NAPF

Securing the future of pensions

Pension Funds' Engagement with Companies

June 2009

NAPF Research Report

Contents

Key findings

- **Pension schemes are responding to the economic crisis**: 49% of schemes said that they will spend more time scrutinising the actions of investment managers on engagement issues as a result of the economic crisis. Of these, over three quarters (78%) said they will give more time to reviewing reporting and 57% said they will pay more attention to votes cast.

- **Pension schemes engage indirectly and directly with the companies in which they invest:** 93% of schemes responding carry out some engagement tasks via delegation to investment managers. 44% have a policy of direct engagement. For larger schemes, as many as 70% do.

- **Most pension schemes consider their engagement policies as having a tangible effect on corporate decisions**: Half of schemes believe that their dialogue with investee companies has been quite effective, while 20% believe it has been slightly effective.

- **Pension schemes face barriers to greater levels of engagement**: 62% of pension schemes said that competing work priorities acted as a barrier to direct engagement. 59% identified a lack of relevant skills as an issue and 54% said that the cost of engagement is a further barrier.

- **Engagement reports can be improved**: While 24% of schemes are happy with the engagement reports provided by investment consultants, 54% believe there is room for improvement.

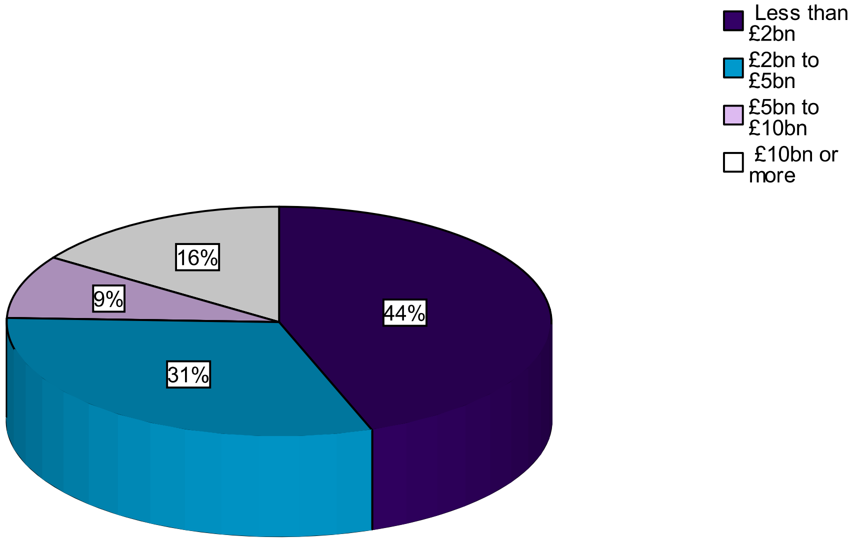
- **Use of the ISC Principles and voting disclosure is increasing**: 51% of schemes stated that the ISC Principles had been incorporated into their contracts with investment managers – up from 33% last year. 70% of schemes disclose voting information to their scheme members compared to 54% in 2008.

Introduction

About the survey – who responded?

This report presents the findings of the NAPF's fifth annual survey on pension funds' engagement with companies. NAPF fund members with more than £1 billion in assets were invited to give their opinions, and responses to the questionnaire were received from 45 respondents. The assets under management from respondents were almost £200 billion, with seven of the respondents managing assets of £10 billion or more.

Figure 1. Respondents by value of assets under management



Base: All respondents (45 funds)

The NAPF is extremely grateful to all funds that assisted with the survey. As some of the questions are not relevant to some funds, the number of respondents who answered each question is stated throughout the report.

Improving institutional investors' role in governance

The 2009 Engagement Survey forms part of continuing efforts being made by institutional investors to improve corporate governance in the wake of the banking crisis. In support of this, the Institutional Shareholders' Committee[1] has issued a 2009 paper which seeks to improve the quality of dialogue between institutional investors and all investee companies. The paper was issued as a contribution to the Walker Review and the Financial Reporting Council's review of the Combined Code.

[1] The ISC is made up of the National Association of Pension Funds, the Association of British Insurers, the Association of Investment Companies and the Investment Management Association.

The engagement issues dealt with in the paper are as follows:

- **Clear mandates**: those responsible for appointing fund managers should be specific in their mandates about what type of commitment to corporate engagement they expect. If corporate engagement is delegated, a policy should be agreed, published and steps taken to ensure it is followed. Beneficiaries should make a considered choice on whether or not they have an engagement policy, but this choice should be based on the objectives of their fund.
- **Effective dialogue**: A simple, non-bureaucratic approach to effective dialogue with investee companies should be established. It is important that there are no regulatory impediments to the development of collective dialogue and this dialogue should be aimed at resolving difficulties. Where dialogue fails to produce an appropriate response, shareholders and their agents should be prepared to use the full range of their powers including voting against resolutions.
- **Board accountability**: A requirement for chairs of committees to put themselves up for re-election would motivate them to keep abreast of investors' views and ensure that concerns are addressed in a timely way. In practice, this would lead to improved dialogue with investors about issues that might be controversial. It would also broaden the agenda beyond the remuneration issues that dominate dialogue at present.
- **Raised standards at institutional investors**: The ISC Statement of Principles on the Responsibilities of Institutional Shareholders and their Agents is a useful benchmark that commands widespread consensus and more needs to be done to promote it. This statement is to be designated as an ISC Code which investors can sign up to. The ISC will publish a list of signatories which will help beneficiaries to make informed choices when issuing mandates to fund managers.
- **Combined code**: The ISC paper outlines several suggestions to enhance the quality of the Combined Code:
    - Chairmen should retain overall responsibility for communication with shareholders and / or their agents. They should be encouraged to inform the entire board of any concerns expressed.
    - If this does not happen, the Senior Independent Director should intervene and take independent soundings with shareholders and / or their agents.
    - Succession planning should be emphasised more clearly, with chairmen reporting annually on the process being followed and progress made.
    - The audit committee's terms of reference should be expanded to include oversight of the risk appetite and control framework of the company.

- o Board evaluation with external input should be expected of banks given their regulated status and the public interest aspect.
- o The Combined Code should encourage independent directors to seek expert advice.[2]

[2] The complete paper can be found on the ISC website at http://institutionalshareholderscommittee.org.uk/

Engagement

Key findings

- 44% of pension schemes have a policy for direct engagement with the companies in which they invest. This figure rises to 70% for larger schemes with over £5 billion in assets. 93% delegate some element of their engagement work to their investment manger or other third party.
- 62% identified other priorities taking precedence as a barrier to direct engagement with companies, with 59% suggesting a lack of relevant skills and 54% saying it was too costly.
- Engagement through an investment manager was considered the most effective form of engagement by 55% of respondents. 41% considered collaboration with other pension funds or individual direct engagement to be the most effective method.
- Half of schemes believed that their dialogue with investee companies has been quite effective, while 20% believe it had been slightly effective and another 20% believed it had had a minimal impact.
- Pension funds reported evidence that their engagement activities had many times resulted in changes to board membership (25%), company strategy (18%), remuneration policy (32%) and social / environmental policy (21%).

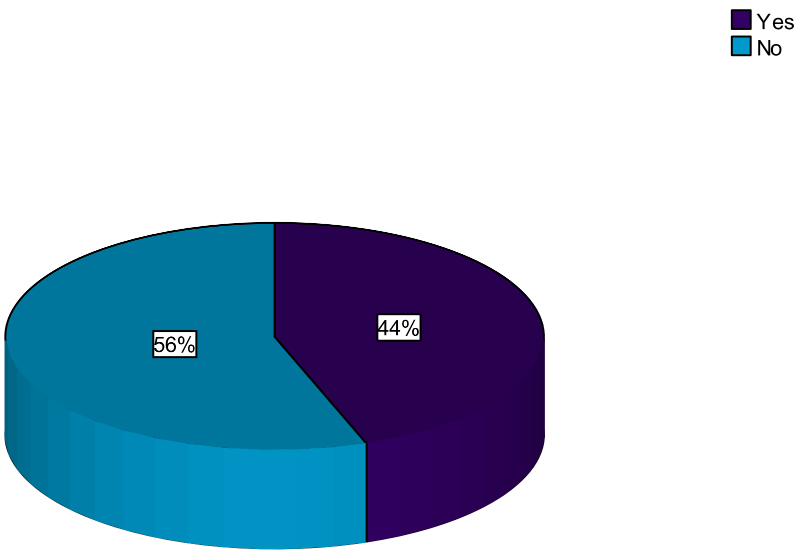
The economic crisis causing turbulence in the markets over the past year has shone a spotlight on the role pension funds should be playing as institutional investors. It has reopened the debate on what exactly the role should be of pension funds and their trustees should be in directing and overseeing the work of their investment managers. Several sources, including Lord Myners, have expressed a wish that pension funds should take their role as owners of companies more seriously.

