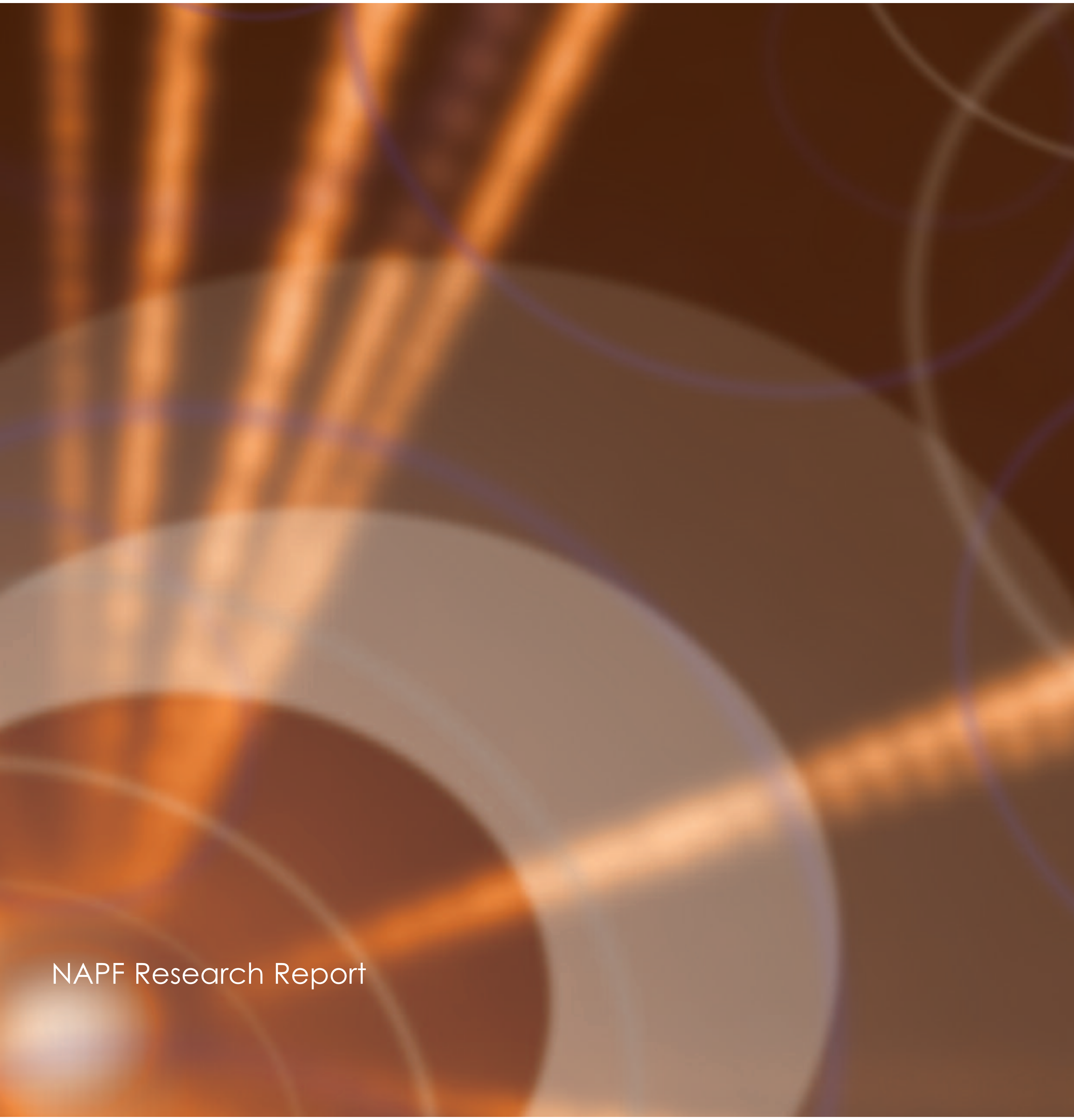
NAPF
Securing the future of pensions

Pension Funds' Engagement with Companies

May 2010



NAPF Research Report

Contents

Key findings

- **Pension funds see engagement as more effective**: The assessment of the effectiveness of engagement has improved in the last year. Two thirds say that the dialogue with investee companies was very effective or quite effective. In the 2009 survey, the comparable figure was 50%.

- **Schemes will also spend more time on engagement**: Looking to the future, 64% of schemes believe that they will devote more of their time to scrutinising the actions of investment managers on engagement issues. Just 19% of respondents did not feel that they would be spending more time on engagement in the future.

- **Most engagement work is delegated:** Most pension schemes delegate engagement to an investment manager: 79% of pension funds delegate engagement to their investment manager. For 11%, engagement is delegated to another third party, usually as a specialist engagement service.

- **Satisfaction with the standard of reporting**: Schemes were broadly positive about the standard of reporting on engagement from investment managers. 11% are very satisfied with the standard of reporting, and 54% are quite satisfied. Another 30% said that they were neither satisfied nor dissatisfied.

- **Pension funds can still do more as owners**: While only 11% of respondents strongly agreed that pension funds were not active enough in engagement, 45% agreed somewhat and 26% neither agreed nor disagreed. 19% either disagreed somewhat or disagreed strongly.

- **More work needed on manager scrutiny**: It is not yet common for pension schemes to request that their investment managers review how voting instructions are being implemented. However, this position is likely to change in the near future as 30% said that they have asked for a review.

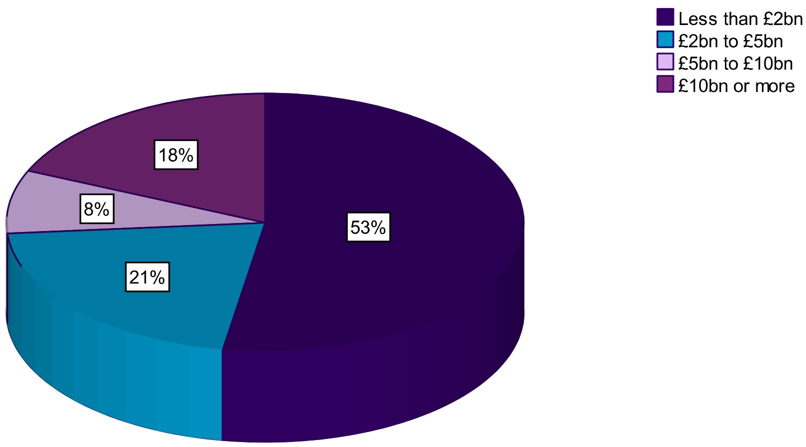
- **Disclosure of voting policy**: While two thirds of schemes disclose their approach to their responsibilities as shareholders, there is no evidence of an accepted best practice developing as yet. 42% of schemes do not disclose any information on voting to their members and 55% do not disclose anything to the general public.

Introduction

About the survey – who responded?

This report presents the findings of the NAPF's sixth annual survey of pension funds' engagement with companies. NAPF fund members with more than £1 billion in assets were invited to give their views. Responses were received from 38 respondents, with combined assets under management of over £200 billion.

Figure 1: Respondents by value of assets under management



Base: 38 respondents

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.

The Year in Corporate Governance

Following the economic crisis, pension funds came under fire for not playing an active enough role as owners of the companies in which they invest. The NAPF feels that this position ignores the efforts of many funds in raising the standards of corporate governance and advancing policy improvements. Our position is that pension funds are responsible investors, and the results from the 2010 Engagement Survey demonstrate how seriously engagement continues to be taken.

In addition, the NAPF has played a crucial role in several corporate governance initiatives over the past year. As a member of the Institutional Shareholders' Committee (ISC), the NAPF helped to shape the new ISC Stewardship Code which covers shareholder engagement and reporting. This was launched in November 2009. In order to assist pension schemes in applying the Code in practice, the NAPF also published *Pension Funds and the ISC Code – A practical guide*[1] in February 2010. The guide encourages pension funds to incorporate effective engagement monitoring into their fund manager reviews, helping to build a stronger corporate governance culture.

