



Interview

Agenda of a **shareholder** activist

Fund managers should be good owners, not just traders, believes the head of Europe's leading shareholder-activist fund.

Paul Coombes

Strong signs of shareholder activism have come in the wake of the many corporate scandals in the United States and Europe over the past few years. Once treated by management as a minor annoyance, activist investors are now increasingly central in the push for corporate-governance reform. In the United Kingdom, the government has threatened to bring in legislation compelling big shareholders to take a more active role in bringing underperforming companies to task. Trade bodies representing fund managers have drawn up codes that require them to become more active, as have global bodies such as the International Corporate Governance Network (ICGN).

Hermes, a UK fund manager that is owned by the BT Pension Scheme and serves more than 200 clients, has long been at the forefront of the shareholder-activist movement, which urges shareholders to challenge managers of companies about the way they are run. Hermes employs some 45 people in its corporate-governance work—more than twice as many as any other institution in the world, including the California Public Employees' Retirement System (Calpers), with which Hermes enjoys a close relationship. It now has £44 billion (\$80 billion) under management.

Back in the early 1990s, Hermes took on the task of improving the performance and governance of underperforming companies in its index tracking fund (known as Index Tracking Investments), which covers all major markets and regions and holds more than 1 percent of the shares of every UK quoted company. It has used its voting rights to intervene on

issues such as the composition of boards, the independence of directors, and executive pay. Of necessity a long-term investor in the stocks of the index tracking fund, Hermes saw intervention as a means of improving its own performance.

Hermes took its corporate-governance program to the next level in 1998 by becoming the world's first major investment institution to establish "shareholder-engagement funds," known as the Hermes Focus Funds: the UK Focus Fund, the UK Small Companies Focus Fund, and the European Focus Fund. Run by Hermes Focus Asset Management (HFAM) and a sister company, Hermes Focus Asset Management Europe (HFAME), these funds take an even more direct approach to improving what Hermes describes as the index fund's "problem companies." The Focus Funds buy stakes in those it believes to be undervalued because of financial, strategic, or governance issues—usually becoming one of the largest owners—and then engages extensively with managements and boards to resolve them. Although reluctant to name names, the Focus Funds have been associated with a management shakeout at the telecommunications company Cable & Wireless and with strategic changes at Kingfisher, Premier Oil, Six Continents, Smith & Nephew, Tomkins, Trinity Mirror Group, and others.

In 2002 Hermes went on to publish the Hermes Principles (see sidebar, "The Hermes Principles," on the next spread). These went beyond the mere



David Pitt-Watson

Vital statistics

- Born September 23, 1956, in Aberdeen, Scotland
- Married with 3 children

Education

- Graduated with BA in politics, philosophy, and economics (PPE) from the University of Oxford and with MA and MBA from Stanford University

The shareholder's advocate

Career highlights

- Braxton Associates, Deloitte Consulting (1980–97)
– Cofounder, partner, and managing director
- The Labour Party, United Kingdom (1997–99)
– Assistant general secretary
- Hermes (1999–present)
– Managing director, Hermes Focus Asset Management (HFAM)

Fast facts

- Visiting professor of strategic management, Cranfield University, Bedfordshire (1990–95)
- Served on various public bodies, including Literacy Task Force (responsible for devising improvement program in UK schools), 1996–97; Co-operative Commission, 1999–2001; Westminster City Council, 1986–90; Labour Finance & Industry Group, 1986–2004
- Currently serves as trustee of the Institute for Public Policy Research (IPPR)

statement of what it expected from companies by way of structural corporate governance and laid out, in some detail, what managements should be doing to generate long-term shareholder value. The Hermes Principles put a company's strategic and ethical decisions, as well as the more usual financial ones, under a spotlight. In 2003 Hermes published a corollary document on the responsibility of share managers.

David Pitt-Watson, the author of the Hermes Principles and managing director of HFAM, runs the UK Focus Fund. He recently spoke with Paul Coombes of McKinsey to explain the Hermes philosophy as well as the challenges and future of shareholder activism.

The Quarterly: *How does Hermes manage its equities differently from other fund managers?*

David Pitt-Watson: Most fund managers would say their key skill was buying and selling shares and hence “outperforming” their peers. We try to do something different. Although we *do* buy and sell from time to time, Hermes tries to excel at being a good *owner* of companies.