As a result of this debate, engagement issues are of particular importance in 2009. The engagement survey for 2009 is designed to examine how pension funds are behaving as company owners, and also to identify any potential barriers or difficulties that pension funds are having in engaging with the companies they invest in.

Direct engagement

Firstly, pension funds were asked if they have a specific policy for direct engagement with investee companies. 44% of schemes responded that they do have such a policy but the majority (56%) do not. Larger funds in the sample were more likely to have a policy for direct engagement, as seven of the 10 largest funds (those with over £5 billion in assets) had a policy for direct engagement. When the results were weighted by the value of assets in the schemes, 63% said that they had a policy compared to 37% who did not.

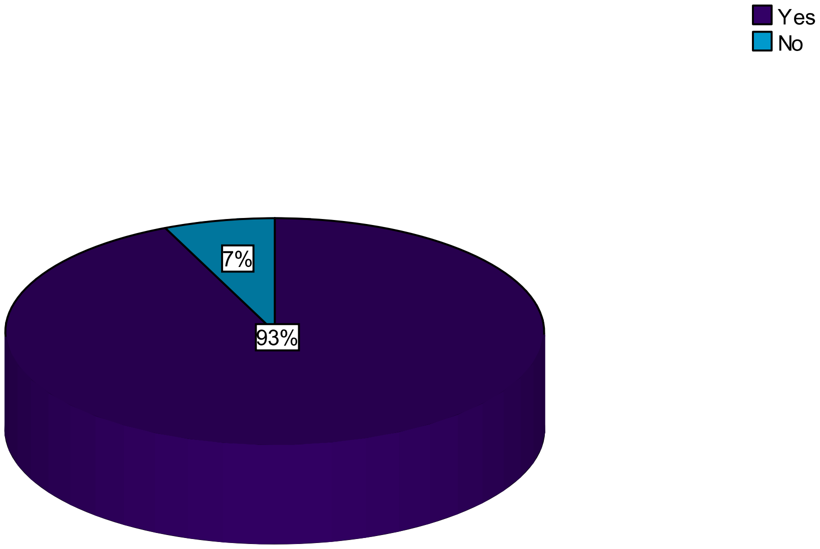
Figure 2. Do you have a policy for direct engagement with the companies you invest in?



Base: All respondents (45 schemes)

The primary reason why pension funds do not have a direct engagement policy can be seen in Figure 3 below. 93% of funds delegate their engagement work to an investment manager or other third party. Thus, it becomes clear that rather than using resources to take on engagement work directly, pension funds prefer to delegate the work to investment managers (or other third parties) who have experience of engaging directly with investee companies.

Figure 3. Do you delegate engagement work to an investment manager?



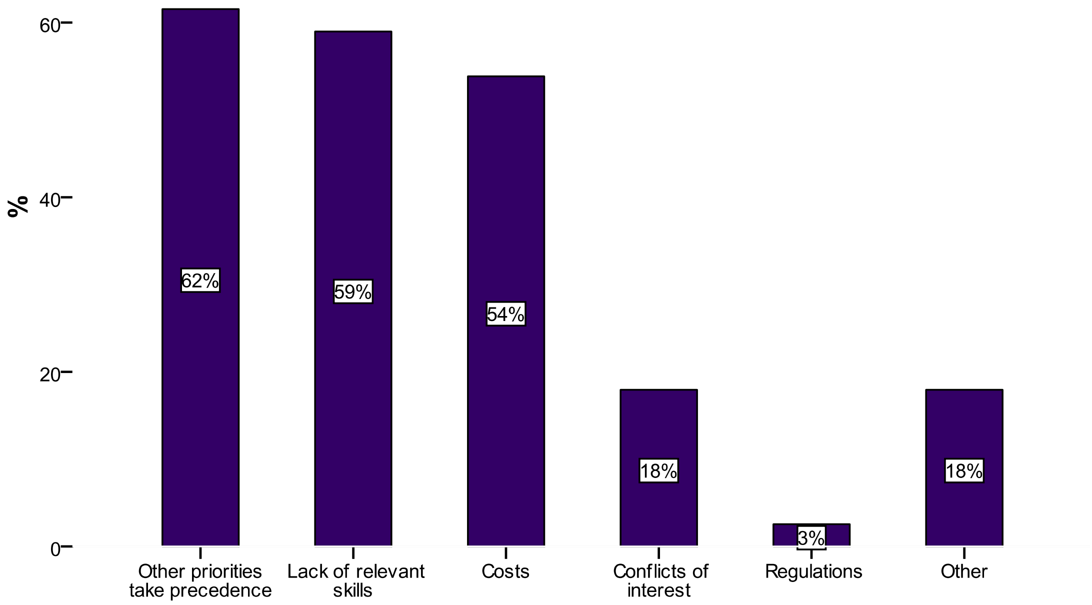
Base: All respondents (45 schemes)

Pension funds were then asked to give their opinion on potential barriers to direct engagement with companies. The top suggestion for a barrier to direct engagement was simply that other priorities take precedence, with 62% of respondents proposing this as a reason. 59% felt that their pension fund staff did not have the relevant skills necessary for direct engagement, while 54% suggested that direct engagement would be too costly for the pension scheme. 18% of respondents suggested that conflicts of interest prevent them from engaging directly. 3% suggested regulations as a potential barrier, with specific mention of the takeover code in the UK and similar legislation in other countries.

Some funds suggested other barriers to direct engagement, such as the difficulty in engaging directly with large numbers of investee companies or the inability to research engagement issues thoroughly enough or with the requisite expertise. Some local authorities noted that individually they do not engage directly with investee companies but instead engage collectively through the Local Authority Pension Fund Forum (LAPFF).

When the results are weighted by asset value, cost becomes the biggest barrier to engagement identified, with 59%. 50% of schemes weighted by asset size suggested that other priorities take precedence.

Figure 4. What are the potential barriers to direct engagement with companies?

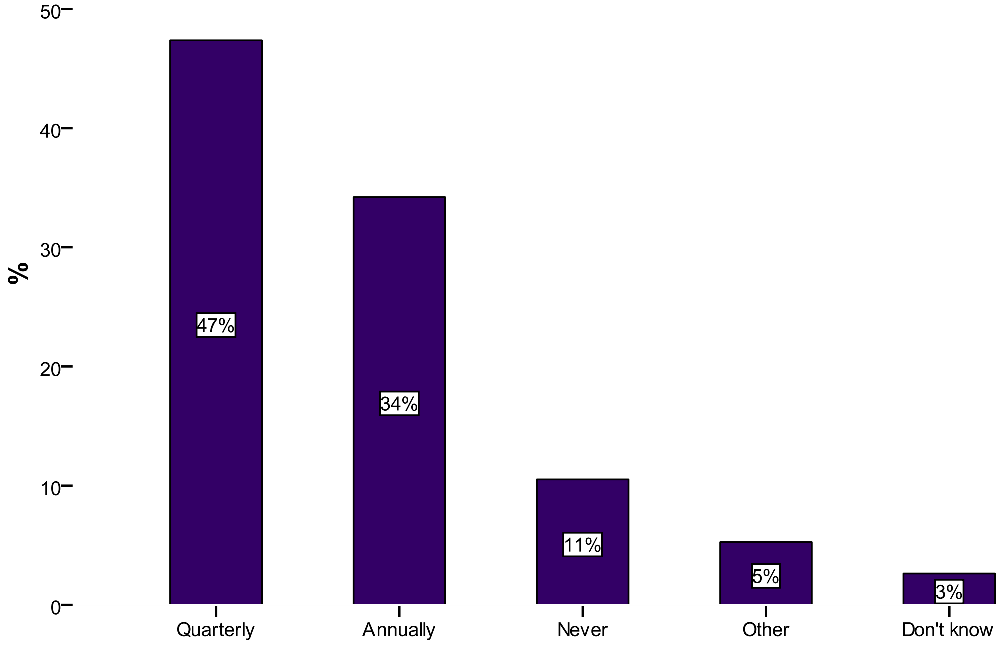


Base: 39 schemes responding

Effectiveness of engagement

In addition to having a policy for engagement or delegating engagement work to third parties, it is important that pension funds keep the effectiveness of their engagement under review. The survey indicates that this is the case, as four fifths of pension schemes responding said that they review the effectiveness of their engagement at least once per year. In fact, 47% of pension schemes conduct this review quarterly and 34% conduct the review annually. However, the results also show that 11% of pension schemes never review how effective their engagement is.

Figure 5.How often do you review the effectiveness of engagement in investee companies?

