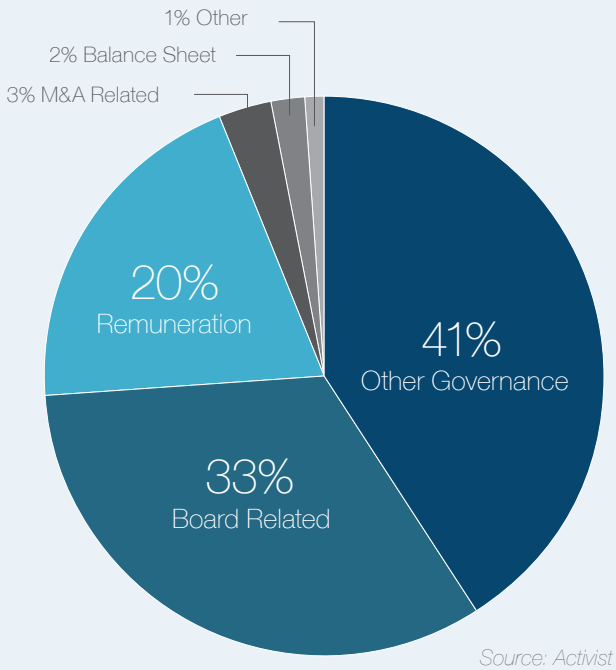
BlackRock, for instance, is "asking that every CEO lay out for shareholders each year a strategic framework for long-term value creation." Its analysts will then be using this blueprint as part of their engagement with directors—testing the board's awareness and involvement in strategic thinking.

Even Vanguard, generally considered the most passive of the large index funds, is pushing for more meetings with directors. "We have no interest in telling companies how to run their businesses, but we have valuable governance insights to share with the board of directors," its CEO wrote earlier this year.

Governance still rules

A review of demands for those investors categorized on Activist Insight Online as "engagement-focused"—mostly pension funds and large asset managers—suggests that governance remains a priority when it comes to their public demands.

Gathered largely from shareholder proposals, the chart opposite indicates that M&A and capital allocation remain the preserve of private conversations, if they are discussed at all. The data runs from 2010 to the end of March 2016.



Source: Activist Insight Online

“This move introduces a new source of pressure in favor of long-termism, which has been missing from the debate.”

“We want to understand if the strategy is right. That doesn’t necessarily show up on a screen.”

Indeed, issues of performance and strategy are likely to come to the fore in the coming years. As Zivnuska told Activism Monthly Premium, “A lot of the low-lying fruit in the governance space has been cleared up. With core shareholder rights secured, there’s space to focus on strategy.”

For an indication as to how this could work, take State Street Global Advisors. Rakhi Kumar, the asset manager’s Head of Corporate Governance, told Activism Monthly Premium in an interview last month that her team screens portfolio companies not just for governance, environmental and social risks, but for underperformance in a similar way to activist investors.

It then arranges meetings with directors at the laggards, with annual dives into specific sectors to enhance its efficacy. “We want to understand if the strategy is right,” Kumar says. “That doesn’t necessarily show up on a screen. We have very intensive engagements, like activists.”

Unsurprisingly, given the assets passive managers are accumulating, the ability to exercise control over investments is becoming a big headache.

Both Kumar and Niles say there is a determination to avoid “outsourcing” problems to activists and that index funds’ concerns stem from a uniquely long-term perspective. “Short-termism is extremely corrosive in terms of what they’re trying to achieve,” Niles says. “This move introduces a new source of rebalancing in favor of long-termism, which has been missing from the debate.”

A bigger stick?

Whether passive investors find that large stakes, regular meetings and entreaties to focus on long-term value are sufficient to protect their interests remains the biggest question mark over this enhanced strategy.

While index funds have so far displayed little interest in running proxy fights, there are some signs their apparent allergy to headline risk is being overcome. In Hong Kong earlier this month, BlackRock actively and very publicly solicited votes against an asset sale by mining company G-Resources, retaining Georgeson and Finsbury and persuading Glass Lewis and Institutional Shareholder Services to publish their research.

Proxy solicitors interviewed by Activism Monthly Premium described the move as “a significant event,” given the participant. Yet with no indication that it will become a regular part of BlackRock’s arsenal, and with the vote going against the investor, it remains unclear whether public campaigns will become more common in future.

In the US, one potential avenue may be opening up. Proxy access, a process that allows long-term investors (or groups of long-term investors) to put forward potential board members for the approval of shareholders, is now on the books of almost one-third of S&P 500 companies. Many are skeptical that institutional investors will put the effort in to make it work, but if anyone has the resources to do so it is the likes of BlackRock, Vanguard and State Street.