The aim is to create value. As fund managers, we're managing the investments of pension funds and insurance companies, which in turn are working for millions of beneficiaries. Some 70 percent of equities in the Anglo-Saxon world are held by institutions on behalf of pension, insurance, and other funds. In Continental Europe, the figure is around 50 or 60 percent.

Our investments' ultimate beneficiaries—those who hold pension and life insurance policies—need their funds to perform well for a really long time: 30, 40, or even 50 years. That kind of outperformance is unlikely to be achieved just by buying and selling to achieve relative performance. It requires the companies we invest in to be well run and achieve absolute performance. So if we have a problem with a company, we are likely to intervene. Hence, the overriding requirement of Hermes is that the companies in which we invest should be run in the long-term interest of their shareholders.

Most fund managers have a different perspective. If they discover they're holding shares in a company that is not terribly good, they sell. If they see a low-priced share in a good company, they buy. The performance of a fund manager is generally judged on the portfolio's performance relative to the market. So, for example, a fund manager who doesn't hold many shares in a poorly performing company might not mind terribly if that company were to go bankrupt, sending market indexes lower. The likelihood is that he or she might get a bigger bonus, as the fund would outperform. There's nothing wrong with this kind of trading activity in itself. But it has

The Hermes Principles

Published in 2002, the Hermes Principles set forth what Hermes thinks companies should do to increase their shareholder value in the long term.¹

Communication

1. Honest, open dialogue

Financial

2. Systems in place to identify value-maximizing activities and skills
3. Investment plans tested for long-term value
4. Capital allocated to exploit core growth opportunities rather than unrelated diversification
5. Cost-effective incentives to maximize long-term value
6. Efficient capital structures to minimize long-term costs

Strategic

7. An accurate understanding of the strengths of the business model and of the forces driving growth
8. Clear insight into why the company is the “best parent” of any business

Social, ethical, environmental

9. Effective relationships with stakeholders; regard for the environment and society as a whole
10. Measures that minimize the transfer of adverse costs to society at large

¹ This version is heavily abridged. See www.hermes.co.uk/pdf/corporate_governance/Hermes_Principles.pdf for the full version.

little to do with being a good owner. As responsible owners, we try to articulate just what it is we would like companies to be doing on behalf of their owners to create long-term value. Hence the Hermes Principles.

The Quarterly: *Why was Hermes Focus Asset Management established?*

David Pitt-Watson: Hermes had long believed we could make certain companies in our portfolio more valuable in the long term if we took initiatives aimed at improving governance. The problem is that this kind of activity becomes quite costly quite quickly. In addition to investment managers, you need teams that include former directors of public companies, strategic consultants, auditors, investment bankers, lawyers, corporate-governance experts, and PR people. The Focus Funds gave us the opportunity to assemble such a group of people by earning a direct return on their activities.

The funds take a stake in companies already held in the Hermes core index fund. We then intervene in a way that we believe will improve the value of the company, and when that change takes place and the shares are revalued we sell back down to the core holding. It has proved to be a successful investment idea. It also supports the Hermes mission, which is to try to make sure that all the companies we’re invested in are as well managed as we can make them.

The Quarterly: *Corporate executives often say that their businesses aren't understood by fund managers. What makes you feel you can intervene?*

David Pitt-Watson: I have considerable sympathy with corporate executives. The primary interest of most fund managers is the value of a company, not whether it is well managed. We take a different approach with the Focus Funds. We would say that when we buy a share it is probably fairly priced. But it is priced in a way that reflects skepticism about its future prospects. We try to change those prospects, but the people we employ know it's inappropriate for a fund manager to be telling the board to do this or that. It's for the board to run the company, and it's for the board, ultimately, to make the decisions about what should be done.

What it *is* legitimate for us to do, and what our teams are well qualified to do, is to ask questions and expect the answers to make good business sense. So we try very hard not to say, "We believe you should dispose of this or that." Instead we ask, "Why do you continue to invest in an unprofitable business?"

We have several other advantages that allow us to engage companies in the way we do. When the Focus Funds buy into a company, Hermes will have been a shareholder in it for many, many years through the index fund. When the Focus Funds sell, Hermes will *remain* a shareholder for many, many years. That strengthens our credibility with companies. And because Hermes is so well established, there is a certain trust that we won't do anything that will damage its reputation. We won't, for example, give unattributed press briefings that undermine management. That's a hopeless way of going about owning companies.