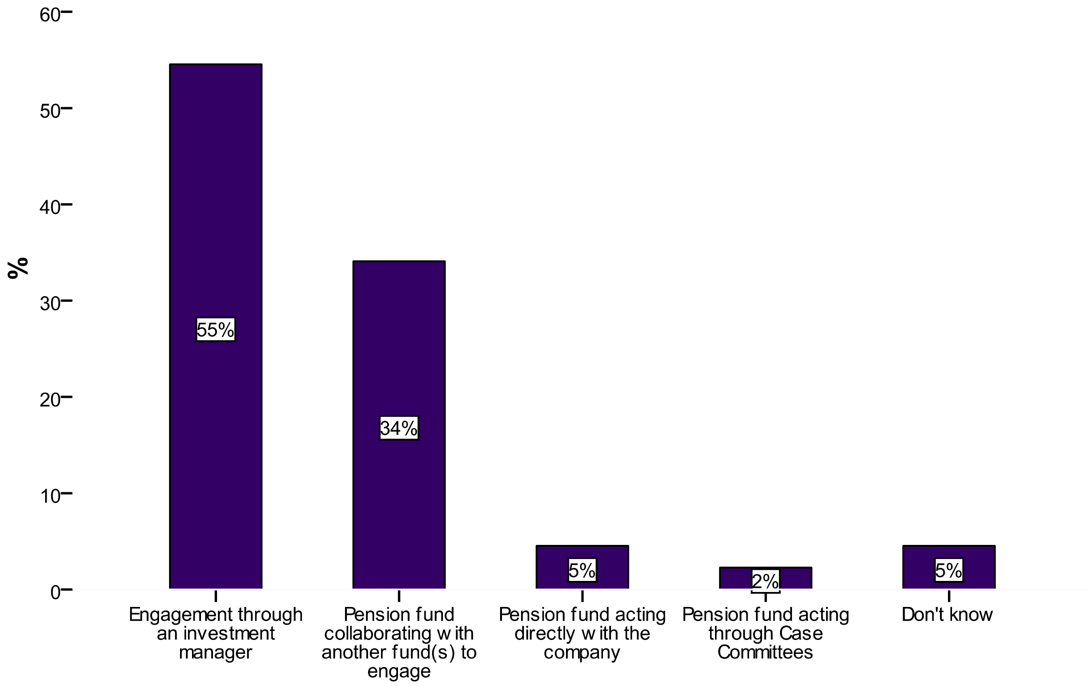


Base: 38 schemes responding

93% of schemes delegate their engagement work to an investment manager or other third party. However, pension funds were also asked what they believed to be the most effective form of engagement. 55% said that this was through an investment manager, but 34% of responding schemes felt that collaboration with other pension funds would be more effective. Just 5% of respondents believed that the pension fund acting directly with the investee company was the most effective way to engage.

Larger schemes offered a different view as the results weighted by asset size show. 46% of funds weighted by asset size suggested that pension funds collaborating with other funds is the most effective form of engagement, compared to just 34% who said that delegating engagement to an investment manager was most effective.

Figure 6. What do you think is the most effective form of engagement?

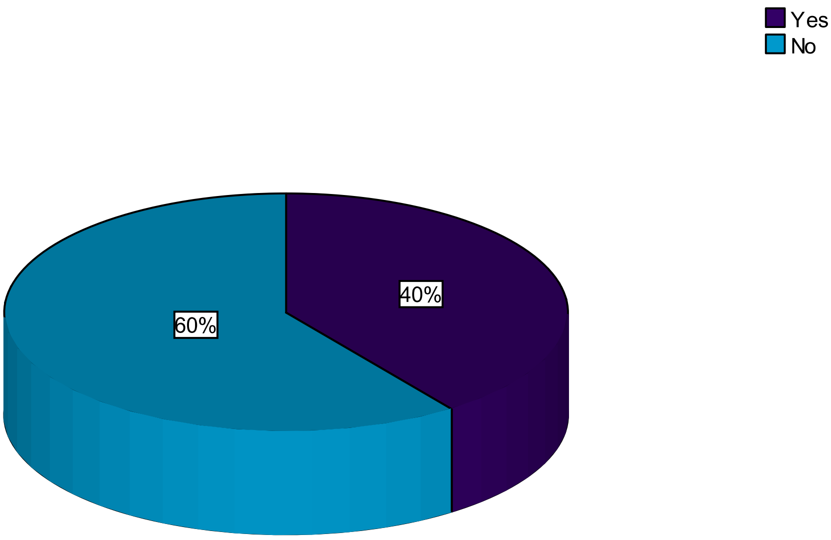


Base: 44 schemes responding

Part of the work of the NAPF on engagement concerns the establishment of a Case Committee. The work of this type of committee is to lobby for change at a company which is seen to be underperforming. Members of the committee are responsible for agreeing how best to approach the issues which they feel are the cause of the company's problems.

Respondents were asked if they had heard about Case Committees in their dealing with engagement issues. 40% had heard of Case Committees but 60% had not. When weighted by asset size, 58% of funds had heard of Case Committees, which shows that it is the larger pension schemes that are aware of Case Committees as a form of engagement.

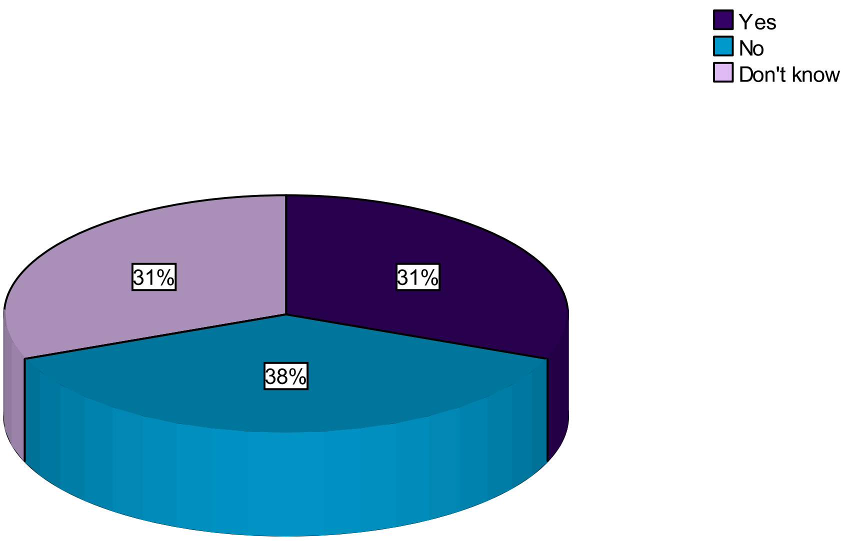
Figure 7. Have you heard of Case Committees before?



Base: All respondents (45 schemes)

Similarly, the response was mixed when pension schemes were asked if they would like to participate in Case Committees in the future. 31% said that they would like to participate, and 31% were unsure. 38% of respondents expressed no interest in participating.

Figure 8. Would you like to participate in Case Committees?



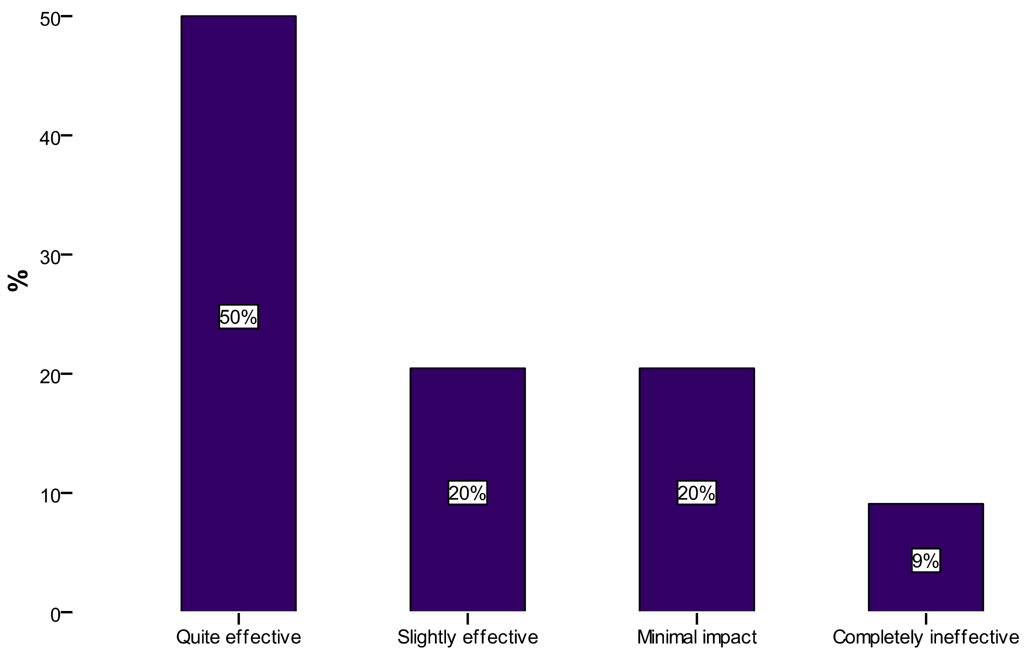
Base: All respondents (45 schemes)

If pension schemes are to be encouraged to be more active investors in companies, it is crucial that they feel that they are being listened to by investee companies on key issues. To gauge opinions on this, pension schemes were asked how effective they believed the dialogue to be between their fund and investee companies.