To supplement this work, February 2010 also saw the launch of the NAPF Corporate Governance PensionsConnection, a dedicated service which will give both pension schemes and investment managers access to expert thinking on a broad range of corporate governance issues[2].

[1] This document is available from the NAPF website at www.napf.co.uk/Policy/Governance.cfm
[2] Join the Corporate Governance PensionsConnection at www.napf.co.uk/PensionsConnection/CG.cfm

Engagement

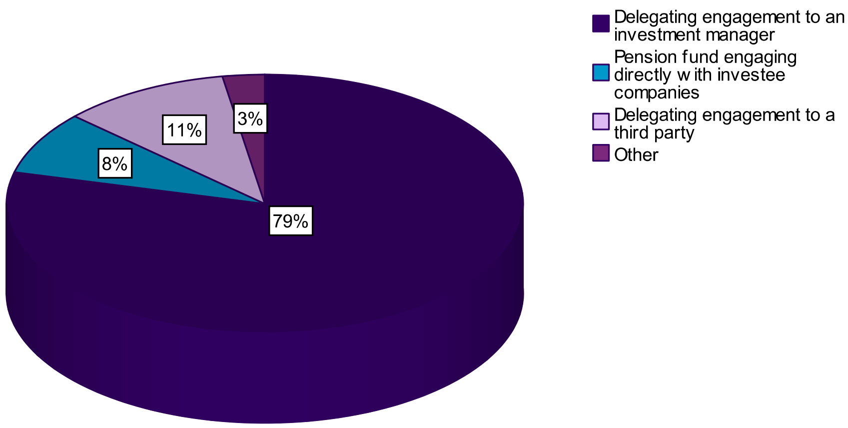
Key findings

- Most pension schemes delegate engagement: 79% to an investment manager and 11% to another third party.
- The effectiveness of the dialogue between investors and companies appears to have improved in the past year, with two thirds of respondents noting that it was very effective or quite effective. In 2009, 50% said that it was quite effective or very effective.
- Respondents felt that other priorities taking precedence was the most significant barrier to engagement – 61% felt that this was a strong or significant barrier. 45% said that lack of relevant skills was a strong or significant barrier, and 42% felt that the costs of engagement were a barrier.

The NAPF Engagement Survey has tracked the mechanics of pension fund engagement over the past few years, including the main approach that pension funds take, potential barriers to engagement and how the funds rate the effectiveness of their engagement with investee companies.

The responses show that the main approach of nearly all pension funds to engagement is to delegate. In 79% of cases, pension funds delegate their engagement to their investment managers. For 11%, engagement is delegated to another third party, usually a specialist engagement service.

Figure 2: What is your main approach to engagement with investee companies?

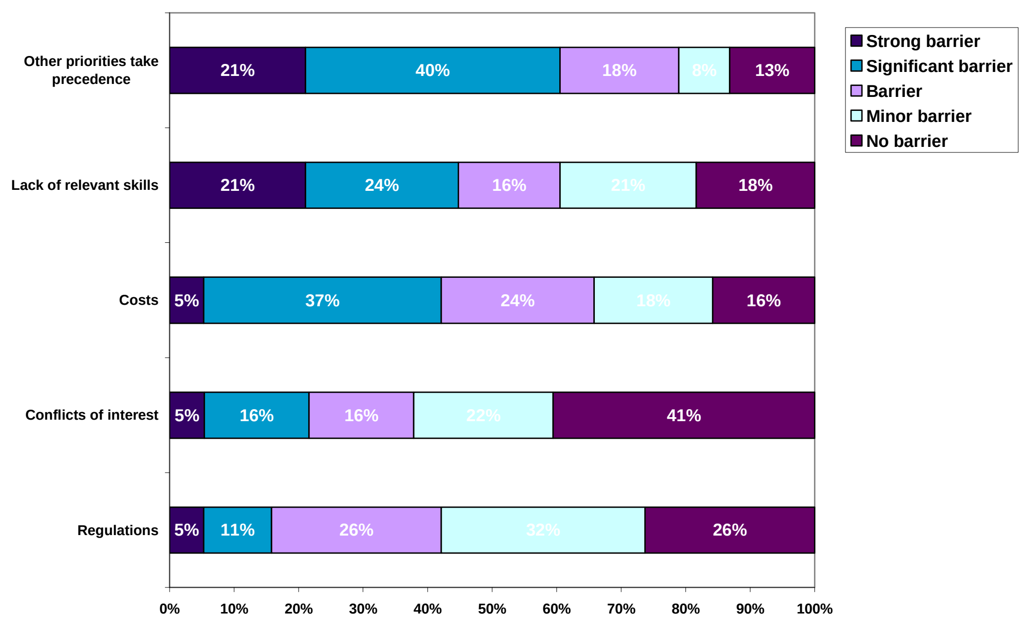


Base: 38 respondents

In order to determine what more can be done to facilitate engagement with investee companies, respondents were asked what they viewed as potential barriers. As can be seen from Figure 3, respondents felt that other priorities taking precedence was the most significant barrier to engagement. 61% felt that this was a strong or significant barrier. 45% responded that lack of relevant skills was a strong or significant barrier, and 42% said the same about the costs of engagement. Given the burden of regulatory changes and large deficits, coupled to the prevalence of delegation, this outcome is not surprising.

Conflicts of interest and investment regulations were seen as less significant barriers to engagement. 63% of schemes said that conflicts of interest were either a minor barrier or not a barrier at all, while 58% said the same of regulations.

Figure 3: How would you rate the following factors as potential barriers to engagement with investee companies?



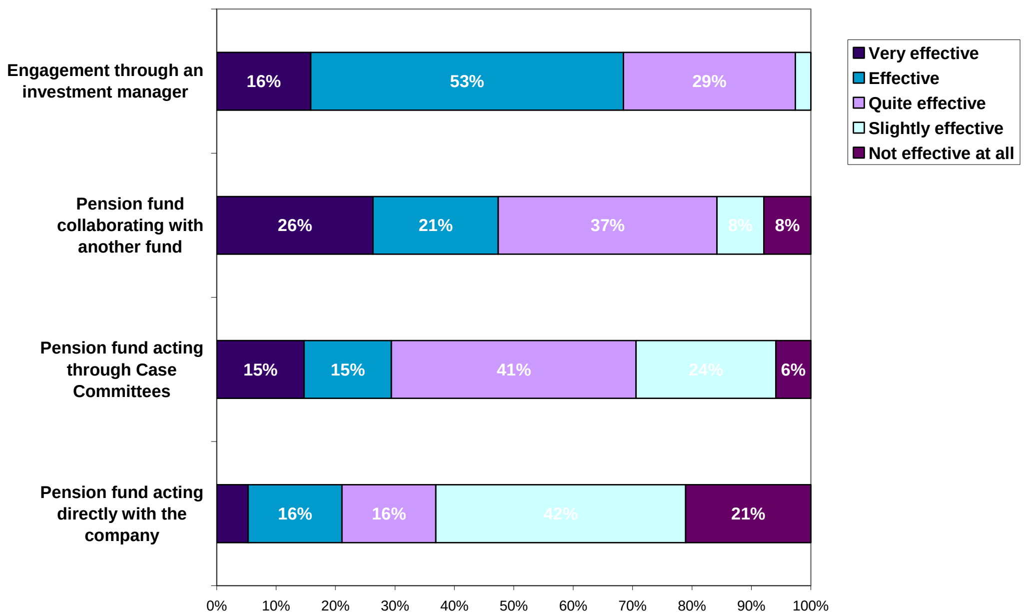
Base: 38 respondents

In addition to asking about barriers to engagement, the survey also asked respondents to rate the effectiveness of four methods of engagement. Engagement through an investment manager was the clear choice. 16% felt that this method was very effective, 53% said it was effective and another 29% stated that it was quite effective. Pension funds collaborating with other funds was also highly rated for its effectiveness – 26% of respondents felt that this was very effective and 21% felt that it was effective.