The fact that the investors in the Focus Funds include the world's largest pension funds also forces us to think about this as an ownership activity rather than about how we can make money in the next quarter.

The Quarterly: *To what extent have the Focus Funds improved shareholder value?*

David Pitt-Watson: There are different ways you can think about this. Our performance isn't on the public record. But the BT Pension Scheme, an initial investor in the Focus Funds, had almost a 49 percent return up to the end of December 2003—41 percent above the FTSE total-return benchmark. That's not bad over five years. It equals an 8 percent annual return, versus a benchmark of 1.6 percent. At any one time, the UK Focus Fund might hold 2 or 3 percent of the stocks of 12 or 15 companies.

But our involvement actually improves the performance of the whole company, not just 2 percent of it. Looked at this way, the value of our activities is tens of billions of pounds of benefit to all other investors.

On top of that, Hermes campaigns for good governance in the hundreds of companies in its index fund. From time to time, Hermes engages directly—trying to use a light touch—with some of these companies about issues of board composition, board renewal, and strategy, even though they aren't in the Focus Funds. This, we believe, adds value too.

The Quarterly: *How do you decide which companies to include in the Focus Funds, and how does your involvement unfold?*

David Pitt-Watson: The Focus Funds look for companies whose performance raises concerns—perhaps a falling share price, perhaps questionable strategic actions. The concerns might come from our analysts or from the brokerage community. Very often they come from other fund managers. We then ask three things. Is it fundamentally a good company? Usually, we don't get involved with the worst companies; it would be daft to risk losing our clients' money. The companies we pick are often very strong but have particular issues that we feel we can help resolve. We then ask whether resolving the problems would make these companies worth at least 20 percent more. That's the sort of hurdle we set. And finally, we ask if the boards and shareholders of these companies would be willing to have a dialogue with us. Therefore we tend to invest in strong companies, with boards we believe are open-minded enough to accept change.

Once invested, we're very up-front about the nature of our investment and the issues we want to discuss. Successful involvement usually goes on for two or three years before we sell. Usually, it's amicable. It should be a good ownership relationship. But of course it doesn't always work that way.

The Quarterly: *Tom Jones, who runs Citigroup's Global Investment Management business, has been quoted as saying he doesn't see himself as a "do-gooder," so he doesn't see why his fund's shareholders should spend money on activity that benefits all shareholders.¹ Does this "free-rider" problem prevent many fund managers from becoming more activist?*

David Pitt-Watson: I think if you're somebody whose money is run by a fund manager that doesn't engage with companies, you need to say, "OK, I understand that's not your skill, but who *will* carry out your ownership responsibilities?" There's an honesty in saying, "It's not my responsibility." But if no one takes responsibility, there is a cost to investors in terms of squandered value creation.

¹ *Financial Times*, June 16, 2003.

One difficulty is the free-rider problem. If you've only got one-quarter of 1 percent of a company, the free-rider problem is absolutely overwhelming because you receive only one-quarter of 1 percent of any improvement you bring about. So we do need to find a way good ownership *can* take place. Different jurisdictions will choose different routes. But any solution will require boards and companies to be accountable and transparent, accountants and other monitors to be independent, and shareholders to take on their ownership responsibilities either individually or collectively.

The Quarterly: *Do you think governments should make this happen?*

David Pitt-Watson: I'm European, not American, and feel that good ownership is more likely to be achieved by consensus rather than by Congress writing a desperately complicated law. The starting point has to be a debate—led as much by the corporate community as by the likes of me in the investment community—about what the overall objective of companies should be. We think it should be long-term shareholder value.

I often talk to company executives who say they don't believe fund managers are interested in the debate. I point out that most fund managers' clients are pension funds. So it's the pension funds that are allowing fund managers to behave as traders rather than as owners. But the pension funds represent the management and workers of companies—so companies themselves can force the debate. There really is a virtuous circle here if we can make it work. It shouldn't need government regulation.

It's certainly difficult for each fund manager individually to become a good owner instead of a trader. But with a consensus we could have a different system. And if we did, we'd have much more profitable companies; a clearer atmosphere, in which boards would be able to make decisions; and greater respect—at a time when there is a lot of mistrust of corporations—for the whole economic system.