No respondent felt that the dialogue was very effective. However, half of the respondents to the survey believed that their dialogue was quite effective. 20% felt that their engagement dialogue was slightly effective and another 20% felt that it had had a minimal impact on the investee company. 9% of respondents believed that their engagement dialogue was completely ineffective.

Larger funds tended to consider the dialogue between their scheme and investee companies to be more effective than the smaller schemes in the sample. 55% of schemes with more than £5 billion saw their dialogue to be quite effective whereas just 30% of schemes with less than £2 billion in assets thought the same. Just one scheme with over £5 billion in assets believed that their dialogue had a minimal impact, with all of the others stating that it was either quite effective or slightly effective. When the results are weighted by the value of assets, the percentage of respondents who believe their engagement dialogue to be quite effective increases to 66%.

Figure 9. What do you consider the effectiveness of the dialogue between your fund and investee companies to be?



Base: 44 schemes responding

As well as discussing the effectiveness of engagement dialogue in general terms, pension schemes were asked if they had seen evidence that their engagement activities had resulted in direct changes to company policy in four key areas:

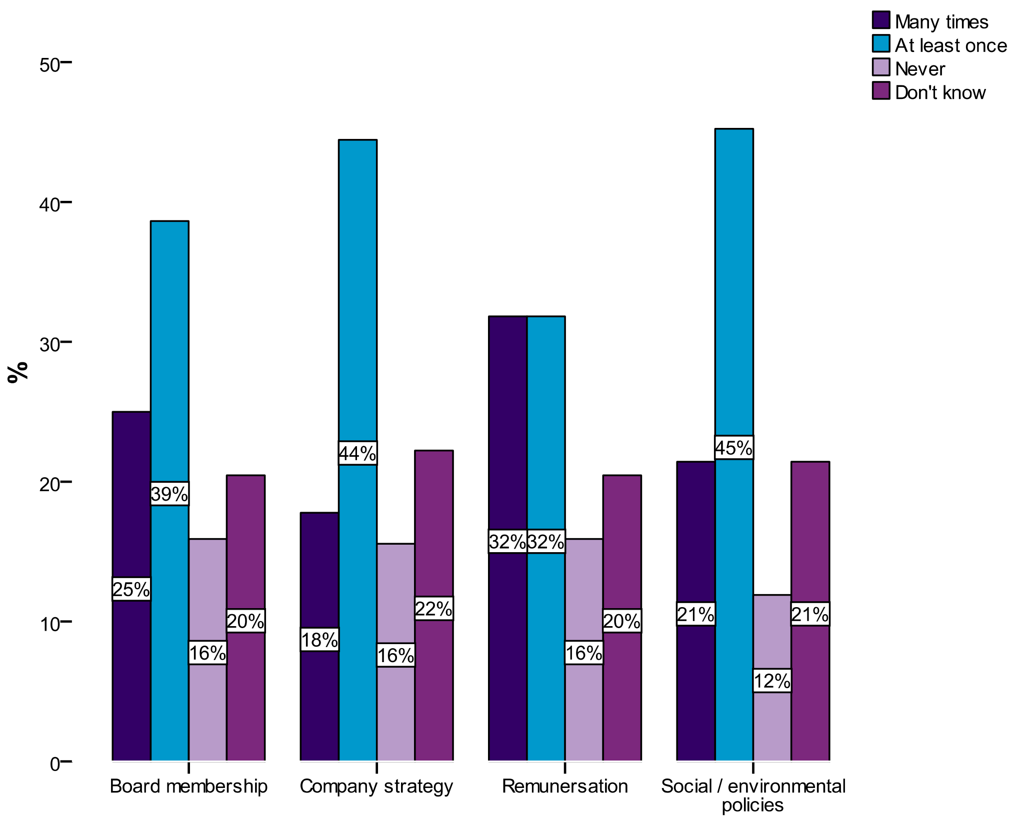
- Board membership
- Company strategy
- Remuneration

- Social / environmental policies

For all four of these company policy areas, the majority of pension funds had seen evidence that their engagement activities had changed policy at least once. One quarter of schemes felt that their engagement activities had changed board membership many times. 18% believed that their activities had led to changes in company strategy many times whereas 32% had seen evidence of changes to remuneration policy as a result of their engagement. Finally, 21% of pension schemes had seen evidence that their engagement activities had led to changes in social / environmental policies.

Again, larger schemes tended to have seen more evidence of their engagement activities having a significant impact. When responses are weighted by value of assets, 39% had seen changes to board membership many times as a result of their engagement. Over one quarter (26%) had seen changes to company strategy and 29% had seen changes to social / environmental policies. 45% of schemes weighted by value of assets had seen changes to remuneration policy.

Figure 10. Have you seen evidence of engagement activities undertaken by you or your managers resulting in changes to:



Base: All respondents (45 schemes)

Approach to responsible investment

Key findings

- Over half of schemes responding to the survey (51%) stated that the ISC Statement of Principles had been incorporated into their contracts with investment managers. This represents an increase from the previous year (33%).

- 77% of schemes reported that trustees set out the fund's approach to the responsibilities of investors as shareholders in the annual report to scheme members. Again, this compared positively with 2008 when the figure was 51%.

- 31% of schemes said that their attitude to the responsibilities of investors as shareholders influences the selection of investment managers as consultants. A further 24% said that they expect that this attitude will influence selection in the future.

In 2009, the NAPF updated its Responsible Investment guidance, which was initially published in 2005. The aim of the guidance is to assist investors, principally pension funds, in developing their Responsible Investment policies. The emphasis of the guidance is on ensuring that trustees, their managers and investee companies all have an appropriate focus on longer-term, sustainable returns to shareholders. Key tenets of the guidance include:

- If a scheme has not yet developed specific Responsible Investment policies, the UN Principles for Responsible Investing provide a basis for such a policy.
- A Responsible Investment policy should be taken into account by trustees during the manager selection process.
- Managers who receive delegated investment responsibility from pension schemes should be encouraged to sign up to the UN Principles of Responsible Investing.
- Ultimate responsibility for the formulation and execution of corporate responsibility policy rests with companies and their boards.

The Engagement survey tracks the attitudes of pension schemes towards Responsible Investment issues and the steps that they take to ensure that Responsible Investment is taken into account when making investment decisions. Part of this process is compliance with the Institutional Shareholder Committee's Statement of Principles. These principles set out best practice for institutional shareholders and their agents in respect of the companies in which they invest.

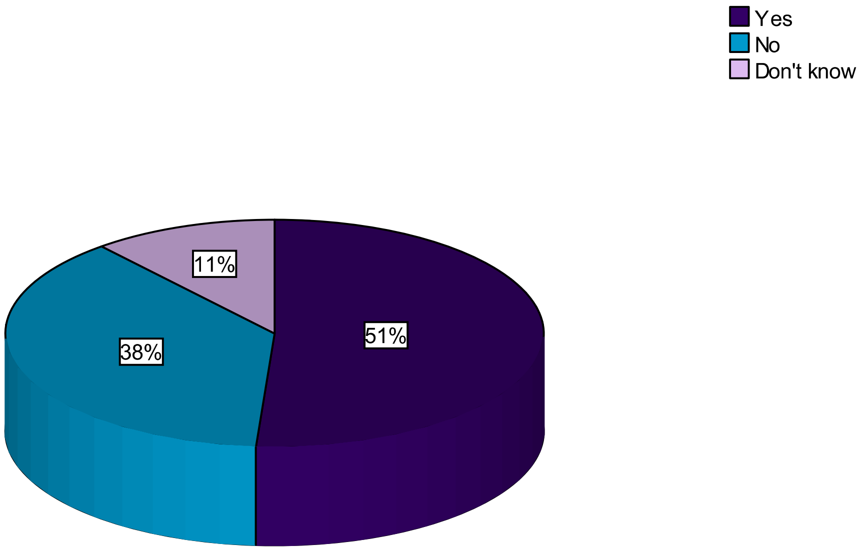
The responsibilities of investors and their agents as discussed by the principles are:

- To set out their policy on how they will discharge their responsibilities – clarifying the priorities attached to particular issues and when they will take action.
- To monitor the performance of, and establish where necessary, a regular dialogue with investee companies.
- To intervene where necessary.
- To evaluate the impact of their engagement.
- To report back to clients / beneficial owners.

