Engagement - It's good to talk

The RBC Global Equity team

All assets are real

As individuals we understand the need to check and maintain the things that we possess. A poorly serviced car will be both a financial and a physical liability. It will be less able to perform its job of transporting people and things efficiently and safely. A central heating system with airlocks and an inefficient boiler will waste energy. Even a kettle that is not regularly de-scaled will, in time, produce unpalatable tea.

In the investment world asset owners are fully aware of the need to monitor the health of their portfolios when it comes to real assets. A property manager will be expected to prove that its commercial real estate portfolio is properly maintained and that tenants are of good standing and pay their rent on time. Equally, the forestry manager will be monitored to ensure that it has healthy trees at the required yield per hectare whilst operating in an environmentally sustainable manner.

Unfortunately the same cannot always be said for the ownership of listed equities. Too often a company's shares are purchased by an asset manager, on behalf of the investor, and then largely ignored. The future success of that business is simply devolved wholesale to the management team. Any monitoring of the company that does occur will be in the shape of following the share price performance or analysing the results– sales, revenues, profits and so on. Where a particular market is held in aggregate through an ETF or passive vehicle there may not even be an incentive to complete this most basic of monitoring.

We think this constitutes both an abdication of responsibility and a missed opportunity; it is simply renting a share certificate.

By holding shares the asset owner has a real stake in the company. The management team is the shareholders' advocate and is there to ensure the long-term success of the business through creating the right culture, sensible planning and the correct allocation of capital. We refer to this as stewardship, and it is where the investment manager and company management can work hand-in-hand.

The idea of stewardship

A company is more than its numbers. The financial results it delivers are the output of decisions made often many years before. They do not happen by chance. They are the result of the strategy implemented by the management team at the time. Management can decide to be either short term or long term in its thinking; the former aiming to deliver immediate share price gains, the latter sustainable shareholder value across the years.

Any assessment of a company that hopes to capture these long-term prospects for the business must be based on a thorough analysis of a vast array of extra financial information – company culture, employee satisfaction, long-term investment plans and environmental responsibility to name but a few. However, once a company meets these criteria and is purchased the responsibility of the asset manager as fiduciary regarding this business does not cease.

The RBC Global Asset Management Global Equities team takes every opportunity to talk to and meet with companies and discuss management's strategy and cross reference with our expectations. On top of this we will look to work with companies to improve the ESG credentials where absent or to alert companies to the fact that some of the good things they are doing may not be being recognised by the market owing to poor levels of disclosure.

This on-going dialogue is a manifestation of our responsibility as active and engaged investors. We want to think and act as owners of businesses not simply a name on an (electronic) share ledger. It is a partnership between management and asset managers on behalf of the ultimate beneficial owners of the shares who may be several steps removed but nonetheless have placed their trust in their chosen managers to act as fiduciaries.

Engagement versus divestment

Divestment, i.e. selling already-owned companies and prohibiting future investment, has a place in a portfolio regarding companies that operate in areas that societal consensus deems unacceptable. This we refer to as possessing a social licence to operate. It is clear, for example, that society does not tolerate landmines and cluster munitions and the handful of companies that produce such terrible armaments find few ready buyers amongst the majority of investors. Most sensible investment guidelines prohibit such investments.

Outside of these clear examples, however, the interpretation of the manager must come in to play. Alcoholic beverages, for example, are permitted and enjoyed in many societies but their sale is commonly restricted to adults. Companies that respect this and market their products to adults only and encourage responsible consumption should be included in the potential investment pool. Those that do not should be eliminated from a responsible investor's consideration for final investment.

The same, for example, could be said for car manufacturers, snack food producers or financial services companies. All have a duty to produce, market and distribute their products responsibly.

The argument for divestment centres on the fact that a company will suffer through a sale or prohibition of its equity. Common terms of reference include starving the company of capital or increasing the cost of this capital. Whilst this may be true in some cases most companies' equity capital is already in the market and widely held. New capital is raised infrequently via the equity markets nowadays. Generally, there are still plenty of indiscriminate buyers who will believe they are acquiring businesses at a bargain price, so the equity will simply change hands.

Where a management team is motivated firstly by a broad mission but also by sensible long-term financial incentives it makes much more sense to engage with this management team to help them improve their businesses. This puts no obligation upon the manager to purchase the stock but it does foster a climate of openness, understanding and collaboration between the owners and stewards of capital. At RBC this is why engagement is our preferred option. The engagement process at RBC involves three stages:

Stages of engagement

1.	Initial Due Diligence: find out about the company – management strengths and weaknesses, culture, contingent assets/liabilities and the governance structure and its effectiveness.
2.	Stewardship Engagement: where a company is owned get to know it better. Exchange views with management and discuss best practice and where the company may currently be falling short.
3.	Advocate for Change: formal engagement with the board on a specific issue that we believe is detrimental to the long-term prospects of a company. Failure to resolve could result in a sale.

Engaging with companies is time consuming and may not lead to readily identifiable tangible benefits immediately. It is, however, consistent with a long-term mindset both from the owner of the equity and those entrusted with its stewardship – the management team.

We believe that it is worth the time and effort involved to engage with companies even where they are not held in a portfolio. It is an opportunity to get closer to management and may deliver investment ideas and opportunities hitherto hidden from view.

Most drivers are happy to commit time and money so that a car will give sterling service over many years and homeowners accept the cost of maintaining property in a sound structural condition. Similarly we take every opportunity to dedicate resource to ensuring that our pool of potentially investible companies constitutes the very best businesses that are thinking about and investing in the future. We believe wholeheartedly that these are the companies that will prevail over the long-term.

ABOUT THE AUTHOR

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Based in London, Simon is the Product Specialist for the RBC Global Asset Management Global Equities team. The team runs high-conviction portfolios investing in select global companies that have strong competitive dynamics, including environmental, social and governance credentials. Simon has over 20 years of industry experience.

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