The Quarterly: *Do you see movement toward consensus?*

David Pitt-Watson: Nothing is going to be resolved in a year—not even in five—but the debate has been transformed over the past few years. We already see some change. In the United Kingdom, for example, the Institutional Shareholders' Committee has drawn up a code of practice setting out the responsibilities of institutional investors in relation to the companies in which they invest. The ICGN has published guidelines too. So a debate is taking place internationally. And the debate *needs* to be international. More than 50 percent of the equities in leading French companies are held outside France. Something similar is true in Germany, and we're moving toward 40 percent in the United Kingdom.

The Quarterly: *The fund-management industry's profit margins are under long-term pressure. Can fund managers afford to engage in shareholder activism?*

David Pitt-Watson: The active trading of shares clearly has a role. It is a huge industry. According to Paul Myners, who drew up a report on the investment industry for the UK government in 2000, roughly £8 billion a year is spent in fees, commissions, and taxes to facilitate share trading. Right now in the United Kingdom I think you'd be hard-pressed to find more than about £8 million spent by fund managers specifically on ownership activities. I'm rather proud that more than half of this figure is spent by Hermes.

How much value do these activities add? As regards share trading, this is pretty controversial territory. As regards good management, McKinsey has looked at the difference between the value of a well-governed company and a poorly governed one and said that the gap comes out somewhere from 15 to 30 percent, depending on the country.² If we improve the governance of companies, we can really add economic value. So I don't think there's a serious problem about whether, in aggregate, there's enough money to pay for a substantial step forward in governance. Even a trivial transfer of 1 percent of the money that we spend trading shares would result in a tenfold increase in what's put into improving governance.

The Quarterly: *You've spoken about the short-term performance pressure companies face. Are you worried about the shorter average tenure of chief executives—attributed in large part to pressure from investors?*

David Pitt-Watson: Yes, it's an issue—it's an issue if good CEOs don't feel supported. Of course, sometimes executives should step down. But it's daft to fire the chairman or chief executive as an immediate reaction to a short-term problem. You need to understand why the problem has arisen. Getting rid of someone makes a good story in the press; it may even move the share price in the short term. But it can be very unhelpful when it comes to managing a company well.

When fund managers make a decision, it takes them a nanosecond to trade millions of pounds worth of shares. Running a company isn't like that. When chief executives make decisions, it can take years to see the results, and it's very unclear to people on the outside whether you're being successful. Which is why I constantly return to the need to raise the level of debate about the responsibility of share ownership.

²Paul Coombes and Mark Watson, "Three surveys on corporate governance," *The McKinsey Quarterly*, 2000 Number 4 special edition: Asia revalued, pp. 74–7 (www.mckinseyquarterly.com/links/12142).

The departure of a CEO needs to be the result of a proper discussion, over time, among people who are fully briefed on what the long-term issues are and can ask appropriate probing questions. It shouldn't be the result of a story in a Sunday newspaper. I've seen two or three stories in the press in recent months speculating on the departure of various executives. The journalists concerned knew nothing about the problems within the company. These stories probably came from fund managers who themselves may not have understood that there were more fundamental things being worked on by the company at the time.

The Quarterly: *How can companies best deal with the short-term pressures they feel from investors?*

David Pitt-Watson: First and foremost, stick to delivering long-term value. That's what will matter at the end of the day. Second, understand the investment process. It's usually about the buying and selling of shares, which doesn't always relate to the reality of whether you're doing the right thing in your company.

Companies need the confidence and entrepreneurship to generate value. They also need independence to listen to and incorporate constructive criticism. Something else we've discovered that is enormously helpful is the importance of separating the roles of chairman and chief executive. The separation makes very clear that the chief executive's role is to run the company and the chairman's role is to run the board and to make sure that the right issues are raised for the board to consider. That way, you get independence of thought, and boards can act as mentor to chief executives, making sure they are doing the right thing and helping them resist undue pressure.

The separation of the roles has worked very well for us in the United Kingdom. I know it's under debate in America right now, and I thoroughly encourage companies there to do the same. It stops this incredible—and I think stupid—pressure on chief executives to say that they're imperial and responsible for everything. We know the world isn't really like that. Chief executives can be the most fantastic people, but they work best when they have boards that function as good teams. Having a separate chairman is an important component of that. *Q*

Paul Coombes, formerly a director in McKinsey's London office, is now an adviser to the firm. Copyright © 2004 McKinsey & Company. All rights reserved.