Responsible investment practices

NAPF best practice suggests that the ISC Statement of Principles should be incorporated into contracts with investment managers. The number of schemes who are taking this on board has been increasing. In 2008, 33% of schemes responded that they incorporate the ISC Principles into contracts with all investment managers. In 2009, this figure is just over half of schemes (51%). This is particularly true for larger schemes, as the results weighted by value of assets show that 64% had incorporated the Statement of Principles.

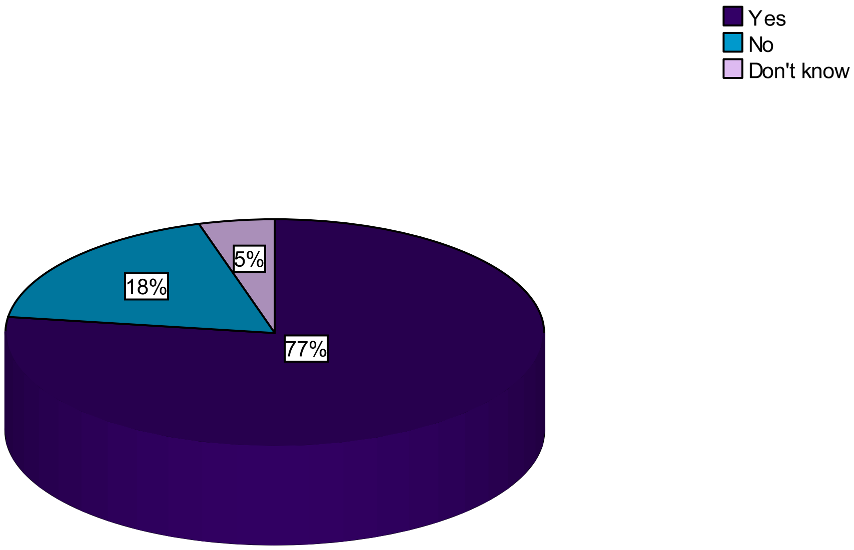
Figure 11. Has the ISC Statement of Principles been incorporated into your contracts with investment managers?



Base: All respondents (45 schemes)

Trustees are expected to set out the pension fund's approach to the responsibilities of investors as shareholders in their annual report to scheme members. Again, this practice is becoming far more commonplace. 2009 has seen a large increase in the number of pension schemes responding that trustees do include Responsible Investment policy in the annual report to members, as 77% of schemes report that trustees now do so. This compares very favourably with 2008, when just 51% said that their trustees abide by this practice.

Figure 12. Do trustees set out the fund's approach to the responsibilities of investors as shareholders in their annual report to scheme members?

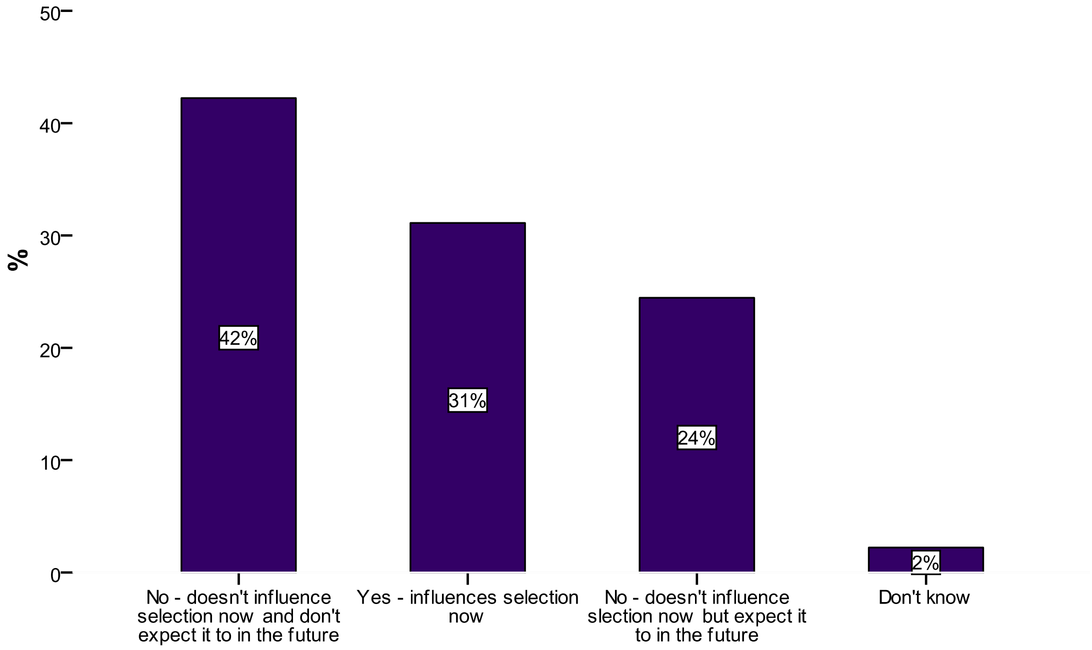


Base: 44 schemes responding

Respondents were asked if the responsibilities of investors as shareholders influence the selection of investment managers or consultants. This is true in 31% of cases, where pension schemes reported that these considerations now influence their selection of managers or consultants. A further 24% of respondents said that they expect their selection of managers or consultants to be influenced in the future. However, 42% of schemes responded that Responsible Investment policy does not influence their selection of investment managers or consultants now, nor do they expect it to have any influence in the future.

When weighted for value of assets, the influence of Responsible Investment on larger schemes becomes apparent, as 45% said that it influences their selection of investment managers now, and 31% said that it would influence this selection in the future. Just 23% of responses weighted by asset value were that Responsible Investment neither influences selection now nor is it expected to in the future.

Figure 13. Does your scheme's attitude to the responsibilities of investors as shareholders influence the selection of investment managers or consultants?



Base: All respondents (45 schemes)

Accountability

Key findings

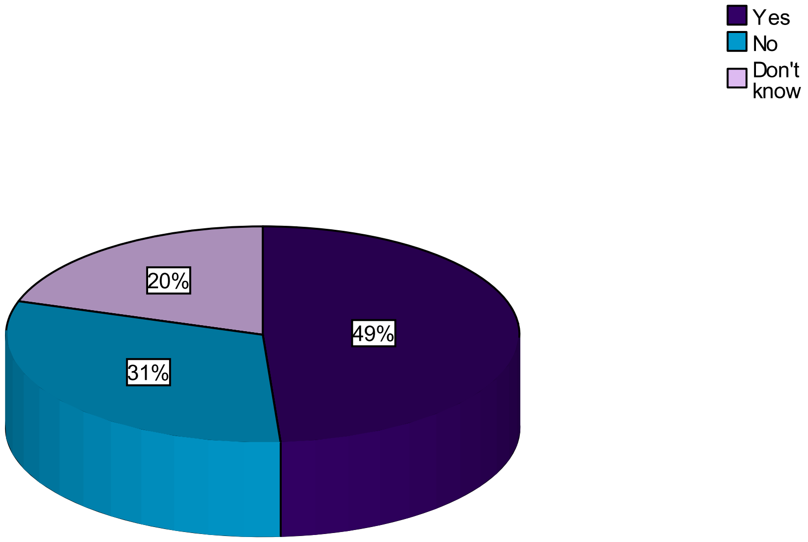
- 49% of schemes said that they would spend more time scrutinising the actions of investment managers on engagement issues as a result of the economic crisis. Of these, over three quarters (78%) said they would spend more time reviewing reporting and 57% would pay more attention to votes cast.
- Schemes expect reports from investment managers to included votes against company management (93%), votes not cast (83%), departures from manager's usual voting policy (80%) and disclosures of conflicts of interest (73%).
- While 24% of schemes are happy with the engagement reports provided by investment consultants, 54% believe there is room for improvement.
- 38% of schemes have asked their managers to review how their voting instructions are implemented in the past two years.

Impact of the economic crisis

The economic crisis has intensified scrutiny of the business practices of companies with a hithertofore unforeseen intensity. As a result, company policies on issues such as remuneration are in the public glare more than ever. Institutional investors are paying increased attention to the way companies in which they invest are run. In light of this, accountability of both investment managers and investee companies is expected to be high on the agenda of pension funds.

Firstly, pension schemes were asked if they would now spend more time in scrutinising the actions of their investment managers on engagement issues. Almost half of responding schemes stated that they would be spending more time on engagement (49%). 31% felt that they would not be spending more time while 20% were unsure.

