Phoenix INVESTOR RELATIONS

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Our guest: Hermes Equity Ownership Services

In the last few years an increasing number of institutions have implemented ESG overlays, expanded proxy-voting policies and incorporated ESG trends into their portfolios. London-based Hermes Equity Ownership Services (EOS) is a global leader in this field, engaging with companies on financial, strategic, capital structure, governance, ethical and environmental issues on behalf of major asset owners. It also undertakes intelligent voting at company meetings to reinforce its programme of engagement. It advises pension funds and global institutional investors which control more than $140 billion, in meeting their ESG responsibilities. Though the US is seen as lagging behind Europe, both CalPERS and CalSTERs have led the way in ESG investing to improve the ROI for investors.

EOS is part of Hermes, a multi-boutique asset management firm with $34 billion in assets under management. Hermes is owned by the BT Pension Scheme which is the UK's largest pension fund.

Jennifer Walmsley joined Hermes in 2003 and leads EOS' engagement with UK, American and Australian companies.

How has demand for CSR increased in recent years?

"The climate for stewardship has developed dramatically since the inception of EOS in 2004. Partly this is due to the launch of the Stewardship Code in the UK which puts the onus on investors to ensure they are acting as responsible owners. This means that investors should intervene when a company is not performing in a way that provides optimal value to shareholders. They should communicate their concerns to members of the board and if necessary take collaborative action by engaging along with other shareholders. Sitting on assets you own and not doing anything about issues that may lead to poor performance over time means you are not doing your job as a responsible owner. As asset owners have become more aware of this and we've seen a number of high profile situations recently where companies have destroyed, or come close to destroying, huge amounts of value, we've seen a massive acceleration in demand for our services. So a year ago, for example, we had £64 billion ($105 billion) under advice and in 2009, we had £40 billion ($66 billion). "

Who are your clients?

"Our clients are major asset owners around the world, mainly pension funds, as well as a number of fund managers. We currently have around 25 clients which include a number of the Australian super funds, public sector retirement funds in North America, Denmark, Switzerland and Ireland, local authorities and corporate funds in the UK in particular but also the Netherlands."

Who are your main competitors?

"When asset owners decide that they need to become more responsible in the way they invest funds, the next step is to consider whether to do this internally or to appoint an external provider so we are often competing against an internal team – or at least a prospective internal team. In terms of external providers, there are a number of organizations that provide similar services such as the Dutch fund Robeco and F&C in the UK, MN Services is a smaller operation based in the Netherlands and EIRIS has also begun to offer engagement services, again mainly on environmental and social issues. Finally you have the voting agencies, ISS - now part of MSCI – and Glass Lewis. They don't offer engagement as such but a voting service in accordance with a predefined policy."

Am I correct in saying that none of the $140 billion you advise on are direct investments?

"That's correct, assuming your question refers to whether we are managing assets directly for clients. This is not what we do. What we do is say to clients that wherever their assets are managed, whoever they use as their fund managers, we can help to give them back their voice as the ultimate owner of the assets. We can liaise with their various fund managers so that you don't have a situation where one fund manager votes against a resolution and another votes for that same resolution – which effectively leaves the owner of the assets disenfranchised. By working with EOS you ensure that your long term interests as an investor are properly represented at companies. A big problem with the fund management industry from the perspective of clients with a long-term investment horizon, is that they are very good at taking the buy and sell decision but they are not necessarily interested in having conversations with companies about their longer-term strategy and how they are going to make sure they are still around and making money for shareholders in 15 – 20 years times which is more akin to the investment cycle of the average pension fund."

What is your business model?

"Our fees vary according to the size of the fund and the asset classes involved as well as the complexity of the set up and client reporting requirements. We also charge incrementally for voting based on the number of stocks in the fund."

Are there any particular countries more interested in CSR (e.g. Scandinavia)?

"Scandinavian investors are certainly very interested and they are at the forefront in terms of appointing engagement service providers. We have quite a few clients in that region. The Netherlands and the UK are also very important, vibrant markets for us along with Australia, where major funds are aware of the differences to investment performance that can result from taking ownership responsibilities seriously."

Which countries are less interested and why?

"The US is among the markets where, to date, we have seen less interest. It's difficult to say why exactly and it varies from fund to fund. For example for the very big public pension funds there's a need to be seen to be doing things themselves rather than appointing an external provider. Most of them are also struggling with big deficits so they don't have funds available to devote to responsible ownership activities – although we could describe this as a false economy! It's also the case that the US climate for shareholder rights is very different. There isn't a history of dialogue between companies and investors and outside directors on boards are not accustomed to talking direct to shareholders even though they are the people they are supposed to represent. It's starting to change though. There are a number of companies who now understand the importance of talking to shareholders although I suspect it will take considerably more time before this is widely accepted."

Some US companies are skeptical about CSR – would they regard you as an activist investor?