Engagement through an investment manager was also considered to be the most effective form of engagement last year, when 55% of respondents chose this option. 34% preferred pension funds collaborating with other funds.

In terms of direct engagement, 63% of funds said that this was either only slightly effective or not effective at all. 41% rated Case Committees as quite effective. These responses are consistent with the fact that the majority of pension funds delegate engagement. The growing interest in collaboration has been evident for some time and in response the NAPF has launched a web-based service – Corporate Governance Pensions Connections. One of the aims of the new service is to make collaboration easier and more effective.

Figure 4: How would you rate the effectiveness of these forms of engagement for institutional investors?



Base: 38 respondents (34 respondents for "Pension fund acting through Case Committees)

Case Committees are one part of the NAPF work on engagement. These committees 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.

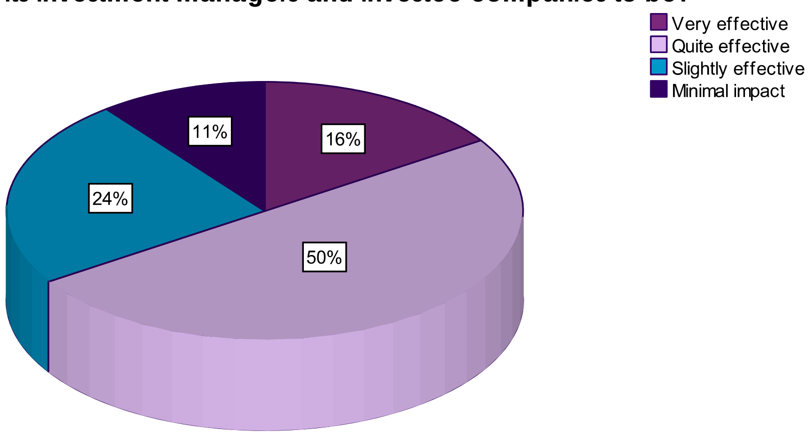
The NAPF has been steadily working to increase awareness of Case Committees, and 42% of respondents in 2010 had heard of this form of engagement. When asked if they would like to participate, almost one quarter of respondents (24%) said that they would. Given that most funds delegate their engagement to a third party, and that the work of the Committees is confidential, we would not expect widespread awareness of or participation in Case Committees by funds themselves.

While a majority of funds responded that they felt that their investment managers had adequately demonstrated the added value of engagement, it is also important that pension funds feel that the time and resources they put into engaging with investee companies is well spent. As such, respondents were asked how effective the dialogue between their fund and their investment manager is, as well as what evidence they had seen of the effect of their engagement.

It is clear from the results that pension funds feel that their engagement work and that of their investment managers has been effective. 16% of funds said that the dialogue with investee companies was very effective, and half said that it was quite effective. Just under one quarter felt that their dialogue was slightly effective, and just 11% felt that it had had a minimal impact.

The effectiveness of engagement appears to have improved in 2010 compared to last year. In the 2009 survey, no schemes responded that they thought the dialogue between their fund or investment managers with investee companies was very effective. 50% said that it was quite effective, and 20% said it was slightly effective. This may be as a result of pension funds paying closer attention to engagement issues over the past year following the economic crisis.

Figure 5: What do you consider the effectiveness of the dialogue between your fund or its investment managers and investee companies to be?

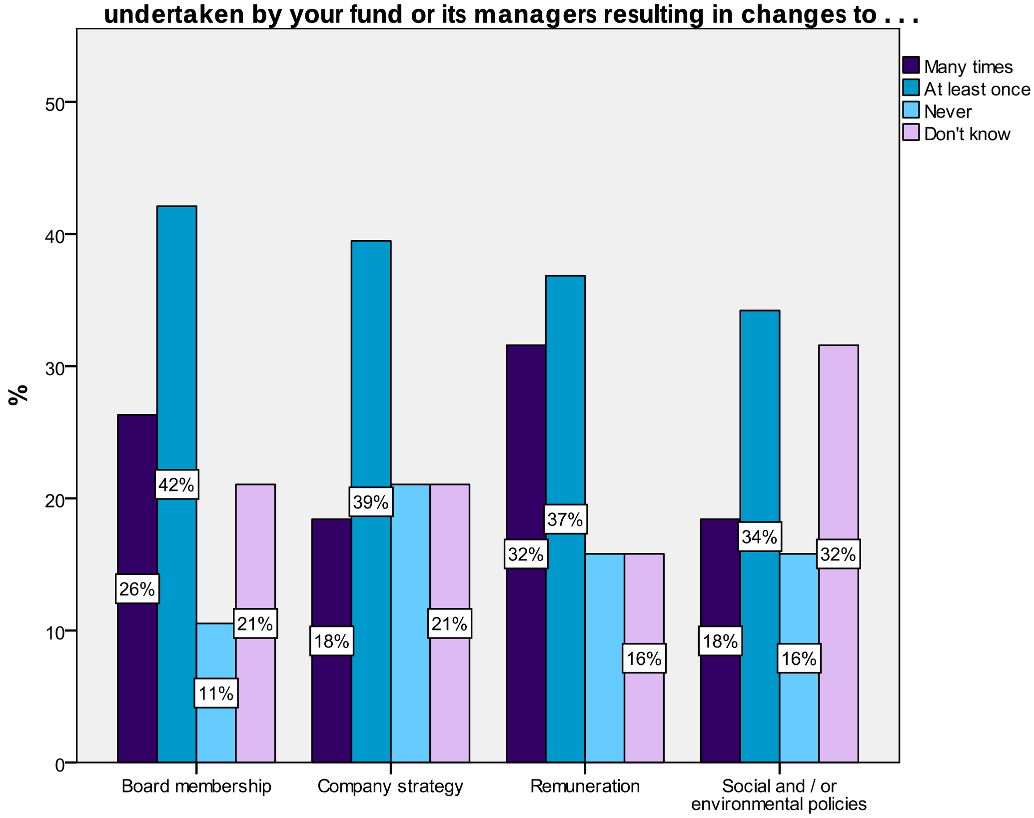


Base: 38 respondents

In terms of engagement activities resulting in changes to company policy, there was considerable evidence that engagement had resulted in changes to company policy at least once. As in previous years, funds were asked this question in four areas – board membership, company strategy, remuneration and social and/or environmental policies. For board membership, 26% had seen evidence many times of changes to investee company policy, while 42% had seen such evidence at least once. 18% had seen changes to company strategy many times, while 39% had seen evidence of change in this area at least once. For remuneration, 32% of schemes had seen evidence many times and another 37% had seen their engagement changing remuneration policy at least once. Engagement appears to have less of an effect in the area of social or environmental policy, with 18% of schemes saying they had seen changes effected many times and 34% stating that they had seen evidence of change at least once.

In comparison to 2009, there was more evidence of engagement resulting in changes to board membership. In 2009, 25% of respondents had seen evidence many times and 39% had seen evidence at least once. Last year, 64% of respondents had seen changes to remuneration policy and 32% had seen evidence of change "many times". In terms of social and environmental policies, there was more evidence of change in 2009, when 66% of respondents had seen changes, compared to the 52% this year.

Figure 6: Have you seen evidence of engagement activities (including voting) undertaken by your fund or its managers resulting in changes to . . .



