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Teneo Insights

Market Volatility and the Effects on Corporate Governance

A discussion between Martha Carter, Head of Teneo's Corporate Governance Advisory offering and senior members of Teneo's Governance Advisory team, Matt Filosa and Sean Quinn. Moderated by Kevin Kajiwara.

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Teneo's Martha Carter, Head of Governance Advisory, and Matt Filosa and Sean Quinn, both senior members of Teneo's Governance Advisory team, discuss the continued market volatility and its effects on corporate governance and ESG issues, including advice on how a company's institutional investors may view issues such as executive compensation, board composition, proxy advisors, and ESG issues in the context of a volatile market.

Kevin Kajiwara (KK): Welcome to our Teneo Insights discussion, Market Volatility and the Effects on Corporate Governance. Let's set the stage with a backdrop on the current state of activism. Martha, how do you think market volatility will impact shareholder activism?

Martha Carter (MC): When companies and their boards think about activism defense in the context of a volatile market, they are likely concerned that the short-term stock price changes create opportunities and entry points for activists. Indeed, market volatility creates uncertainty, and uncertainty can test risk tolerance. For example, a company might hesitate on an M&A transaction, unsure of how well it will be received in an up-and-down market, and then an activist has an opportunity to say the board isn't doing enough, they should have done the transaction and they should be replaced; that's one example of an entry point.

Similarly, activists are no different in needing to assess their decision-making through a framework that includes more risk in a volatile market. They must do their due diligence when targeting companies. In a bull market, an activist taking a position in a company with a higher stock price is more expensive, but those performers at the bottom are a bit more obvious and may be less risky for an activist, and those that are under performers relative to peers, may be masked by the general upswing in the market and harder to identify.

But in volatile markets, investors may be fearful, and the opportunity for activists to capitalize on the nervousness around strategy and performance can be very beneficial for them. Arguably, there can be easier targets for activists in a volatile market, at least initially, because it opens up entry points due to uncertainty, but the activists (who certainly don't possess a crystal ball) are also taking on risk in trying to accurately identify those opportunities.

It's important to note that the backdrop to this is a banner year for activist campaigns in 2018. Much has been written about 2018 as a record year for activists – an increase in the number of campaigns (approx. 250), the average market cap of companies targeted continues to increase, the number of board seats won (approximately 150) was an increase over 2017, and an increase in the number of first time activists.

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Arguably, we are seeing hedge fund activists mature from what we knew years ago, from a handful of activists targeting companies with poor performance and poor governance, to now targeting profitable companies or companies that aren't returning as much cash as they would like to the market; how the activists evolve will be a function of both market dynamics and volatility, but also the maturity and growth cycle of activism in general.

One area where we might see additional activity, for example, is in the number of Vote-No Campaigns, for some of the following reasons:

- Vote-No Campaigns are a less costly, easy form of activism, that can be launched on short notice, after the proxy filing.
- Activists sometimes cite poor performance as evidence of poor stewardship/oversight, and they have gained traction in Vote-No Campaigns with proxy advisors with that argument.
- Vote-No Campaigns are sometimes more palatable than replacing directors for investors to support as a signal-sending exercise, and thus activists could run up a high vote total with the platform and declare victory.

Speaking of declaring victory, it is certainly an important activity for activists. Activists themselves have suffered in their funds – hedge fund AUM dropped by $88B in 2018, as nervous investors pulled out and some funds closed their doors, and those that have suffered in performance need to attract their own investors by demonstrating they can change companies, increase their own performance, and justify their fees. And market volatility separates winners from losers. In a volatile market, activists with small, concentrated portfolios are more exposed and need to protect against downside risk to continue to attract their investors. That could mean, for example, that we see more activist in companies with brand names to create more media attention, activists turned PE investors; long-only activists move toward multi-strategy approaches; and M&A activism will certainly continue as long as M&A does, and potentially there could be more global activity, though there continues to be a high percentage of activity (approx. 60%) focused in the US.

KK: It sounds like a lot of interesting changes are on the horizon for the whole industry.

MC: That's right. There are also some interesting statistics on activism as an industry and its level of concentration, such as the fact that 3 activist funds accounted for 70% of board seats in 2018, or that the top five activist funds accounted for 25% of the campaigns in 2018. Considering the ongoing volatility and uncertainty, a short-term downturn might not be impactful, and could even be helpful to activist campaigns, but a long-term, protracted downturn could mean shakeouts of smaller, less profitable activist hedge funds and much more concentration of activists as a group.

KK: Thanks Martha. Sean – how about executive compensation issues? This seems to be a perennial issue with investors, but how might a volatile stock market impact executive compensation?

Sean Quinn (SQ): Many investors and both major proxy advisors evaluate executive pay relative to company performance, so there are several ways a volatile stock market can color their views.