"Very often in the US, shareholders are still regarded as the enemy, regardless of what we want to talk about. So it can be very difficult to have the conversations in the US that we have easily elsewhere in the world. For example, if we want to talk to the Chairman, a presiding director or a remuneration committee chairman of a US company, we often find that we are blocked by the corporate secretary who sees their job as stopping us having conversations with board members. Many US companies try to avoid being involved with shareholders at all in any other forum than their quarterly earnings call which can be very frustrating. It's important to add here though that, whenever we hold a meeting with a company we aim to have a holistic conversation about all of the challenges facing them. We don't adopt a single-issue, pressure-group style approach."

Are certain sectors banned by EOS?

"EOS doesn't make investment decisions; it undertakes engagement and voting on its clients' behalf. Some of our clients chose to exclude certain companies from their investment universe. Some funds won't invest in companies that make cluster munitions or landmines for example. Interestingly, we've had a program of engagement with manufacturers of cluster munitions and discovered that some companies have stopped making cluster munitions but haven't updated their websites accordingly - so investors were excluding them. There are a number of instances when companies shouldn't have been on an exclusion list but were and through engagement we have been able to discover that information which helps our clients."

Can you name any companies with which you are currently engaging?

"It is difficult to talk about engagement when it is ongoing as this can jeopardize the success of the engagement. While we obviously report to our clients about what we are doing, we don't disclose this information publicly. "

Is there value in companies publishing stand alone sustainability reports?

"We would much prefer to see companies include the main "sustainability" risks in the annual report as part of their standard risk disclosures, where these are significant. If companies don't consider these risks significant then arguably they shouldn't be talking about them at all! It is far better in our view to provide brief disclosures within the annual report and more extensive information on the website so those investors who really want to drill down and get more detail on carbon emissions or waste or whatever can get that from the website rather than companies feeling they have to clutter their annual report or produce a voluminous sustainability report."

How do you engage with a company?

"There are variety of different approaches that we use depending on the nature of the issue but broadly we would ask to speak to an executive or a non-executive director to discuss our concerns. If it was an issue to do with compensation, for example, then we would seek a meeting with the chair of the compensation committee. It is important that the person we meet is able to influence the company's direction of travel so usually that means someone on the board. Often we meet an executive director first and then subsequently an outside director if we continue to have concerns."

How often will a US company refuse to meet you?

"It's increasingly rare that a company will refuse to meet us altogether but we often get blocked by US companies at the general counsel level. Elsewhere, company secretaries consider it their job to facilitate appropriate access to board members, not to prevent it. The companies that think carefully about these issues and understand the role of outside directors are willing to facilitate meetings, which we understand are helpful on both sides. I find it quite baffling though that, in the US in particular, many outside board directors don't see it as their role to talk to shareholders. It shows that there is a huge misunderstanding in the US about what the outside directors are there for. "

Can you explain your process and how this impacts your investment advice?

Editor's note: EOS uses proprietary screening to determine which companies will benefit from intensive engagement.

1. EOS looks at whether a company is creating value for shareholders or not by comparing their WACC with their cash returns.
2. EOS assesses other factors that may impact on the prospects for engagement success.
3. EOS further screens include strategic, capital structure, governance, environmental and social.

"Our team is divided regionally. One of the things we think is very important is to have individuals within the team with the relevant language skills and cultural backgrounds to be able to engage across different markets. It's vitally important that we don't appear to the companies with which we engage as having an "Anglo-Saxon" point of view. This multi-cultural, multi-lingual team is one of the key elements contributing to the success of our engagement work."

What external inputs do you use in your process?

"We use a variety of external inputs to inform our engagement work. We are primarily a team of engagers not researchers so we want our people to be out there talking to companies, not sitting doing research. There's a lot of external research that we can use rather than re-inventing the wheel by starting from the ground up ourselves. For example we use RepRisk to screen global media sources for instances of companies breaching international guidelines and Trucost to assist us in better understanding the impact companies have on the environment."

What is your 'engagement' universe globally?

"In total our clients own about 9,000 companies. From that universe, we engage with around 450 to 500 companies every year. When deciding which companies we should engage with, we look primarily at financial performance. Where companies are underperforming, we look to understand why this might be and whether there are any underlying strategic, governance, social or environmental issues. We then decide which companies to devote engagement resources to on the basis of how likely the engagement is to succeed and the size of our clients' holdings."

Do you spend more time on certain sectors than others?

"Yes there are certain sectors where we tend to find ourselves undertaking a greater number of engagements. Over the past several years we have done a lot of work with the financial services sector – but our work in this area goes beyond engaging with banks. For example we also engage with policy makers such as the SEC, the IIF and governments around the world on issues that we believe require an industry-wide solution such as remuneration. We also spend time on sectors that are inherently more problematic such as the extractive industries. Lots of those companies have issues with health and safety for example. They are also extremely resource-intensive and often operate in difficult areas of the world so there are always lots of risk management issues to discuss."

How do you see the outlook for HEOS and its competitors?

"It will become increasingly difficult for those pension funds that are currently sticking their heads in the sand and saying 'this doesn't matter' to continue to do so going forward. The world is waking up to the importance of responsible asset management - not in the narrow sense of putting a small percentage of assets into an ethical fund but across all asset classes with the aim of preserving value. Major asset owners need to think about what they are doing to ensure that they are adopting a responsible approach to the way they manage money for their beneficiaries."