Base: 38 respondents

Approach to shareholder responsibility and engagement

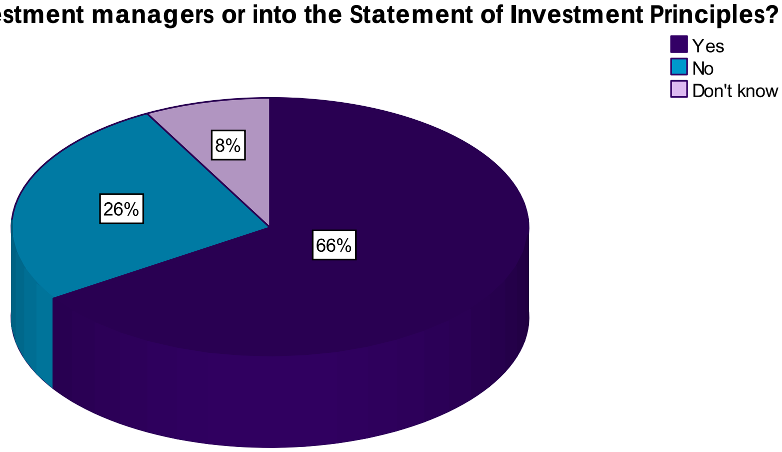
Key findings

- Two thirds of schemes have now incorporated the Institutional Shareholders' Committee's Statement of Principles into either their contracts with investment managers or the Statement of Investment Principles.
- 63% of respondents confirm that trustees set out the fund's approach to the responsibilities of investors as shareholders in their annual report.
- 39% of respondents said that the scheme's attitude to the responsibilities of investors as shareholders influence the selection of investment managers or consultants. This is compared to 31% in 2009.

As in previous years, respondents were asked if the Institutional Shareholders' Committee's Statement of Principles had been incorporated into contracts with investment managers or into the pension fund's Statement of Investment Principles, as suggested by NAPF best practice. The number of schemes taking this on board is increasing – in 2008, 33% of schemes had incorporated the principles while 51% had incorporated them in 2009.

The 2010 survey shows further improvement. Two thirds of respondents affirmed that these principles had been incorporated into contracts with investment managers or their Statement of Investment Principles.

Figure 7: Has the ISC Statement of Principles been incorporated into your contracts with investment managers or into the Statement of Investment Principles?

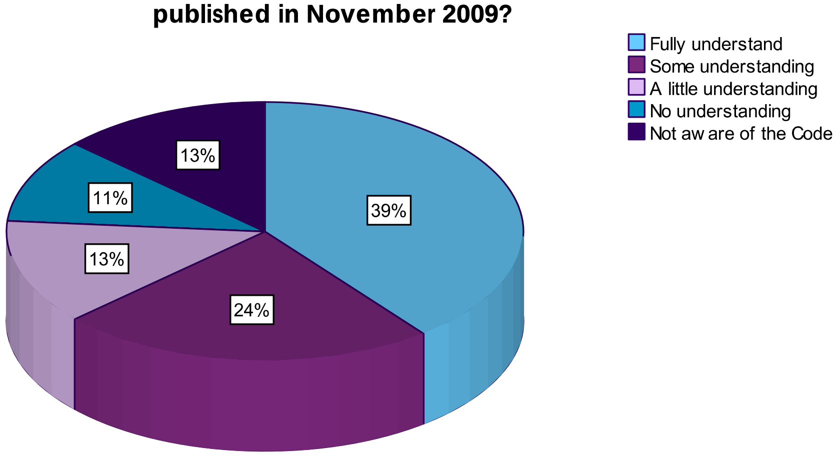


Base: 38 respondents

The ISC's Code, published in November 2009 updated the Principles and converted them into a Code of Practice for Institutional Investors. In support of the Code, the NAPF issued *Pension Funds and the ISC Code – A Practical Guide* in February 2010. This guide is designed to assist pension funds in understanding their obligations under the ISC Code. The structure of the ISC Code is still under discussion, led by the Financial Reporting Council, but the NAPF believes that pension funds should begin now to consider how they should adapt to its requirements, as a stronger corporate governance culture will help to protect and enhance the value of their investments.

In line with this, respondents were asked about their degree of understanding of their obligations under the ISC Code. Over one third (39%) stated that they fully understand their obligations, while another 24% said that they had some understanding. 11% of respondents said that they had no understanding at all of their obligations, while 13% were not yet aware of the new ISC Code.

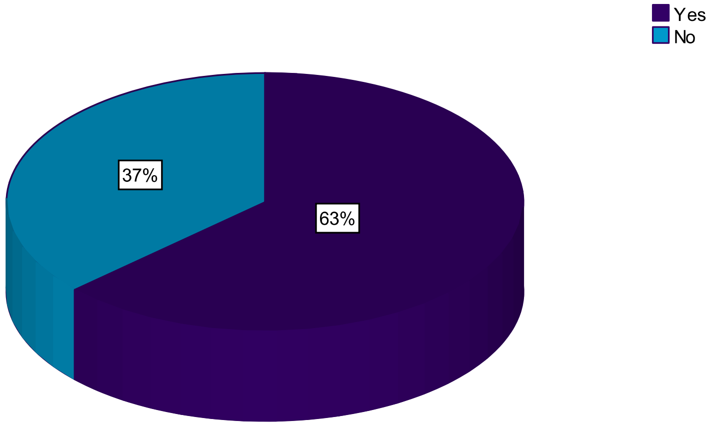
Figure 8: What is your understanding of pension funds' obligations under the ISC Code published in November 2009?



Base: 38 respondents

Pension funds were asked if trustees set out the fund's approach to the responsibilities of investors as shareholders in the annual report to scheme members. In a majority of cases, 63%, trustees do so. This is, however, a decrease from 2009, when over three quarters of respondents (77%) said that trustees set out the approach in their annual report, reflecting a slightly different respondee group.

Figure 9: Do trustees set out the fund's approach to the responsibilities of investors as shareholders in their annual report to scheme members?

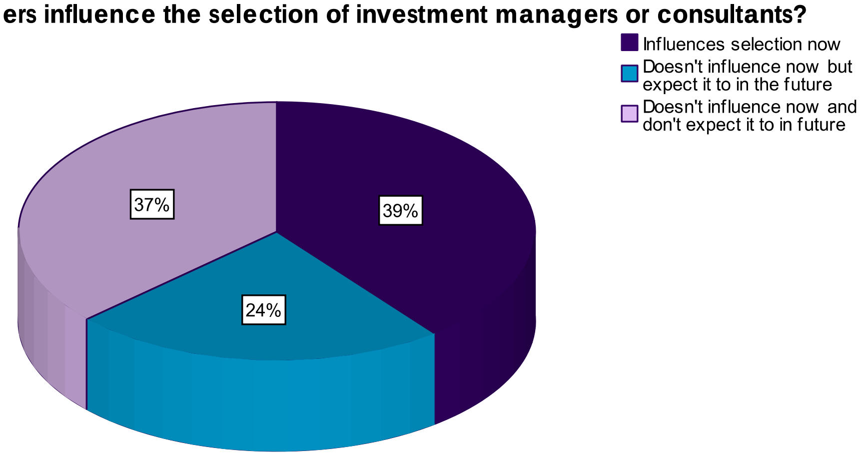


Base: 38 respondents

The interaction with investment managers and consultants is crucial to effective oversight by pension funds. However, a scheme's policy on the responsibilities of investors can also affect the selection of investment managers and consultants in the first place. 39% of schemes take such factors into account when selecting an investment manager or consultant. 24% of schemes responded that while it does not influence their selection now, they expect it to in the future. Almost two fifths (37%) of schemes said that it does not influence their selection of investment managers and consultants now, nor will it in the future.

In 2009, 31% of schemes said that their attitude to the responsibilities of investors as shareholders influences this selection. 24% said that they expect that this attitude will influence selection in the future.

Figure 10: Does your scheme's attitude to the responsibilities of investors as shareholders influence the selection of investment managers or consultants?