First, since companies are required to report the value of equity awards on the date of grant, a falling market can make awards appear to be out of synch with year-end values of equity awards and could give the perception of excessive pay. Alternatively, there could be a perception of windfall compensation from equity values rising due to a market trend.

Second, companies can face anomalous situations where they achieve the financial metrics in incentive plans, but the share price is significantly down for the year, and investors are hurting. Boards may need to think carefully about rewarding strictly for operational performance versus exercising negative discretion to better align with shareholders' experience.

KK: By negative discretion, you are talking about the board coming along and saying, *'We know we set up these internal targets for awards at a time when the stock price was better, but now our stock price doesn't align with our operational performance, so we're bringing down your award.'*?

(SQ): Correct. It falls on the Compensation Committee to assess the awards being granted based on the targets that were set. Committees can have some latitude for discretion – both upward and downward. Let's say the operational performance has met or exceeded targets – the Committee could determine that the executives met their goals, but if the stock price isn't correspondingly good, they may feel that shareholders will not view favorably a payout that rewards executives at a time when the stock price is significantly down. That's where the judgment comes in as to whether or not to apply negative discretion to align pay and stock performance. For most companies, this would be an extreme situation, but it can happen, as after the 2008-2009 crash, for instance.

That leads into my next point. There are challenges in using TSR goals in incentive plans. In an up market, absolute TSR goals can draw scrutiny if they award high pay for performance that simply tracks the market. While companies that use a relative TSR metric in their long-term plan and outperform their peers in a down market should rightly reward executives, shareholders may object to large payouts. Paying out awards above target when TSR performance is negative, for example, can draw investor scrutiny, so some companies have opted to cap the TSR component of long-term awards at target if absolute TSR is negative.

KK: Thanks Sean. Matt - let's turn to board issues. Board composition has become more a prominent theme with investors in recent years, but how will these issues be impacted by market volatility?

Matt Filosa (MF): Investors have certainly sharpened their focus on board composition issues - board diversity, skillsets, tenure, refreshment - all in the name of good governance and long-term value preservation.

But institutional investors have evolved in recent years to also hold boards more directly accountable for a company's performance (with performance here defined as total shareholder return). For example, many investor and proxy advisor policies now include a company's performance as a significant factor in determining whether to support a proposal requesting an independent chairperson.

And activist investors increasingly cite board composition in the context of a campaign against an underperforming company. So this view that boards are now directly accountable for company performance is a significant shift within the last 10 years during a mostly positive stock market - and it will likely have consequences in a more volatile market.

KK: What do you think has driven this shift of investors holding boards more accountable for company performance over the past 10 years?

(MF): It seems to me that this is a result of the rise of passive investment management. We know that the largest investors in the world are now predominantly passive managers. By definition, passive managers don't research and pick stocks for their portfolios like the active managers do. The stocks are already picked for them by their index provider. So as a result, they don't have the same focus on company management as active managers have to have, and instead primarily focus on boards. So I think the increased responsibilities of boards (which again, now includes performance) is linked to the rise of passive managers.

The key takeaway here is that all investors are more likely to want to tinker with board composition and board leadership structures in a volatile market – kind of an "if it's broke, let's help fix it" investor approach. Boards that have low levels of diversity, poor skill set disclosure, lack of refreshment and/or long-tenured directors will likely be at a higher risk for shareholder engagement, low shareholder support at the AGM and activist campaigns.

Companies can prepare for this by being proactive and assessing the board's vulnerabilities in the context of board composition and investor expectations.

KK: Let's turn to everyone's favorite acronym - ESG. Matt, how do you think all this focus on ESG holds up in a volatile market?

MF: Let's make sure we define what we mean by ESG as everyone likely knows what the acronym stands for, but not everyone uses it in the same way.

In terms of ESG investing, it is defined as passive or actively-managed products that are either benchmarked to an ESG index and/or have integrated ESG issues (such as a company's ESG rating) into the management of the fund. The Forum for Sustainable and Responsible Investment (formerly US SIF) reports that 1 in every 4 dollars in the US is invested in an ESG product (totaling about $12 trillion), and that number is on the rise with record flows to ESG funds in 2018. So the key question will be how does the performance of those ESG funds hold up in a volatile market? Some studies have shown that ESG funds outperform non-ESG funds, including in 2018 where the broad indexes were down about 5%. These studies provide some support for the belief that investors do not have to sacrifice returns to "do good" - and may even outperform non-ESG funds in a down market.

In terms of ESG shareholder proposals – proposals asking companies to address climate change, political contributions, diversity, etc. - many investors historically did not want to opine on these issues. In fact, many of the largest investors had a policy to abstain on these types of shareholder proposals as they believed it was best to defer to companies on these ESG issues. But that has changed - the case for ESG has been more strongly framed in the context of long-term value preservation and creation. As a result, ESG proposals have gradually been receiving more support from shareholders. For example, support for proposals relating to environmental issues rose from about 20% in 2016 to about 30% in 2018. Blackrock, Vanguard and State Street have all reported significantly increased support for these types of proposals over the years.

