

The Case for Active Engagement

We have become so used to thinking about indexes, ETFs and beating the market that we have turned shares into financial commodities. They have become building blocks with which we can synthesise ever more exotic instruments, but it has reached the stage where today the number of equity ETFs rivals that of the underlying equities. We have forgotten that within every index and behind each share price is a real company – a company that employs people, provides suppliers with livelihoods and customers with valuable goods and services. It increasingly feels as if we understand the price of everything but the value of nothing. Investors who bear in mind that equity investing is company ownership may be able to secure improved investment outcomes.

We need to go back to basics and remind ourselves what a 'share' is – a piece of a real company, quite literally 'our share'. That share brings benefits, such as a claim on the company's net assets and a right to future distributions, but also responsibilities which include the duty to ensure that the company is managed in a way that does not impair but rather enhances the sustainability of those benefits. This is not only in the interest of the owner, who will enjoy an increase in value, but also for the employees, customers, suppliers and the community upon whose support the company relies.

This might sound like common sense, but in the quest to squeeze as much return as possible out of financial instruments, the belief that short term profit maximisation leads to the most efficient allocation of resources has become a dogma. Without an audible voice making the case for a more sustainable approach, company management teams have responded to the only signal heard: maximising short term profits by borrowing from the future. But not everything that counts can be counted, and the focus on squeezing maximum profit out of a company today often creates problems in the future. Shortcuts create contingent liabilities that are often ignored by traditional financial reporting but which can hurt shareholders in the pocket when they ultimately become realised. Recent examples include falsified emissions statements, over-priced drugs or the promotion of 'fake' news. This brings all commerce into disrepute.

Thankfully something can be done. Company owners can engage and make the case for a more balanced approach to business that will lead to sustainable results. This will be to the benefit of the owner as well as those other stakeholders upon whose support the company relies. When asset-owning clients work with active managers who engage with companies on their behalf, they not only contribute to a more sustainable outcome for the company – and thereby society – but if done correctly,

they also gain access to a source of under-appreciated value that will enhance outcomes.

By allocating capital to investment strategies that employ active engagement, investors can better manage the longer term risks that can arise from contingent liabilities. These may include issues relating to environmental, social and corporate governance factors ('ESG') and this can help the client protect capital. Management teams that engage in more sustainable business practices may also create 'contingent assets', however, and these may be hard to find in a balance sheet. Things like human capital, innovation and corporate culture can end up playing a significant part in determining the path of a company's long term financial results, but they can be hard to identify, can take time to become apparent, and are often qualitative in nature. By selecting active managers with the right philosophy and ownership mind-set, however, such contingent assets can be a valuable source of shareholder value creation.

Finally, such an approach is of increasing interest to investors. Those with longer term investment objectives are uniquely placed to benefit from such an engaged approach to active ownership as their time horizon matches the delivery of benefits from owning sustainable companies. It also frequently matches their own objectives as sustainable investing can bring alignment between the value they see in their investment portfolio and their own personal values.



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