Base: 38 respondents

Accountability

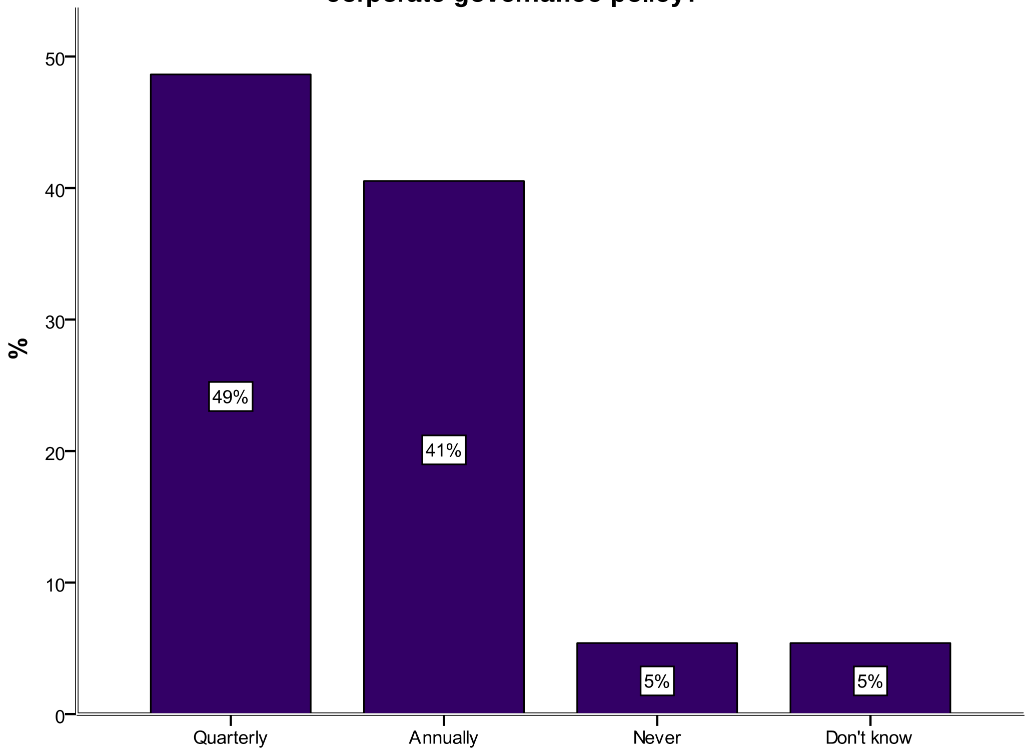
Key findings

- Almost half of respondents (49%) review their investment managers' application of corporate governance policy quarterly.
- 64% of respondents will spend more time scrutinising the actions of their investment managers on engagement issues in future.
- 11% of pension schemes are very satisfied with the standard of reporting from investment managers, and 54% are quite satisfied. Another 30% said that they were neither satisfied nor dissatisfied.
- 30% of schemes responded that they have asked for a review of how voting instructions are implemented in the past two years. 65% have not requested a review in that time.

In 2009, pension funds reported that following the economic crisis, they would be spending more time on accountability issues, particularly in scrutinising the actions of their investment managers on corporate governance issues.

In addition to having a clear policy on corporate governance, the NAPF believes that schemes should also periodically review the application of this policy by their investment managers. 49% of schemes responding in 2010 stated that they review it quarterly. 41% state that they review this annually. We expect that there will be changes to reporting and monitoring following the publication by the FRC later this year of its Stewardship Code. To assist pension funds to understand their obligations under it the NAPF published a Guide in February, which it plans to update later in 2010.

Figure 11: How often do you review your investment managers' application of corporate governance policy?



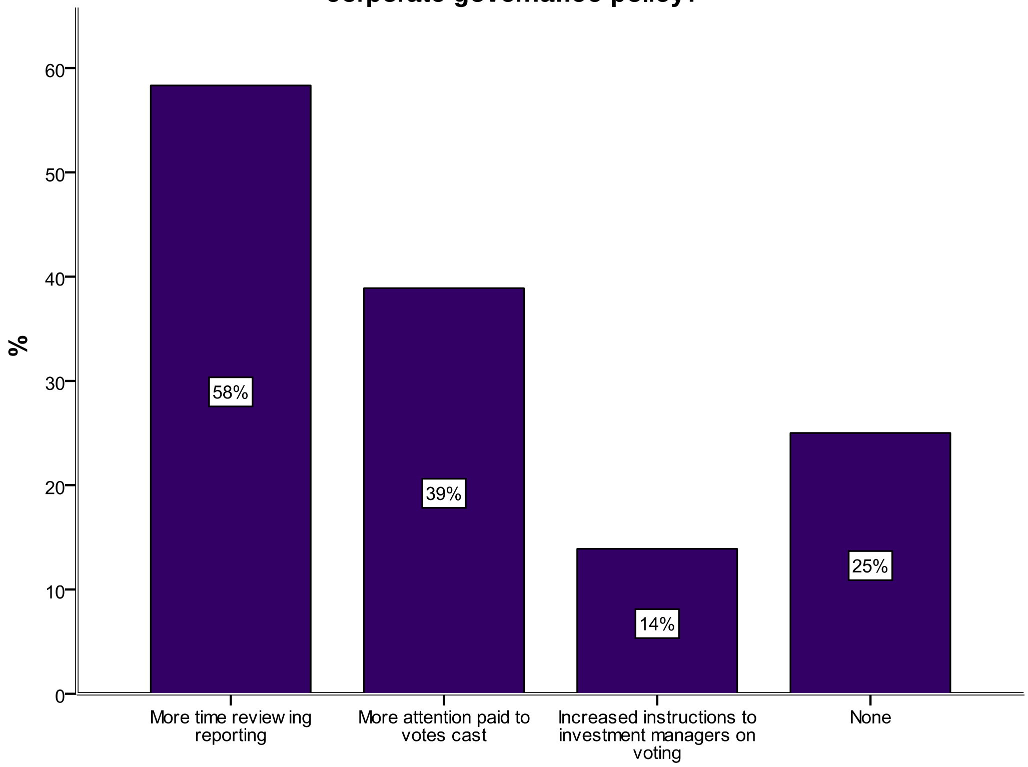
Base: 37 respondents

Schemes were also asked to describe the steps that they would be taking in order to increase the scrutiny of the application of their corporate governance policy. Over half of schemes (58%) stated that they would spend more time reviewing the reports that they receive on voting and engagement from investment managers. 39% of schemes said that they would pay more attention to votes cast, while 14% said that they would give more instructions to their investment managers on voting issues.

While one quarter of respondents said that they would not take any steps to increase scrutiny of their investment managers' corporate governance policy, this can often be due to the fact that schemes already put considerable effort into tracking and assessing the application of their policies.

These results show that while the majority of pensions funds delegate their engagement work to investment managers and other third parties, they clearly intend to increase the attention paid to the application of their corporate governance policy in the future.

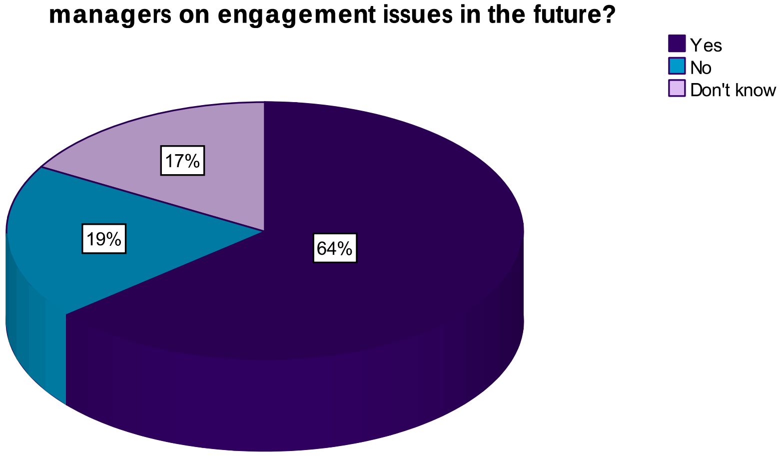
Figure 12: What steps will you take to increase this scrutiny of the application of corporate governance policy?



