Global Asset Management

ESG EXCHANGE:

EXECUTIVE INCENTIVES

RBC Global Asset Management (UK) Limited

The RBC ESG Exchange - a series of discussions bringing together thought leaders and industry experts, passionate about Environmental, Social & Governance (ESG) related topics, to share their views and opinions.

Exchange of ideas around Environmental, Social & Governance (ESG)

ESG considerations have gained increasing prominence in investment decisions in recent years, something we expect to continue to gain momentum. As a firm, RBC Global Asset Management is committed to being active and engaged owners by integrating ESG factors into its investment process.

In a bid to further the conversation, RBC Global Asset Management has begun hosting a series of discussions bringing together thought leaders and industry experts who are passionate about ESG-related topics - to share their views and opinions in an interactive and engaging setting.

To kick-start the series of events, **Mike Tyrrell**, editor at SRI-CONNECT.com, the professional network and information exchange for sustainable companies and responsible investors, moderated the first event held in April. Mike chaired the discussion on executive incentives with three panelists from the fields of business, academia and finance, RBC's very own **Ben Yeoh** (RBC Global Asset Management), **Alex Edmans** (London Business School) and **Tom Gosling** (PwC), all armed with wide-ranging views on the issue of executive compensation.

Please see the appendix for full biographies of the moderator and panellists.

ESG Exchange in Context

Within the backdrop of the University of Westminster's hallowed Fyvie Hall, Environmental, Social & Governance (ESG) issues were the overarching theme that shaped the discussion around executive compensation, a topic that remains at the forefront of corporate governance discussions for the investment community. The high levels of executive pay, allegedly regardless of performance, continue to be an issue at many organisations, and has become a focus for regulators and the financial press. In a nutshell, executive pay is perceived to be unfair in the court of public opinion.

Key issue - how best can we align executive pay with ESG factors?

'The Purposeful Company' & Business, Energy and Industrial Select Committee report: Corporate Governance

Alex Edmans, a Professor of Finance at the London Business School, has conducted rigorous academic research into incentive schemes across thousands of organisations - often reaching different conclusions than those portrayed by the media, which are, based on one or two high-profile anecdotes. He expressed the importance of disseminating the insights of academic research in a non-technical, clear way for industry practitioners.

Ultimately, Alex felt executive pay was a mere tip of the iceberg regarding policies that could be potentially reformed, arguing that pay is a symptom of broader corporate governance problems, which are ultimately rooted in a lack of shareholder engagement. Thus, reform should not focus narrowly on executive pay, but extend to these governance failures more generally. This is indeed the aim of The Purposeful Company.

He discussed the work of **The Purposeful Company**, a consortium of leading executives, investors, consultants, policymakers, and academics, set up by Bank of England Chief Economist Andy Haldane, political economist Will Hutton, and non-executive director Clare Chapman. (Alex and fellow panelist Tom Gosling serve on the Steering Group, alongside Will, Clare, and Oxford academic Colin Mayer). This consortium aims to transform UK business by embedding purpose into the heart of companies, involving radical reforms to company law, accounting, ownership, and governance - including executive pay. Its recommendations are grounded in both rigorous academic research and practitioner insight, and both Alex and Tom drew on their work with The Purposeful Company in their discussions.

Ben Yeoh, Senior Portfolio Manager, Global Equity at RBC Global Asset Management, expanded on the often short-term focus of the management teams he sees at many companies. Ben observed that some chief executives might consider that they have a 'put option' on their careers, a limited time that they can expect to be in their current position, as such they manage to a shorter time horizon than is optimal. This has the potential to bring about unintended consequences particularly with respect to long-term sustainable investment performance.

Tom Gosling, a Partner and leader of PwC's UK Reward Practice, has been advising large companies and their remuneration committees in the UK and overseas for the past fifteen years. He highlighted the **Business, Energy, and Industrial Strategy (BEIS) Committee report on Corporate Governance**. This report was carried out in response to concerns about the perceived disconnect between workers and business leaders and about cases of corporate malpractice in the private sector.