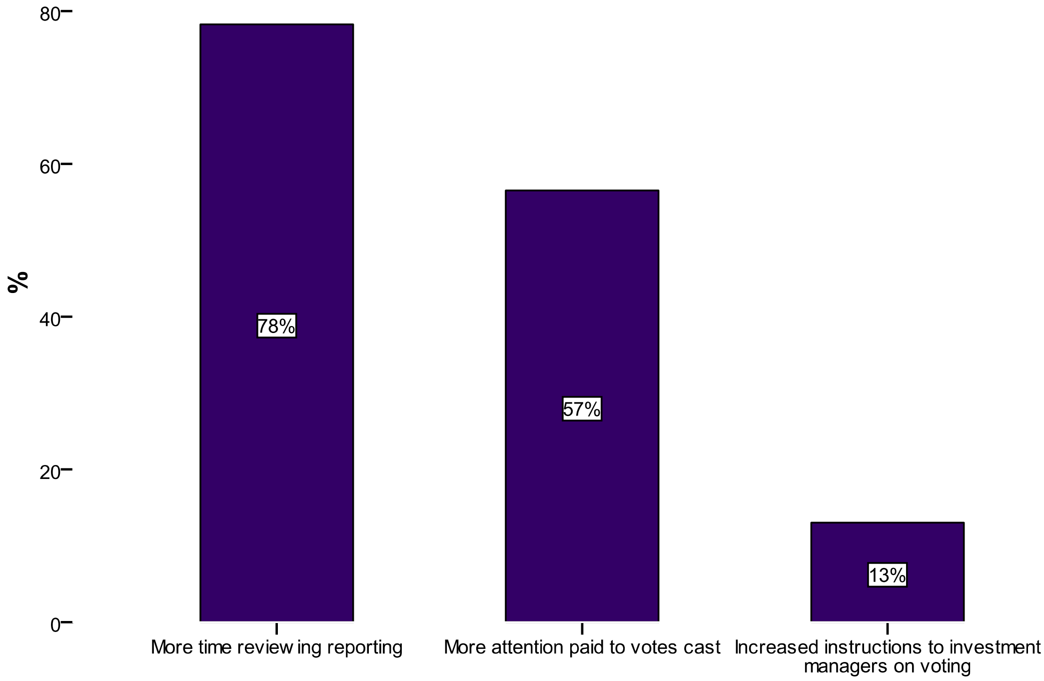
Figure 14. In light of the economic crisis, do you expect to spend more time scrutinising the actions of your investment managers on engagement issues?



Base: All respondents (45 schemes)

Funds who responded that they would spend more time scrutinising the actions of their investment managers on engagement issues as a result of the economic crisis were then asked what steps they would take to increase this scrutiny. Just over three quarters (78%) said that they would spend more time reviewing the reports from investment managers. 57% said that they would pay more attention to votes cast at company meetings. However, spending more time giving instructions to investment managers on how they would vote was not a popular option, with just 13% of schemes stating that they would spend more time doing this.

Figure 15. What steps will you take to increase this scrutiny?



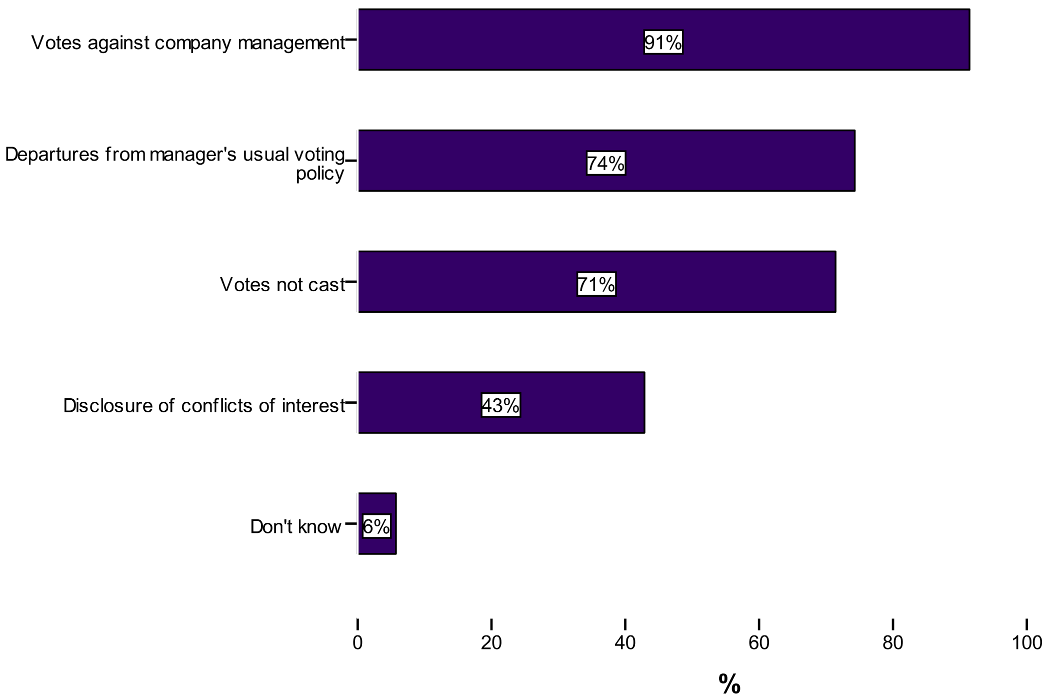
Base: 23 schemes responding

Manager reports

As 78% of schemes who plan to increase the attention they pay to engagement issues responded that they would be spending more time in reviewing reports from managers, the content of these reports must be comprehensive. Schemes were asked about the actual content of reports they have received in the past and also about issues they would expect to be included if they arose.

91% of schemes stated that votes against company management had been included in reports from their investment managers. 74% had seen departures from their manager's usual voting policy reported. 71% had read about votes not cast in their reports and 43% had seen disclosures of conflicts of interest in their reports from managers.

Figure 16. Which of the following have been included in reports that you have received from managers?

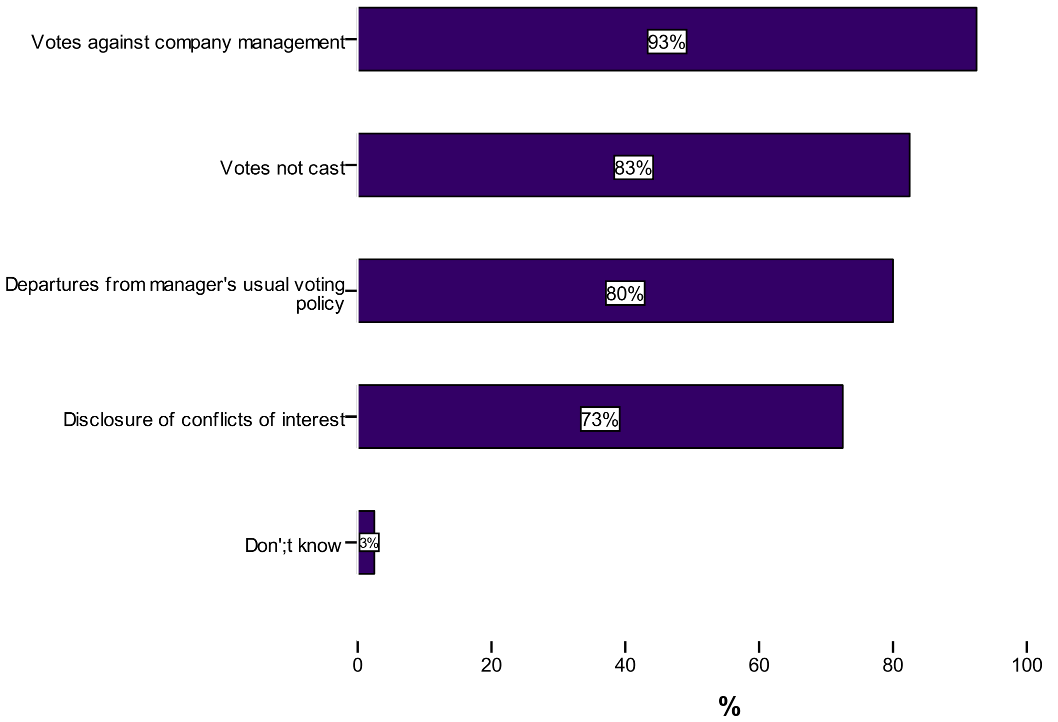


Base: 35 schemes responding

It is clear from the results that schemes expect investment managers to flag these issues in their reports. The expectation of what should be included in these reports was also significantly higher in 2009 than last year when it came to votes against company management and votes not cast.

93% expected to see votes against company management reported, compared to 87% in 2008. 83% expected to read about votes not cast in their reports, compared to 68% last year. 80% expected to see departures from the manager's usual voting policy reported and 73% expected to see disclosures of any conflicts of interest.