Base: 38 respondents

Looking to the future, a large majority of schemes, 64% believe that they will devote more of their time to scrutinising the actions of investment managers on engagement issues. Just 19% of respondents did not feel that they would be spending more time on engagement in the future.

Figure 13: Will you spend more time scrutinising the actions of your investment managers on engagement issues in the future?



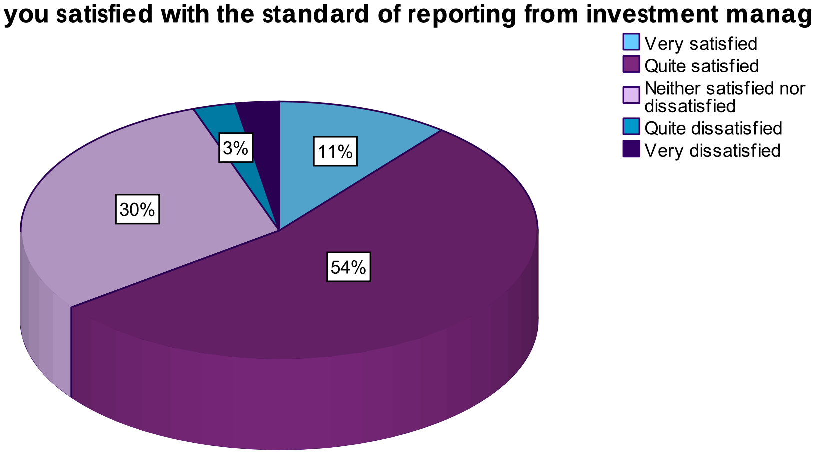
Base: 36 respondents

Reporting from investment managers

The quality of reporting on engagement from investment managers is crucial for pension schemes to allow them to monitor how their voting and engagement instructions are being implemented. Schemes were asked if they were satisfied with the quality of this reporting.

There was a broadly positive response from pension schemes. 11% were very satisfied with the standard of reporting, and 54% are quite satisfied. Another 30% said that they were neither satisfied nor dissatisfied. As noted earlier we expect reporting standards to improve further as the Stewardship Code is implemented.

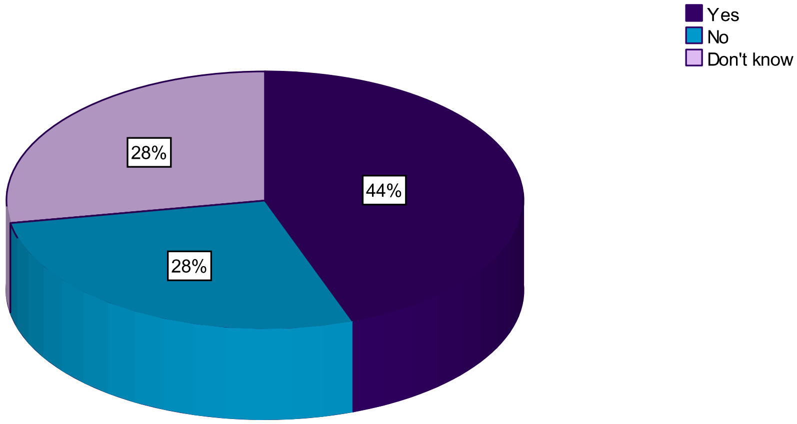
Figure 14: Are you satisfied with the standard of reporting from investment managers?



Base: 37 respondents

To explore this in more depth, schemes were asked if their investment consultants had reviewed to the scheme's satisfaction what is said about voting and engagement in manager reports. 44% of schemes said that they were satisfied with the reporting on voting and engagement, while 28% were not satisfied. This level of satisfaction is an improvement on 2009, when just 24% of respondents reported that they were satisfied with investment consultants' review of managers' reports.

Figure 15: Do your investment consultants review to your satisfaction what managers have said about their voting and engagement activities in these reports?



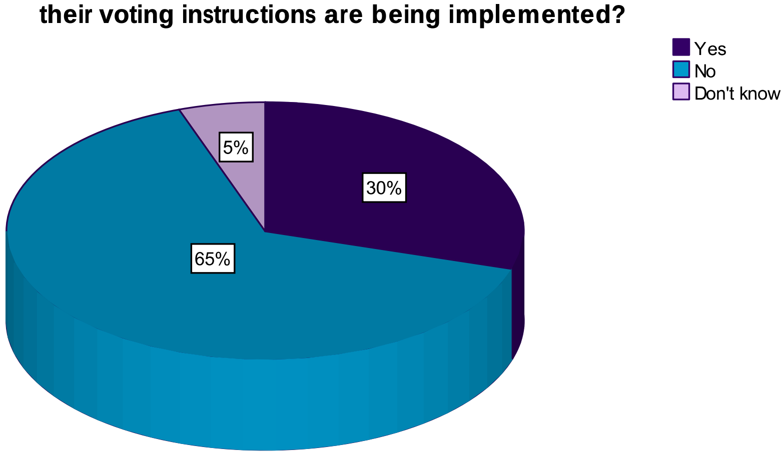
Base: 36 respondents

It is not common for pension schemes to request that their investment managers review how voting instructions are being implemented. In 2009, just 38% of schemes had requested such a review.

This year, just 30% of schemes responded that they have asked for a review in the past two years. 65% have not requested a review in that time, while 5% did not know if a review has been requested.

The NAPF believes that this is an area for further action from pension funds. The introduction of the Stewardship Code is intended to lead to greater scrutiny of managers' voting activity and the NAPF will examine this issue when it provides members with further guidance on the application of the Code.

Figure 16: In the past two years, have you asked any of your managers to review how their voting instructions are being implemented?



Base: 37 respondents

Role of institutional investors

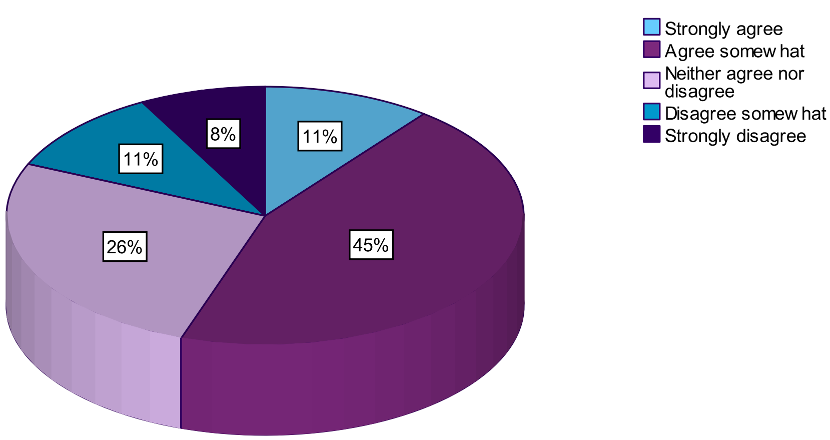
Key findings

- While only 11% of respondents strongly agreed that pension funds were not active enough in engagement, 45% agreed somewhat and 26% neither agreed nor disagreed.
- 16% of respondents strongly agreed that their investment manager had demonstrated the value of engagement, and 45% agreed somewhat. 32% of respondents neither agreed nor disagreed, while just 8% disagreed.

Improving standards of corporate governance has been a consistently high priority policy objective of the NAPF. Nevertheless, in the wake of the economic crisis, pension funds came in for criticism for being "absentee owners" and not playing an active enough role as share owners. Pension funds were asked if they agreed with this assertion.