Tom Gosling informed that the report covered far more than executive pay alone. He stated that the report did find problems with executive pay environment and the Committee made a number of recommendations including:

- Shareholders need to have more powers to enter discussion on executive pay
- Companies should publish pay ratios
- Remuneration committees should have broader accountability for ensuring the company is operating fairly
- Employee representation in relation to pay - these people should be included on remuneration committees and board meetings
- Long-term incentive plans should be phased out, and should instead be replaced with long–dated awards of shares

The most surprising element for him, albeit a positive one, was on pay design, with the committee making it clear they want to see a shift in this area from companies.

The same report also struck a chord with Alex Edmans, who felt the report outlined a suitably simple approach to pay. He went on to outline that the problem with executive pay at the moment is that stakeholders perceive that increases in executive pay are not linked to performance.

He used the example of an energy boss who was rewarded generously as a result of a target-based incentive scheme, tied to incentives that didn't necessarily have a material impact on profit generation, thus compounding the issue of 'undeserving' chief executives.

Alex Edmans instead advocated the simple solution of using share awards, on a long-dated time scale to ensure that the executive is motivated to consider the long-term. He believed the target-based incentive schemes we often see were too trivial, and easy to manipulate.

Ben Yeoh was also surprised by how strong the recommendations were from the BIS report, and pointed out that there is still debate among practitioners on whether target-based incentives should still be used, with the feeling that if they can be designed well, they should be. He also agreed with Alex Edmans, praising the report for its simplistic presentation of an alternative pay design. However, he did argue that often these regulatory or policy updates are overly long and complicated, calling for these to also be simplified so practitioners can actually get to grips with the ideas, and understand what they need to do to implement these recommendations.

Additionally, Ben Yeoh spoke about the metrics for ESG measurement and other material non-financial factors, although noting this will differ across companies and industries. For example he felt that research & development-based firms could offer metrics on R&D productivity, or service-centric companies could be providing more effective disclosure of metrics on customer satisfaction or employee metrics.

Eight Common Myths About CEO Pay

Moderator Mike Tyrrell then moved the conversation on to the **Eight Common Myths About CEO Pay**, asking the panel to demystify these to the audience. The myth that garnered the most attention was the first on the list: CEOs don't deserve their pay, something all panellists felt was well wide of the mark.

Alex Edmans cited an example of footballers, Wayne Rooney and Pele to colour this, pointing out that Rooney is paid far more now than Pele used to earn in the professional era nearly 50 years ago, despite the fact Pele was arguably a far more talented footballer than Rooney. He reasoned that it came as a result of seismic growth in the marketplace. He then directly compared this to business, highlighting that the stakes have also grown here, with enterprises much larger and complex today than ever before.

Alex Edmans went on to highlight examples showing the value of 'good' chief executives, citing research that found that CEOs who experienced bereavement saw a decline in their company's performance soon after. In his opinion, his staunch defence of chief executives is supported by the fact the fortunes of CEOs are closely wedded to the company, highlighting that FTSE bosses held an average of £8 million of their own wealth invested in the business. Therefore the wrongful perception of CEOs not being worth their pay, is one of the most damaging.

Tom Gosling adopted a similar defence of chief executives pay levels, with his belief that executive pay levels are largely economically rational, albeit difficult to justify politically. He argued that pay can be important in attracting top talent, with the evidence suggesting that companies with wider pay dispersion actually perform better.

Ben Yeoh brought up a new topic linked to this; calling for certain companies, where appropriate, to consider some form of 'return on capital' (ROC) metric. He reasoned that there is evidence, from some practitioners, that this is helpful, although this must be done in concert with other metrics and would not be appropriate for all companies.

Importantly however, he stressed that remuneration committees should be always be thinking about both relvant business specific and non-financial metrics when structuring pay.

This is something Tom agreed with, adding that PwC advocates incorporation of this metric alongside the widely used 'earnings per share' (EPS) metric that does little to paint a true picture of economic performance.

Alternatively, Alex felt that a laser focus on an ROC target would put other important dimensions in the shade.

Takeaways from the speakers

The exchange included discussion on the myths and potential solutions on remuneration and executive pay in the UK, and crucially, how we can better align this to ESG considerations. The conclusion from the event was that investors need to scrutinise this better.

Ben Yeoh: Asset owners should ask their fund managers if the risk taking portfolio manager is reading proxies and deciding how to vote on incentive pay packets. He suggests they should refrain from outsourcing this process completely to 3rd party advisors, who often do not have enough time to properly assess the nuances.