Figure 17. Which of the following would you expect to be included in reports from managers if relevant?

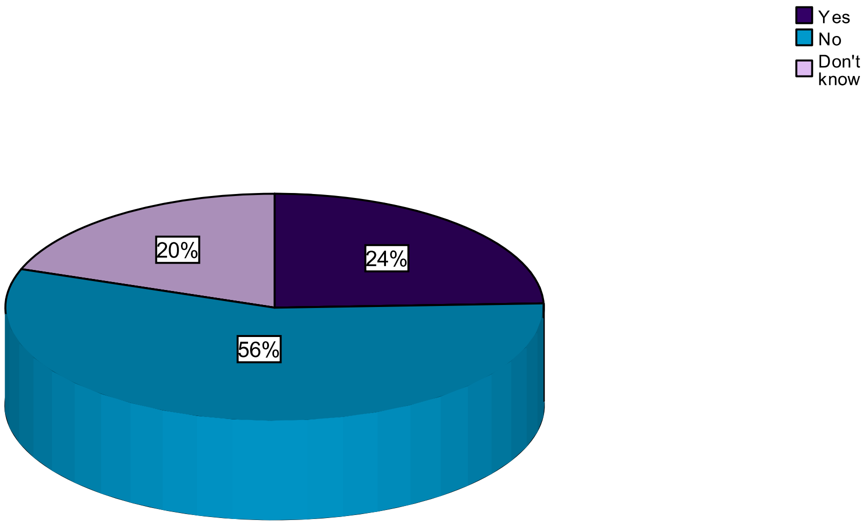


Base: 40 schemes responding

Reports on voting and engagement

An issue identified by schemes responding to the survey is that they would like improvements in the way voting and engagement are reported. Over half of schemes (56%) said that they were not satisfied with how their investment consultants review what managers have said about their voting and engagement activities in these reports. 24% of schemes said that they were satisfied and a further 20% were unsure.

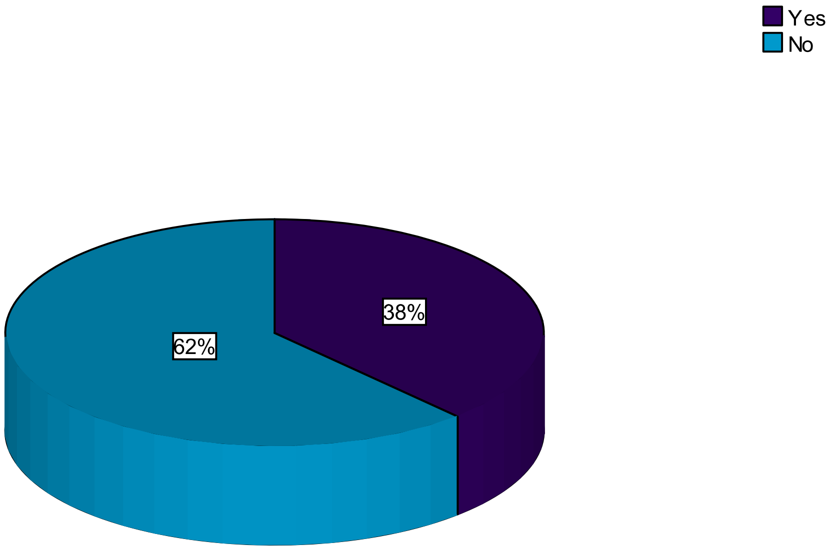
Figure 18. Do your investment consultants review to your satisfaction what managers have said about their voting and engagement activities in these reports?



Base: 41 schemes responding

The survey results indicate that reporting to pension fund trustees by investment managers could be improved. This is in line with the findings of the NAPF review of the Myners' principles of 2007. In particular, only 38% of schemes have asked their managers to review how their voting instructions are being implemented over the past two years.

Figure 19. In the past two years, have you asked any of your managers to review how their voting instructions are being implemented?



Base: 42 schemes responding

Voting

Key findings

- 70% of schemes disclose voting information to their scheme members while 40% disclose voting information to the general public.
- 56% of respondents said that they lend stock. Of these, 29% recall stock that is on loan to vote on contentious resolutions and 9% recall stock to vote on all resolutions.
- The number of pension schemes exercising their voting rights in UK, US and European company meetings remains high.

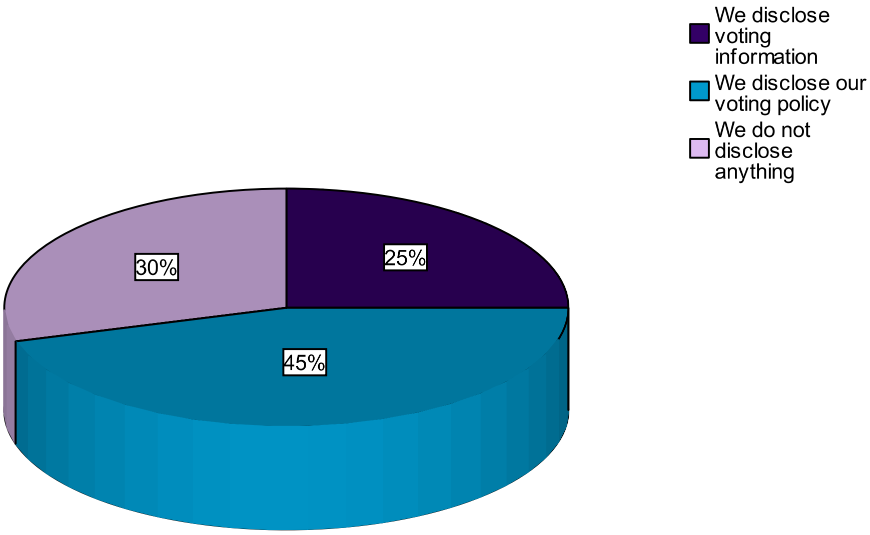
In 2007, the ISC produced a framework on voting disclosure to supplement its Statement of Principles. The Statement declared that both institutional shareholders and their agents should have a clear statement of their policy on engagement and on how they will discharge the responsibilities they assume. The policy statement should be a public document and should detail the policy on voting. The framework on voting disclosure declared that:

- The ISC supports a voluntary approach to voting disclosure which takes account of institutional shareholders' fiduciary obligation to act in the interests of beneficiaries.
- Voluntary public disclosure is generally desirable but may not be appropriate in all cases.
- The precise method of voting disclosure is a matter for each institution: some may choose to disclose how each individual vote was cast; others may publish details of specific votes only when they have departed from their general voting policy.
- Given the complexity of the voting chain, disclosures will usually relate to voting instructions.
- Voting disclosure must not jeopardise the creation of value through engagement with investee companies.

Voting disclosure

Respondents to the survey were asked what exactly they disclose in terms of voting, to both scheme members and to the general public. As Figure 20 shows below, 25% of schemes disclose information on specific votes to their scheme members. 45% of schemes disclose their general voting policy, while 30% of schemes do not disclose anything to members.

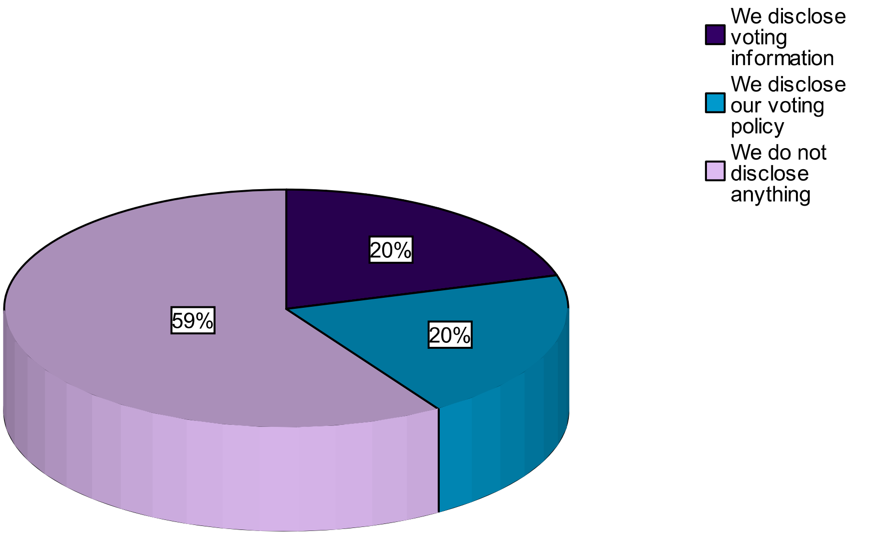
Figure 20. Do you disclose information on voting to scheme members?