The results show an almost even split with 11% strongly agreeing that pension funds were not active enough and 45% agreeing somewhat. 26% neither agreed nor disagreed, while 19% either disagreed somewhat or disagreed strongly. What this shows is that pension funds feel that their role as owners can be strengthened in the future. As our Engagement Survey shows, the majority of schemes delegate their investment work and respondents plan to scrutinise the actions of those involved with engagement more closely in the future. There is a willingness amongst pension funds to review procedures and policies in order to help prevent a recurrence.

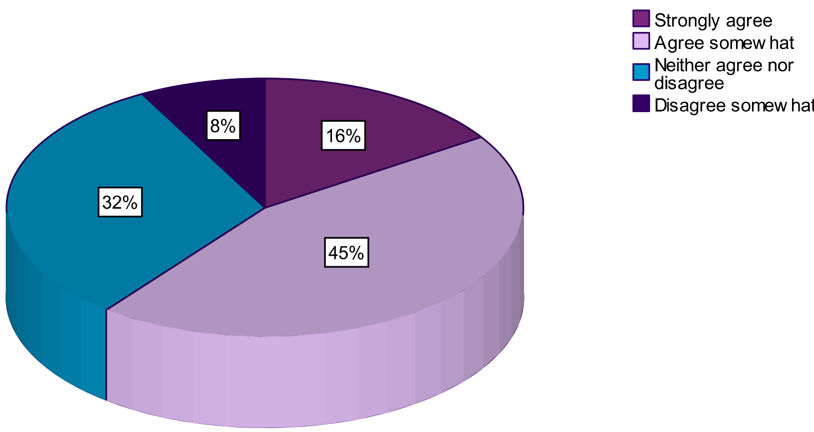
Figure 17: Do you agree with the assertion that institutional investors did not play an active enough role as owners?



Base: 38 respondents

While a majority of funds agreed that they could be doing more in terms of engagement, it is important that the value of engagement with investee companies is made clear. Pension funds were asked if their fund manager had adequately demonstrated this. 16% of respondents strongly agreed that their investment manager had demonstrated the value of engagement, and 45% agreed somewhat. 32% of respondents neither agreed nor disagreed, while just 8% disagreed. This shows that pension funds on the whole are aware of the added value that engagement with investee companies can bring them.

Figure 18: Do you agree that your fund manager has demonstrated that engagement with investee companies has added value?



Base: 38 respondents

Voting

Key findings

- While it is clear that reporting to trustees is generally of a good standard and 58% of schemes disclose information on voting to their members, there is generally much less disclosure to the public.
- Most respondents do not lend stock, but 3% of respondents recall stock that is on loan to vote in all resolutions and 32% do so for contentious resolutions.
- The number of pension schemes exercising their voting rights in UK, US and European company meetings remains high.

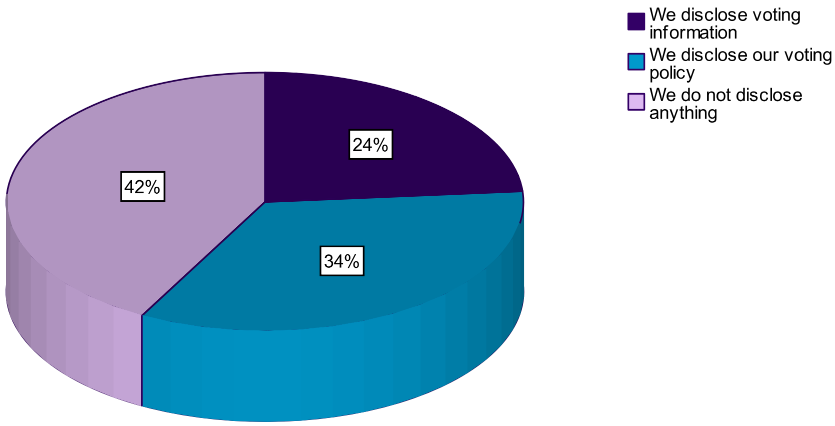
Voting disclosure

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.

In line with the framework on voting disclosure, schemes vary in what information on voting they disclose, both to scheme members and to the general public. Firstly, 24% of schemes disclose voting information to members of the pension scheme. A further 34% of schemes responding disclose the voting policy to members. The remaining 42% do not disclose any information on voting to members of their scheme. This is broadly similar to the 2009 responses, when 25% of schemes stated that they disclose voting information to members and 45% disclosed voting policy.

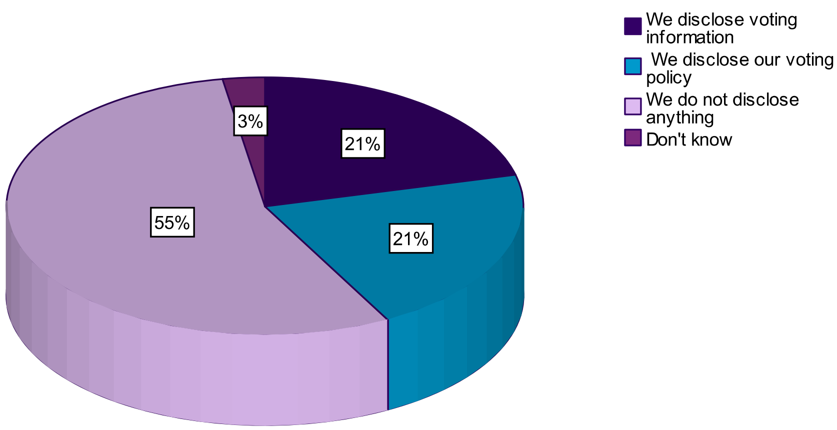
Figure 19: Do you disclose information on voting to scheme members?



Base: 38 respondents

It is far less common to disclose information on voting to the general public. 55% of schemes do not disclose any such information. Nevertheless, there are 21% of schemes who disclose voting information and 21% who disclose general voting policy to the general public. Again, this is similar to the 2009 figures, 20% of schemes disclosing voting information to the general public and 20% disclosing voting policy.

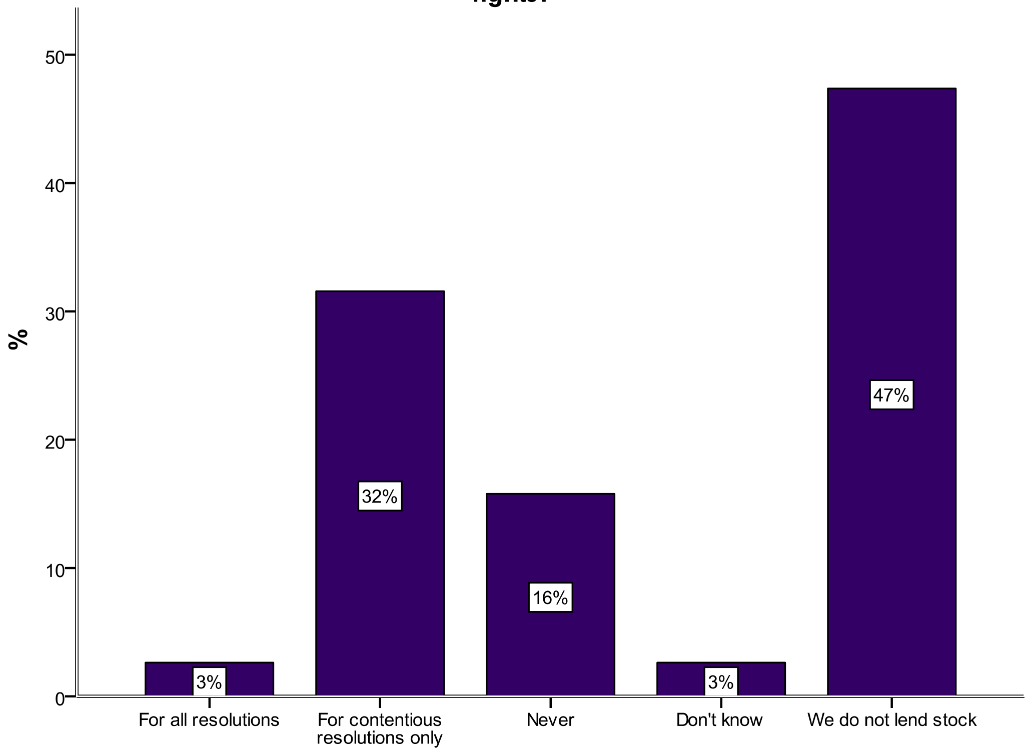
Figure 20: Do you disclose information on voting to the general public?