What happens to this support level in a volatile market? Well, we believe that the upward trend of shareholder support will continue because those investors that previously were giving companies the benefit of the doubt on these ESG issues no longer will.

So I think the takeaway here is that ESG – however you define it - is here to stay, and a volatile market will likely only increase its importance to investors.

KK: We have talked a lot about investor expectations, which is of course top of mind for companies. But Sean, what about proxy advisory firms? How do they tend to act in a volatile market environment?

SQ: Company performance is a consideration for many of the issues ISS and Glass Lewis opine on. As Martha noted, market volatility creates uncertainty and makes proxy advisors' review of certain issues like executive compensation more difficult and takes more time for teams that area already stretched during proxy season.

On top of that, ISS recently lost several key members of its research team, so they'll be understaffed and short of experience on the ground. This will further increase the risk of errors in their work, so companies need to be extra vigilant. It could also mean that companies seeking to engage with ISS about errors in research will be dealing with newer staff who aren't as familiar with ISS policy. In this environment, knowing how to request engagement through ISS' new portal, and how to present your case, is key.

Speaking of which, Glass Lewis has a new report feedback service that allows companies that are the subject of its research, as well as shareholder proponents to provide feedback on reports directly to Glass Lewis's clients. The service is open to just a dozen participants each week during proxy season. Participants must meet eligibility requirements and pay a fee of $2,000. The service may not be clear to those unfamiliar with Glass Lewis, but we can help companies navigate the process.

KK: And finally, Sean, what's going on in the regulatory environment? What issues do companies need to keep watch of?

SQ: With a divided Congress, any changes this year will probably come from the SEC. The Commission indicated that a review of the shareholder proposal submission thresholds is one of its top priorities for 2019, so we could see changes there. Business groups and investors are lobbying hard on a number of fronts, so expect calls for regulatory reform to increase as the 2020 election cycle approaches. Examples include investor calls for stronger disclosure requirements on ESG and diversity. Also, representatives of both major political parties have come out in favor of regulating stock buybacks. One of the most ambitious proposals comes from Presidential hopeful, Elizabeth Warren, who introduced the Accountable Capitalism Act. The Act would require large companies to obtain a new federal charter, adopt certain stakeholder provisions, and provide board representation for employees. While it is unlikely to become law anytime soon, it reflects growing dialogue around corporate purpose and sustainability, themes also covered in letters from the CEOs of BlackRock and State Street. Investors report a growing interest in these issues, so companies should be prepared to address them when they engage with their shareholders.

KK: Martha, before we close, do you have any tips for companies on navigating the upcoming proxy season?

MC: First of all, going back to where we started this conversation on activism, companies and their boards have got this message – think like an activist. Review board composition and governance structure for potential vulnerabilities, make sure you have a defense plan, and understand any changes in your ownership base. Don't forget corporate culture and purpose. One of the successful activist campaigns last year was the Vote-No Campaign that Elaine Wynn launched at Wynn Resorts after the sexual harassment and management shake up at the company. Boards are responsible for corporate culture and they need to understand its risk and implications.

Second, don't ignore retail – who is more invested in the long-term, sustainable health of the company than employees and former employees? Those with a pensioner's timeline won't necessarily benefit from a quick uptick in the stock that an activist could propose, for example, to deploy capital for share buybacks. They may see the value in not selling a company whose stock is down and may view it as a fire sale.

Third, engagement and disclosure are key. Most companies now have an institutional investor engagement program – it's good to have one that is off-cycle from the proxy and to include directors. A retail engagement program that touches the retail owner, and not just when times are tough, is a good program to have. And don't use the same engagement program on retail that is used on institutional investors. Here is where the discussion goes from Wall Street to Main Street; recognize and respect the differences. Retail has different needs and time horizons. And it's very important to engage with proxy advisors, and watch for new developments (such as the GL portal that Sean discussed).

Fourth, boards, specifically their individual directors, could be active in the governance community and/or in engagement – there are many ways that board members can be active. Engagement isn't just one-on-one, there are conference, speaking opportunities, events, publications, etc., where a board member can be recognized as a positive contributor in the governance community. Building a strong reputation could help in a contested situation.

Fifth, communication of a company's long-term strategy in a way that resonates with investors is an imperative; a volatile market can create a short-term bubble of fear that needs to be assuaged with a solid and reasoned, and well communicated long-term strategy.

Finally, be mindful of your ESG disclosures and ratings, as Matt discussed – the ESG ratings and data collections are, as an industry, highly fragmented. Stay on top of it, because they can be influential.

For more information, please reach out to Teneo's Corporate Governance Advisory Team, or visit teneo.com.

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