Base: 44 schemes responding

In terms of disclosure to the general public, 20% of schemes disclose specific voting information. Another 20% disclose their voting policy whereas 59% of schemes do not disclose any information on voting to the public.

Figure 21. Do you disclose information on voting to the general public?

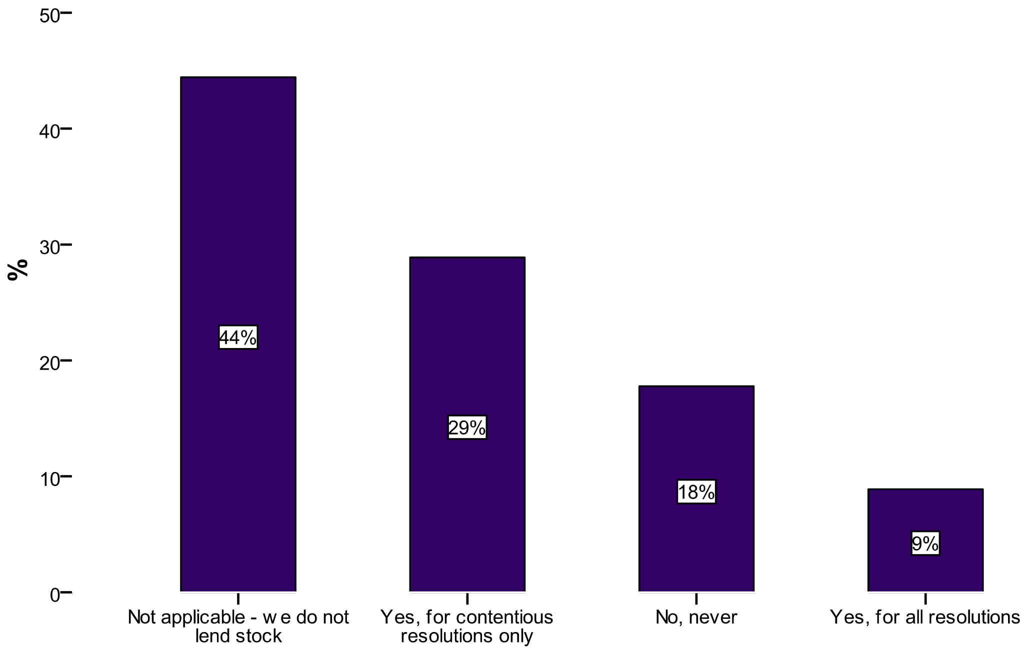


Base: 44 schemes responding

Stock lending and recall

56% of the pension schemes responding to the survey said that they lend stock. They were asked if they recall stock that is on loan in order to regain control of the voting rights. Over one quarter (29%) said that they do recall stock for contentious resolutions and 9% recall stock for all resolutions. 18% of the schemes stated that they never recall stock that is on loan.

Figure 22. Do you recall stock that is on loan in order to regain control of the voting rights?



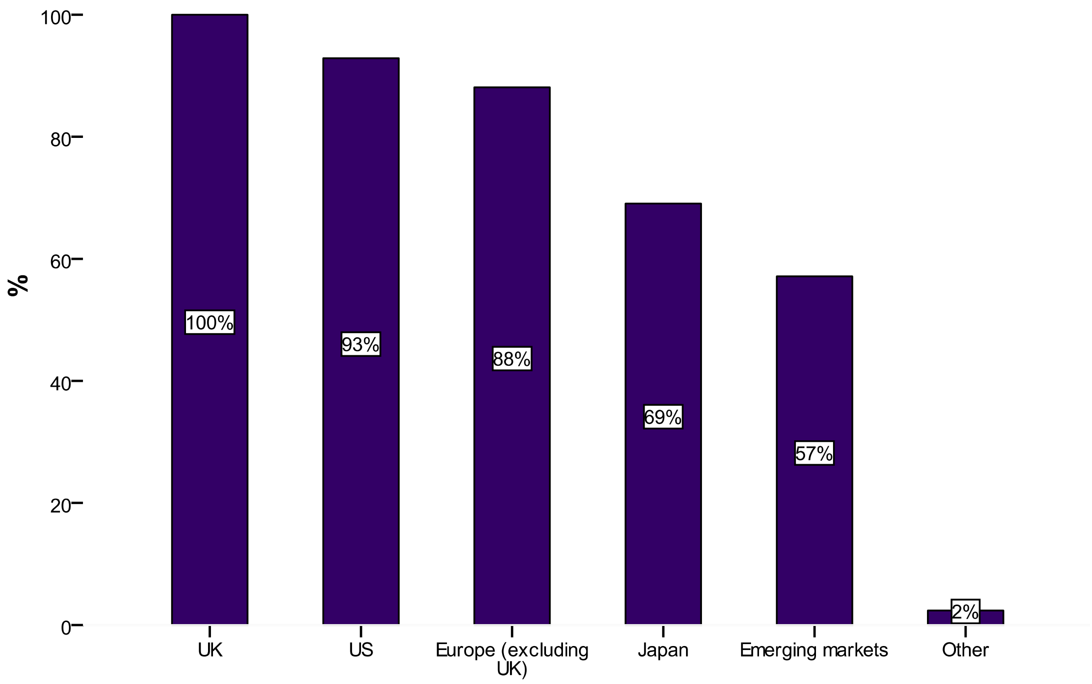
Base: All schemes (45 respondents)

Voting rights

The Engagement Surveys have shown over the years that in addition to exercising voting rights at UK company meetings, pension funds are exercising their voting rights in other countries more and more. The 2008 survey showed 87% of responding funds as voting in the US, 93% in Europe, 67% in Japan and 43% in emerging markets.

The 2009 results paint a similar picture. Slightly more schemes had exercised voting rights in the US, at 93% of respondents, with slightly less exercising rights in Europe, at 88%. 69% had exercised voting rights in Japan in 2009 and there was an increase of schemes that had done so in emerging markets – 57% in 2009 compared to 43% in 2008.

Figure 23. In the past 12 months, have your voting rights been exercised in any of the following markets?



Base: 40 schemes responding

Class actions

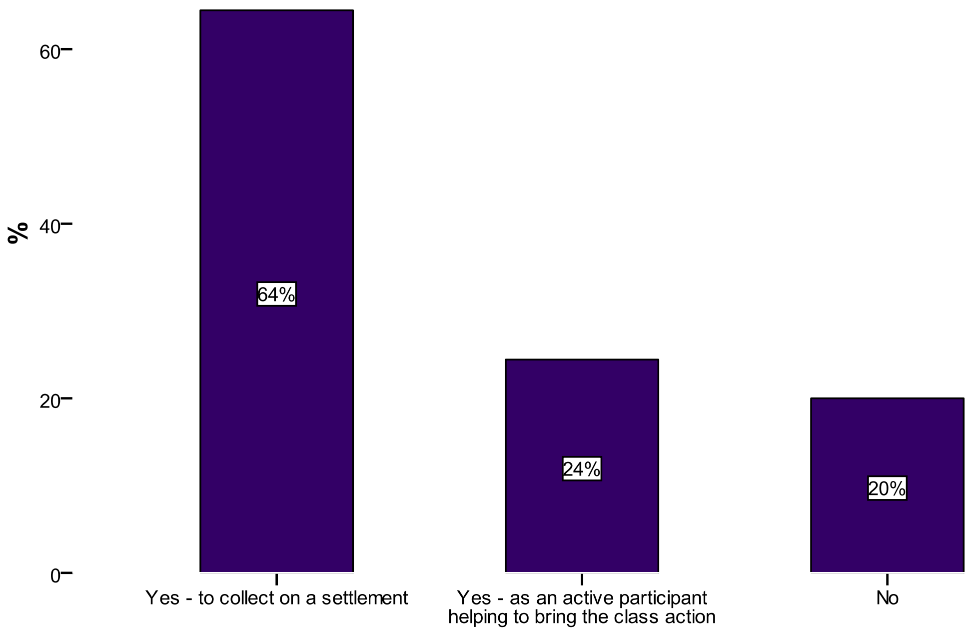
Key findings

- 64% of respondents had participated in a class action to collect on a settlement.
- 24% of pension funds had actively participated in a class action.

The past two NAPF Engagement Surveys showed a trend toward increased participation in class actions by large pension schemes. 73% of schemes had participated in a class action settlement to collect on a settlement in 2008, while 23% of funds responding had been an active participant. Just 15% of schemes stated that they had never been involved in a class action.

In 2009, there was a slight decrease in the number of funds who had participated in a class action. 64% of respondents had participated to collect on a settlement and 24% had been an active participant. 20% had never been involved in a class action, an increase of 6% on the previous year.

Figure 24. In the past 12 months, have you participated in a class action settlement?



Base: All schemes (45 respondents)

Appendix 1: List of figures