Base: 38 respondents

Recall of stock that is on loan in order to regain control of voting rights is a more common step in engagement in 2010 than it was last year. 47% of schemes responding to the survey do not lend stock. For the others, it is common practice to recall stock that is on loan in order to regain control of the voting rights. 32% (some 60% of those who lend stock) do recall their stock to vote in contentious resolutions, while just 16% of schemes responding never recall their stock in order to exercise their voting rights. In 2009, 29% recalled for contentious resolutions and 18% said that they never recall their stock.

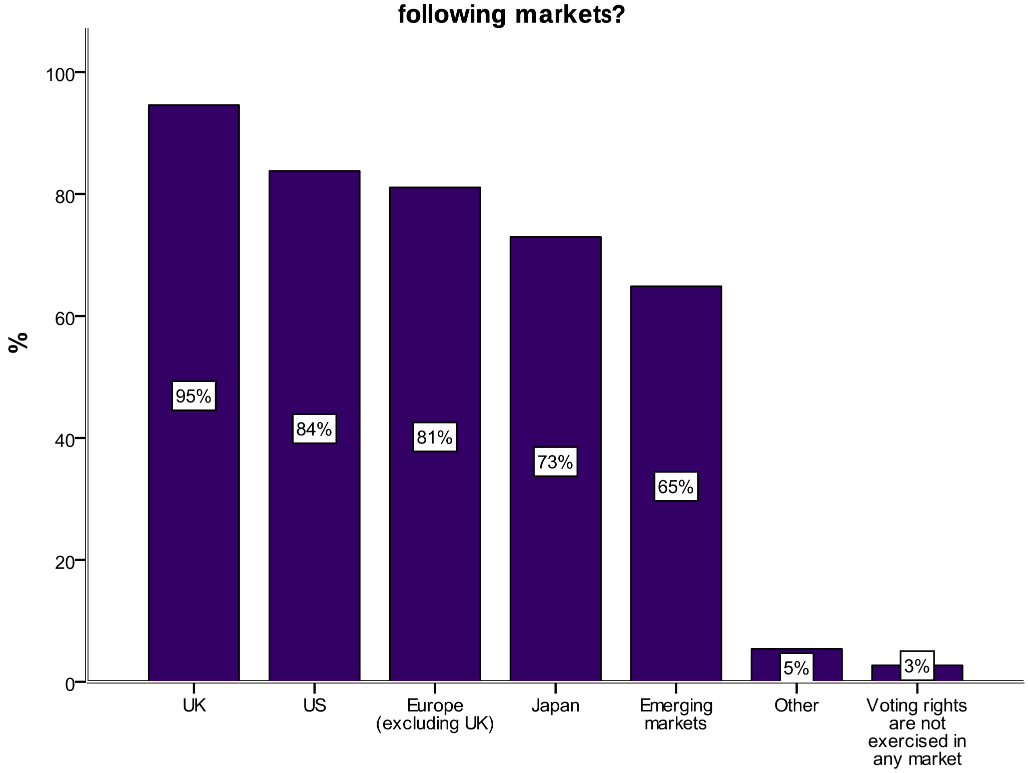
Figure 21: Do you recall stock that is on loan in order to regain control of the voting rights?



Base: 38 respondents

The Engagement Survey has also over the years tracked the exercising of voting rights in different countries. As in previous years, voting rights in the UK are exercised by almost all pension schemes. There is also significant exercise of rights in other markets, and this trend is borne out by the results of the 2010 survey. 84% of respondents exercise their voting rights in the US, and 81% in Europe (excluding the UK). In Japan, 73% of schemes exercise their voting rights, and 65% exercise their rights in emerging markets.

Figure 22: In the past 12 months, have your voting rights been exercised in any of the following markets?



Base: 38 respondents

Class actions

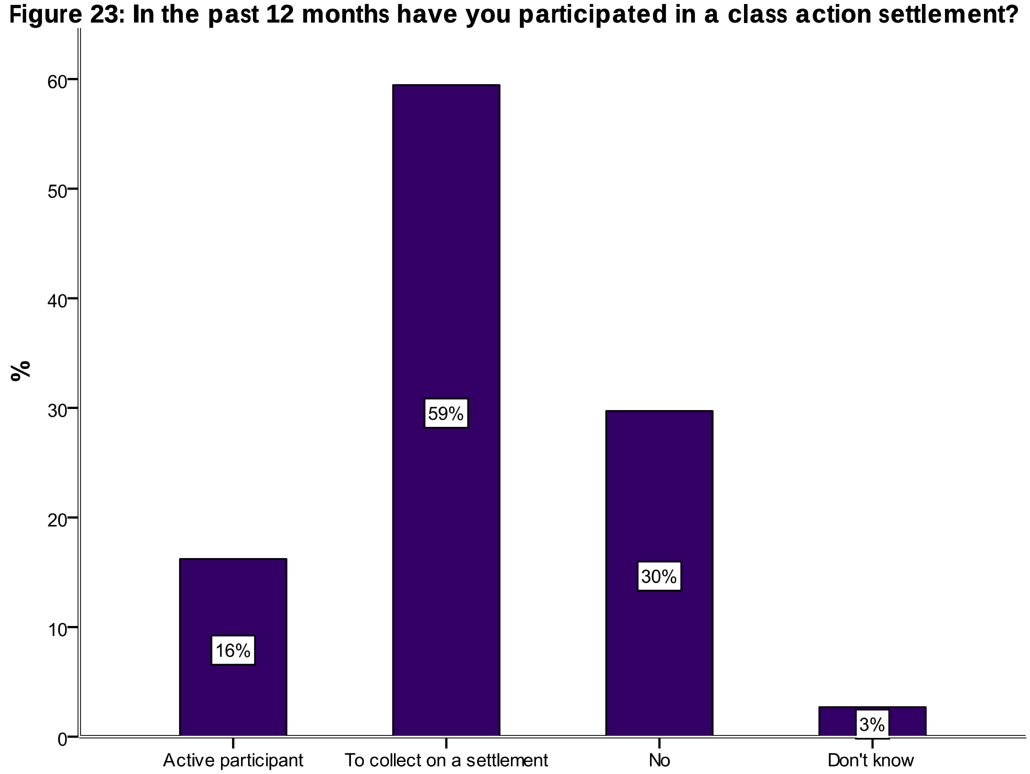
Key findings

- 59% of respondents had participated in a class action to collect on a settlement.
- 16% of pension funds had actively participated in a class action.

Engagement Surveys in the past have showed a trend toward increased participation in class actions by large pension schemes. The 2010 results again show that pension funds are participating in these class actions, whether to collect on a settlement or as an active participant.

59% of schemes responding had participated in a class action in order to collect on a settlement in the past 12 months. 16% of schemes had been an active participant in a class action. Finally, just 30% had not participated over the past 12 months.

Figure 23: In the past 12 months have you participated in a class action settlement?



Base: 38 respondents

Appendix 1: List of figures

NAPF

Securing the future of pensions

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Disclaimer: Nothing in this guide should be treated as an authoritative statement of law on any particular aspect or in any specific case. Action should not be taken on the basis of this guide alone.