Alex Edmans: Recommended that boards follow the example of what works in businesses as the guideline to success in this area. This means referring to evidence when thinking about how to design pay, or other areas of governance. He feels there is a lot of evidence to see what works around executive pay out there, research that can subsequently serve as a guide to good decision making for investors.

Tom Gosling: Called for boards to persevere in trying to better link pay to strategy. He accepted that this is often fraught with difficulties, but nevertheless is a necessary pursuit. He also finished with the fact he believes engagement across all stakeholders needs to be improved. However, he was optimistic that developments in political and investor views could set a template for a simpler, better future for pay design.

Appendix - Biogrpahies

MIKE TYRRELL - Editor, Investor & Analyst Relations, www.SRI-CONNECT.com

Mike has 15 years of experience as an SRI analyst.

He is currently the developer and editor of SRI-CONNECT – an online research marketplace, professional network & communications hub for SRI research and sustainability professionals.

Before this, he ran the SRI team at Citi for four years. During this time Citi regularly received top rankings in investor polls for their SRI analysis and also saw widespread support from quoted companies for their 'investor access programmes'.

Before joining Citi, he established the first SRI research capacity on the sell-side at HSBC Global Equities. Here he defined the practice of sell-side sustainability research and relationship broking.

His buy-side experience came from five years a specialist SRI analyst at Jupiter Asset Management.

ALEX EDMANS - Professor of Finance, London Business School

Alex Edmans is Professor of Finance at London Business School. Alex graduated from Oxford University and then worked for Morgan Stanley in investment banking (London) and fixed income sales and trading (New York). After a PhD in Finance from MIT Sloan as a Fulbright Scholar, he joined Wharton in 2007 and was tenured in 2013 shortly before moving to LBS.

Alex's research interests are in corporate finance (corporate governance, executive compensation, investment/growth/innovation, and mergers and acquisitions), behavioural finance, corporate social responsibility, and practical investment strategies. Alex has spoken at the World Economic Forum in Davos, testified in the UK Parliament, and given TEDx talks on "The Social Responsibility of Business" and "From Post-Truth to Pro-Truth". He has appeared on Bloomberg, BBC, CNBC, CNN, ESPN, ITV, Reuters, Sky News, and Sky Sports, written for for Harvard Business Review, Huffington Post, and CityAM, and serves on Royal London Asset Management's Responsible Investment Advisory Committee. Alex is Managing Editor of the Review of Finance, the leading peer-reviewed academic finance journal in Europe.

TOM GOSLING - Partner, PwC

Tom Gosling is a Partner and is the leader of PwC's UK Reward Practice. He specialises in advising companies and remuneration committees on all aspects of executive compensation, covering benchmarking, design, metric selection and calibration, investor consultation, and communication. Tom has over fifteen years of experience in giving reward advice across all sectors to large companies and their remuneration committees in the UK and overseas and works with a dozen FTSE-100 companies across sectors. Tom has also been responsible for our market-renowned briefings and thought leadership on executive remuneration issues and is a regular media commentator and book contributor.

BEN YEOH - Senior Portfolio Manager, RBC Global Equity, RBC Global Asset Management (UK) Limited

Ben is the Global Equity team's Healthcare sector specialist. In addition he is the team's ESG expert and sits in a non-executive advisory capacity for Responsible Investment and ESG for a leading UK investment trust. Before joining RBC Global Asset Management in early 2014 Ben worked in the same capacity for three years at First State Investments. Previous experience includes roles at Atlantic Equities where Ben was responsible for global healthcare research with a special focus on the US and at ABN AMRO where he was recognised with a #1 Thomson Extel rating across all sectors for integrated ESG research. In 2012, Ben won the Starmine award for best stock picker in Healthcare.

Ben holds an MA (Natural Science) from Cambridge University gaining the top first in his year. He won a scholarship to Harvard University and studied there at post graduate level specialising in behavioural neuroscience. Ben is a CFA charterholder.

Appendix - Referenced Publications & Websites

Business, Energy, and Industrial Strategy, (BEIS)

Eight Common Myths About CEO Pay; Alex Edmans

The Purposeful Company Taskforce

For more information, please contact us at:

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www.rbcgam.com

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